Southern Michigan Bancorp, Inc.

2006 Annual Report

your Community. your Bank.

to our shareholders

I am pleased to announce that Southern Michigan Bancorp, Inc. earned a record $4 million in 2006. On a per share basis, net income totaled $2.26 per share. Record earnings for 2006 represented an increase of more than five percent over 2005 totals of $3.8 million and $2.12 per share, respectively.

Southern Michigan's 2006 financial performance achievements are remarkable in light of one of the most challenging economic environments confronting community banks in our market area and throughout Michigan. The inverted yield curve has further compressed net interest margins at most financial institutions. Slower growth throughout the southern tier of Michigan is creating greater challenges for attracting new quality client relationships. In addition, the unfavorable economic climate throughout Michigan will create further impediments for attaining strategic growth objectives.

Despite these conditions, Southern's return on average equity of 14.54 percent and return on average assets of 1.25 percent rank us in the upper tier among high performance community banks. Our balance sheet, deposit and loan growth totals reflect continuation of the prudent business strategy management and directors implemented approximately five years ago. Total assets grew modestly in 2006 by more than 3.5 percent to over $329 million. Total deposits increased by more than $14 million to nearly $283 million while commercial loans grew by more than $18 million, or 12 percent, to $171 million. For the year, total loans increased by $10 million to $253 million. The favorable mix of core deposit and small business loan growth increased the net interest margin by $1.1 million from $13.4 million in 2005 to $14.5 million in 2006.

Our management team and directors are focused on identifying future growth opportunities. In February 2007, we opened our newest office in Marshall. Our ninth full service office is situated in a market that can be exceptionally served by our value-oriented community banking philosophy. We are proud to lease space in our new Marshall facility to BEANER'S, a premier gourmet coffee shop. We expect this to further enhance local residents' banking experiences with Southern.

Our annual report also spotlights three of our outstanding business client relationships. Coldwater Veneer is a locally headquartered business that manufactures veneer products for sale throughout the United States and Europe. The Community Health Center of Branch County offers state-of-the-art health care services throughout our market area. Asama Manufacturing is a foundry and machining operation that manufactures automotive components, including exhaust manifolds, brake drums and gear casings for customers domestically and in Canada and Mexico. All three share with us the commitment to create the highest quality of life for residents throughout the tri-state region.

The Southern Michigan family was deeply saddened by the death last December of Jim Briskey. Jim was a valued and loyal director of Southern Michigan for nearly a quarter of a century, serving from February 1982 through April 2005. Sadly, Jim's beloved wife of 46 years, Eva, passed soon after, in February of 2007. We extend our heartfelt sympathies to their children and family members.

We are excited about the opportunities that will present themselves to us in 2007 and beyond. The strength of our company and the commitment of our management team and directors to deliver value in all phases of our operation and performance will ultimately serve our shareholders, customers and communities well into the future. Should you have any suggestions or comments that might enable us to improve our organization, please feel free to contact me or any member of our management team.

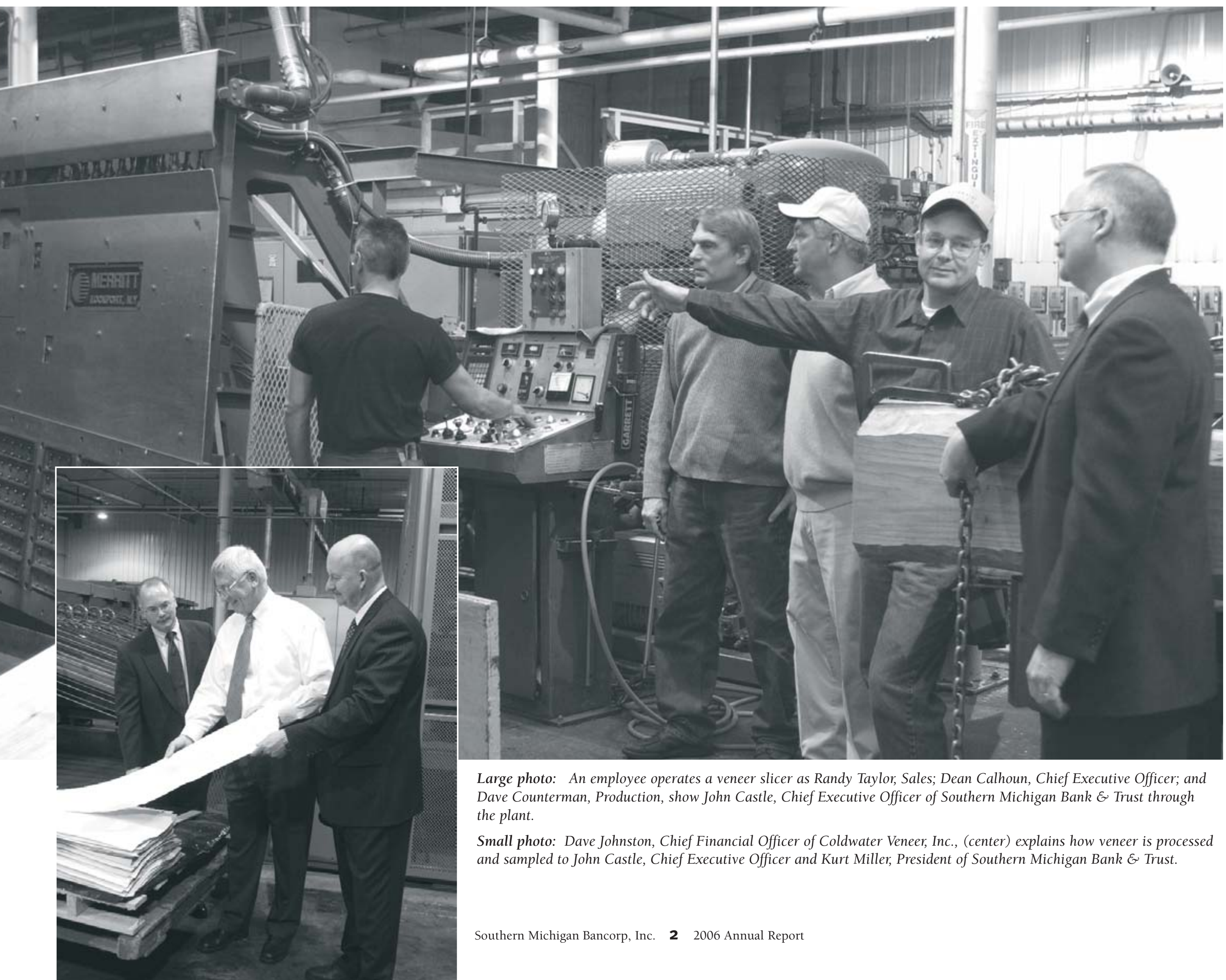
Respectfully,

John H. Castle
Chairman and Chief Executive Officer

business

Partnering for Growth

Southern Michigan Bank & Trust is proud to be a part of the success of Coldwater Veneer, Inc., which manufactures hardwood veneer, serving domestic and European markets. In 1992, Coldwater Veneer selected Southern Michigan Bank & Trust to be the lead bank in the acquisition of the company. Since that time, production has tripled and a second veneer mill has been added in West Point, Virginia. Today, Coldwater Veneer provides a strong employment base of 160 area residents in over 185,000 square feet of manufacturing and showroom facilities. Cash management and financing services provided to Coldwater Veneer and other area businesses allows SMB&T to continue to support and promote the vitality of our community.



Large photo: *An employee operates a veneer slicer as Randy Taylor, Sales; Dean Calhoun, Chief Executive Officer; and Dave Counterman, Production, show John Castle, Chief Executive Officer of Southern Michigan Bank & Trust through the plant.*

Small photo: *Dave Johnston, Chief Financial Officer of Coldwater Veneer, Inc., (center) explains how veneer is processed and sampled to John Castle, Chief Executive Officer and Kurt Miller, President of Southern Michigan Bank & Trust.*

leadership

Demonstrating Commitment to Community

Since 1996 Asama Coldwater Manufacturing, Inc., a successful auto parts manufacturer of automotive components for Honda Motor Company, has been dedicated to continuous growth and development of their product line and facilities. The company is committed to being a responsible corporate citizen, supporting a wide variety of community and charitable organizations. As Asama has grown over the years, they have completed several major expansions, and now employ over 400 area residents. They recently began a $20 million expansion that, when completed in early 2008, will provide employment for 50 additional local people. Southern Michigan Bank & Trust provides cash management services and lease financing for lift trucks and other equipment utilized in the plant, and looks forward to partnering with them in the future. Asama's success enables them to be a strong contributor to the economic well-being of the entire Coldwater community.

Large photo: *Yasuhiko (Fuji) Fujii, President of Asama Coldwater Manufacturing, points out aspects of production to Dave Clow, First Vice President Head of Commercial Lending, Kurt Miller, President, and Tom Swoish, Vice President Commercial Lender at Southern Michigan Bank & Trust.*

Small photo: *Dan Drinan, Assistant Vice President and Plant Manager at Asama Coldwater Manufacturing shows parts they manufacture to Dave Clow, First Vice President Head of Commercial Lending and Kurt Miller, President of Southern Michigan Bank & Trust.*

healthcare

Seeking Creative Solutions

We know how vital the Community Health Center of Branch County is to the health of area citizens. That is why Southern Michigan Bank & Trust has worked closely with CHC in many ways – from supporting their fundraising efforts to encouraging our employees to volunteer their time to numerous Community Health Center projects. Continuing their proactive approach to providing quality medical care, the Health Center recognized the need to replace their computer system. We provided a flexible financing structure that assisted them with the purchase of a $3.8 million, state-of-the-art computer information system (Meditech). The new system will impact every aspect of the Health Center's operations; from electronic patient records and accounting to on-screen imaging, allowing the Health Center to offer more efficient diagnostic and treatment plans resulting in better patient care.

Large photo: *Randy DeGroot, Chief Executive Officer of The Community Health Center of Branch County, looks on while Christine Smith, R.N., demonstrates use of a portable workstation, a component of the PACS, to John Castle, Chief Executive Officer of Southern Michigan Bank & Trust and Kurt Miller, President of Southern Michigan Bank & Trust.*

Small photo: *These computer screens show some of the capabilities of the CHC's Picture Archiving & Communications System (PACS).*

financial

Summary

For the Year	2006	2005
Net interest income	$14,495,000	$13,437,000
Provision for loan losses	500,000	750,000
Non-interest income	4,105,000	4,226,000
Non-interest expense	12,600,000	11,801,000
Net income	4,009,000	3,802,000
Per Share		
Basic earnings	$2.27	$2.13
Diluted earnings	$2.26	$2.12
Cash dividends declared	0.78	0.67
At Year End		
Assets	329,891,000	317,952,000
Gross loans	252,825,000	242,714,000
Allowance for loan loss	3,302,000	3,167,000
Deposits	282,509,000	268,078,000
Other borrowings	7,157,000	12,164,000
Shareholders' equity	28,482,000	26,110,000
Ratios		
Return on average assets	1.25%	1.19%
Return on average equity	14.54%	14.81%
Total risk-based capital ratio	14.14%	14.20%
ALLL as percentage of loans	1.31%	1.30%

contents

Southern Michigan Bancorp, Inc. is a one bank holding company. The Company’s subsidiary bank (the “Bank”) offers individuals, businesses, institutions and governmental agencies a full range of commercial banking services primarily in the southern Michigan communities in which the Bank is located and in areas immediately surrounding these communities.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

The following discussion provides information about the Company's financial condition which supplements the Consolidated Financial Statements. The analysis should be read in conjunction with such financial statements.

The Company's net income for 2006 was $4,009,000, a 5.4% improvement from 2005. During 2006 the Federal Reserve Bank raised short term interest rates 25 basis points four times. These increases had a positive effect on net interest margin which improved $1,058,000 or 7.9% compared to 2005. Provision for loan losses in the amount of $500,000 was expensed in 2006; down from $750,000 in 2005. Non interest income of the Company including gain on loan sales declined 2.9% to $4,105,000 in 2006. Non interest expenses of $12,600,000 in 2006 were 6.8% higher than the 2005 costs. In February 2006 the Company declared and paid a 5% stock dividend. All earnings per share and dividends per share numbers have been adjusted for this stock dividend.

	Percent Change from Prior Year			Percent Change from Prior Year	
	2006	2005		2006	2005
Net interest income	7.87%	9.56%	Assets	3.75%	1.43%
Provision for loan losses	-33.33%	undefined	Gross loans	4.17%	.55%
Non-interest income	-2.86%	-.96%	Allowance for loan loss	4.26%	-8.44%
Non-interest expense	6.77%	1.19%	Deposits	5.38%	6.44%
Net income	5.44%	5.49%	Other borrowings	-41.16%	-44.46%
			Shareholders' equity	9.08%	-4.93%

Forward Looking Statements

Statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations include forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and about the Company itself. Words such as "anticipate," "believe," "can be," "estimate," "expect," "intend," "is likely," "may be," "probable," "project," variations of such terms, and similar expressions are intended to identify such forward-looking statements. In addition, the information under the heading "Interest Rate Sensitivity" is forward-looking and management's determination of the provision and allowance for loan losses involve judgments which are inherently forward-looking. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict with regard to timing, extent, likelihood, and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Internal and external factors that may cause such a difference include changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; the bank's ability to manage non-earning assets; changes in banking laws and regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of pending and future litigation and contingencies; trends in customer behavior and customer ability to repay loans; and changes in the local, national or world economy. The Company undertakes no obligation to update, amend or clarify forward-looking statements, whether as a result of new information, future events, or otherwise.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. Following are critical accounting policies the Company has identified. For a detailed discussion on the application of these and other accounting policies, see Note A - Nature of Operation and Significant Accounting Policies to the audited consolidated financial statements.

Allowance for loan losses: The allowance for loan losses provides coverage for probable incurred credit losses inherent in the Company's loan portfolio. Accounting for loan classifications, accrual status and determination of the allowance for loan losses is based on regulatory guidance. This guidance includes, but is not limited to, generally accepted accounting principles, the uniform retail credit classification and account management policy issued by the Federal Financial Institutions Examination Council, and the joint policy statement on the allowance for loan losses methodologies also issued by the Federal Financial Institutions Examination Council. Using this guidance, management estimates the allowance balance based on past loan loss experience, nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, information in regulatory examination reports, and other factors. Many of the factors listed are inherently subjective, and requires the use of significant management estimates.

Loan impairment: A loan is impaired when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage and consumer loans and on an individual loan basis for other loans. Loans are evaluated for impairment when payments are delayed, typically 90 days or more, or when it is probable that all principal and interest amounts will not be collected according to the original terms of the loan. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral if repayment is expected solely from the collateral.

Financial Condition

Loans: The Company uses its funds primarily to support its lending activities. There were no significant concentrations in any loan category as to borrower or industry. Substantially all loans are granted to customers located in the Bank's service area, which is primarily southern Michigan. Loans in 2006 and 2005 increased by 4.2% and .6% respectively.

In 2006, commercial loans increased $18,479,000 or 12.1%, while consumer and real estate mortgages were down $2,571,000 and $5,797,000 respectively. Likewise, in 2005, commercial loans increased $3,153,000 or 2.1%, while consumer and real estate mortgages were down $478,000 and $1,345,000 respectively.

Loan commitments, consisting of unused credit card and home equity lines, available amounts on revolving lines of credit and other approved loans which have not been funded, were $57,141,000 and $44,868,000 at December 31, 2006 and 2005, respectively. Most of these commitments are priced at a variable interest rate thus minimizing the Bank's risk in a changing interest rate environment.

Securities: Another significant component of cash flow is the securities portfolio. Total securities decreased by 1.0% or $369,000 in 2006 and decreased 18.3% or $8,325,000 in 2005.

The securities available for sale portfolio had net unrealized losses of $64,000 and $187,000 at December 31, 2006 and 2005, respectively.

Deposits: Deposits have traditionally represented the Company's principal source of funds. Total deposits increased 5.4% in 2006 and 6.4% in 2005. Attracting and keeping traditional deposit relationships will continue to be a focus of the Bank.

Other borrowings: As another alternate funding source, the Bank obtains bullet advances from the Federal Home Loan Bank (FHLB). The advances are secured by a blanket collateral agreement with the FHLB giving the FHLB an unperfected security interest in the Bank's one-to-four family mortgage and SBA loans. FHLB advances may be a less expensive way to obtain longer term funds than paying a premium for long term deposits. Other borrowings decreased in 2006 as the Bank paid off a $5,000,000 advance. At December 31, 2006 the bank had $5,651,000 in FHLB advances with interest rates between 3.49% - 4.57%.

Subordinated debentures: In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by the Company, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of $1,000 per security. The Company issued $5,155,000 of subordinated debentures to the trust in exchange for ownership of all of the common security of the trust and the proceeds of the preferred securities sold by the trust. The Company may redeem the subordinated debentures, in whole or in part, in a principal amount with integral multiples of $1,000, on or after April 7, 2009 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures mature on April 6, 2034. The subordinated debentures are also redeemable in whole or in part from time to time, upon the occurrence of specific events defined within the trust indenture. The Company has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed five consecutive years.

The $5,000,000 in trust preferred securities may be included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations. The trust preferred securities and subordinated debentures have a variable rate of interest equal to the sum of the three month London Interbank Offered Rate (LIBOR) and 2.75%. The rate at December 31, 2006 was 8.12%. The Company's investment in the common stock of the trust was $155,000 and is included in other assets.

Capital Resources

The Company maintains a strong capital base to take advantage of business opportunities and absorb the risks inherent in the business.

Shareholder equity increased 9.1% or $2,372,000 from $26,110,000 at December 31, 2005 to $28,482,000 at December 31, 2006.

The Federal Reserve Board (FRB) has imposed risk-based capital guidelines applicable to the Company. These guidelines require that banks and bank holding companies maintain capital commensurate with both on and off balance sheet credit risks of their operations. Under the guidelines, a bank must have a minimum ratio of total capital to risk-weighted assets of 8 percent. In addition, a bank and a bank holding company must maintain a minimum ratio of Tier 1 capital equal to 4 percent of risk-weighted assets. Tier 1 capital includes common shareholders' equity, qualifying perpetual preferred stock and minority interests in equity accounts of consolidated subsidiaries less goodwill, core deposit intangibles and 10% of mortgage servicing rights assets.

As a supplement to the risk-based capital requirements, the FRB has also adopted leverage capital ratio requirements. The leverage ratio requirements are intended to ensure that adequate capital is maintained against risk other than credit risk. The leverage ratio requirements establish a minimum ratio of Tier 1 capital to total assets of 3 percent for the most highly rated bank holding companies and banks that do not anticipate and are not experiencing significant growth. All other bank holding companies are required to maintain a ratio of Tier 1 capital to assets of 4 to 5 percent, depending on the particular circumstances and risk profile of the institution.

Regulatory agencies have determined that the capital component created by the adoption of FASB Statement 115 should not be included in Tier 1 capital. As such, the net unrealized appreciation or depreciation on available for sale securities is not included in the ratios listed in Note R to the financial statements. The ratios include the common stock subject to repurchase obligation in the Company's employee stock ownership plan (ESOP). As seen in Note R, the Company exceeds the well capitalized requirements at December 31, 2006.

Liquidity

Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. The Bank maintains certain levels of liquid assets (the most liquid of which are cash and cash equivalents, federal funds sold and investment securities) in order to meet these demands. Maturing loans and investment securities are the principal sources of asset liquidity.

The Bank maintains correspondent accounts with a number of other banks for various purposes. In addition, cash sufficient to meet the operating needs of its branches is maintained at its lowest practical levels. At times, the Bank is a participant in the federal funds market. Federal funds are generally borrowed or sold for one-day periods. During 2006 and 2005 federal funds were sold with an average balance of $ 7,746,000 and $4,904,000, respectively. As disclosed in note N, the Bank has available credit arrangements enabling it to purchase up to $22,000,000 in federal funds should the need arise.

Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an important impact on the growth of total assets in the banking industry and the resulting need to increase equity capital at higher than normal rates in order to maintain an appropriate equity-to-assets ratio. Another significant effect of inflation is on other expenses, which tend to rise during periods of general inflation.

Management believes the most significant impact on financial results is the Company's ability to react to changes in interest rates as discussed below.

Interest Rate Sensitivity

Net interest income is the largest component of the Company's earnings. Net interest income is the difference between the yield on interest earning assets and the cost of interest bearing liabilities. Interest rate sensitivity management seeks to avoid fluctuating net interest margins and enhance consistent growth of net interest income through periods of changing interest rates.

Interest rate risk arises when the maturity or repricing characteristics of assets differ significantly from the maturity or the repricing characteristics of liabilities. Accepting this risk can be an important source of profitability and shareholder value, however excessive levels of interest rate risk could pose a significant threat to the Company's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Company's safety and soundness.

A number of tools are used to monitor and manage interest rate risk, including income simulation and market value of equity analyses. The income simulation model is used to estimate the effect that specific interest rate changes would have on net interest income assuming 1-3% up and down ramped changes to interest rates. Assumptions in the simulation are based on management's best estimates, and are inherently uncertain. As a result, the models cannot predict precisely the impact of higher or lower interest rates on net interest income. Based on the results of the simulation model as of December 31, 2006, the Bank would expect a maximum potential reduction in net interest income of less than 3% if market rates increased or decreased under a 300 basis point ramp over one year.

The market value of equity analysis estimates the change in the market value of the Bank's equity using interest rate change scenarios from +3% to –3% in 1% increments. The following table illustrates the percent change in the Bank's equity based on changes in market interest rates:

	change in market value of equity
3% increase in market rates	1.33%
2% increase in market rates	.69%
1% increase in market rates	.48%
No change	0.00%
1% decrease in market rates	-.85%
2% decrease in market rates	-1.93%
3% decrease in market rates	-2.94%

The results of both simulations at December 31, 2006 are within the guidelines set and approved by the Company's Board of Directors.

Results of Operations

Results of operations can be measured by various ratio analyses. Two widely recognized performance indicators are the return on equity and the return on assets. The Company's average return on equity was 14.54% in 2006, 14.81% in 2005 and 13.34% in 2004. The return on average assets was 1.25% in 2006, 1.19% in 2005 and 1.14% in 2004.

Net interest income: The following table shows the year to date daily average balances for interest earning assets and interest bearing liabilities, interest earned or paid, and the effective rate, for years ended December 31, 2006 and 2005 (Dollars in Thousands):

	2006			2005		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS						
Interest earning assets:						
Loans (A) (B) (C)	$ 248,088	$ 19,475	7.9%	$ 245,637	$ 17,208	7.0%
Federal funds sold	7,746	406	5.2	4,904	206	4.2
Taxable investment securities (D)	22,909	1,018	4.4	26,215	875	3.3
Tax-exempt investment securities (A) (D)	14,533	555	3.8	13,748	519	3.8
Total interest earning assets	293,276	21,454	7.3	290,504	18,808	6.5
Non-interest earning assets:						
Cash and due from banks	9,056			10,240		
Other assets	22,737			14,321		
Less allowance for loan loss	(3,175)			(3,584)		
Total assets	$ 321,894			$ 318,649		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest bearing liabilities:						
Demand deposits	$ 104,108	2,249	2.2%	$ 97,013	$ 1,249	1.3%
Savings deposits	29,295	113	.4	32,296	121	.4
Time deposits	96,751	3,721	3.8	88,629	2,672	3.0
Federal funds purchased	39	2	5.1	229	6	2.6
Other borrowings	10,519	475	4.5	29,732	1,015	3.4
Subordinated debt	5,155	399	7.7	5,155	308	6.0
Total interest bearing liabilities	245,867	6,959	2.8	243,054	5,371	2.2
Non-interest bearing liabilities:						
Demand deposits	42,146			43,218		
Other	4,285			4,552		
Common stock subject to repurchase obligation	2,030			2,155		
Shareholders' equity	27,566			25,670		
Total liabilities and shareholders' equity	$ 321,894			$ 318,649		
Net interest earnings		$ 14,495			$ 13,437	
Interest rate spread			4.5%			4.3%
Net yield on interest earning assets			4.9%			4.6%

(A) Interest income on tax-exempt loans and securities has not been adjusted to a taxable equivalent basis.
(B) Average balance includes nonaccrual loan balances.
(C) Interest income includes loan fees
(D) Average balance includes average unrealized gain (loss). The yield was calculated without regard to this average unrealized gain (loss).

Net interest income is an effective measurement of how well management has balanced the Company's interest rate sensitive assets and liabilities. Net interest income increased by 7.9% in 2006, 9.6% in 2005, and 3.4% in 2004. The Bank's prime lending rate increased from 7.25% to 8.25% during 2006 which increased interest income on variable rate loans. Increases in deposit rates partially offset this increase. In 2005 the Bank's prime lending rate increased 2% from 5.25% to 7.25%. Also in 2005 a $10,000,000 higher rate FHLB advance was paid off.

The Company continues to be positioned to benefit when interest rates increase.

Provisions for loan losses: The provision for loan losses is based on an analysis of the required additions to the allowance for loan losses. The provision is charged to income to bring the allowance for loan losses to a level deemed appropriate by management. The allowance for loan losses is maintained at a level believed adequate by management to absorb probable incurred losses in the loan portfolio. Some factors considered by management in determining the level at which the allowance is maintained include specific credit reviews, historical loan loss experience, current economic conditions and trends, results of examinations by regulatory agencies and the volume, growth and composition of the loan portfolio. The provision is adjusted quarterly, if necessary, to reflect changes in the factors above as well as actual charge-off experience and any known losses. For further information, see "Allowance for Loan Losses" below.

The provision for loan losses was $500,000 in 2006, $750,000 in 2005 and $0 in 2004. In 2006 the Bank incurred provision expense to fund net charge offs and to fund the allowance for the growth in the commercial loan portfolio. Net charge offs were $365,000, while the commercial loan portfolio increased in excess of $18,000,000. In 2005 the Bank charged off a commercial loan which necessitated provision expense. No provision was considered necessary for 2004 as net recoveries of $207,000 were recorded for the year and nonperforming loans (defined as loans over 90 days past due or non accrual loans) decreased 2.4% from December 31, 2003.

Non-interest income: Non-interest income decreased 2.9% in 2006 and 1.0% in 2005, and 23.5% in 2004. In order to reduce the risk associated with changing interest rates, the Bank regularly sells fixed rate real estate mortgage loans on the secondary market. The Bank recognizes a profit at the time of the sale. The Bank originated for sale $26,343,000 in 2006 compared to $35,572,000 in loans during 2005 and $42,932,000 in 2004. Net gains on loan sales decreased $169,000 in 2006 and $58,000 during 2005 as residential mortgage refinancing activity declined as rates moved up from historic lows in the prior year.

Security gains of $1,000, $4,000 and $-0- were recognized in 2006, 2005 and 2004, respectively.

Non-interest expenses: Non-interest expense increased by 6.8% in 2006, increased by 1.2% in 2005 and decreased by 4.6% in 2004. In 2006 the Bank recorded over $900,000 in unusual expenses. These included a loss on a repossessed asset associated with a prior year failed commercial loan, payments for marketing consultants and legal expenses. Management anticipates non interest expense costs will decrease to a more normal level in 2007.

As a result of lower volumes of mortgage loans being generated, commissions paid to mortgage loan originators were down in 2005 and 2004 compared to 2003. Offsetting the decrease was an increase in employee benefit plan costs, with the largest increase in the pension costs. Many other non-interest expense costs were down in 2005 and 2004 compared to 2003 as the Bank continued to see benefits from cost saving and efficiency measures put into place during 2003.

Income tax expense: Income tax expense was $1,491,000 in 2006, $1,310,000 in 2005 and $1,265,000 in 2004. Tax-exempt income continues to have a major impact on the Company's tax expense. The benefit offsetting lower coupon rates on municipal instruments is the nontaxable feature of the income earned on such instruments. This resulted in a lower effective tax rate and reduced federal income tax expense by approximately $180,000 in 2006, $170,000 in 2005 and $207,000 in 2004.

Nonperforming Assets

Nonperforming assets include nonaccrual loans, accruing loans past due 90 days or more, and other real estate which includes foreclosures and deeds in lieu of foreclosure.

A loan generally is classified as nonaccrual when full collectibility of principal or interest is doubtful or a loan becomes 90 days past due as to principal or interest, unless management determines that the estimated net realizable value of the collateral is sufficient to cover the principal balance and accrued interest. When interest accruals are discontinued, unpaid interest is reversed. Nonperforming loans are returned to performing status when the loan is brought current and has performed in accordance with contract terms for a period of time.

The following table sets forth the aggregate amount of nonperforming assets in each of the following categories:

	December 31		
	2006	2005	2004
	(Dollars in thousands)		
Nonaccrual loans:			
Commercial, financial and agricultural	$ 3,062	$ 2,472	$ 2,002
Real estate mortgage	449	118	-
Installment	7	-	-
	3,518	2,590	2,002
Loans contractually past due 90 days or more and still on accrual:			
Commercial, financial and agricultural	-	934	1,479
Real estate mortgage	-	-	-
Installment	6	62	20
	6	996	1,499
Total nonperforming loans	3,524	3,586	3,501
Other real estate owned	693	706	584
Total nonperforming assets	$ 4,217	$ 4,292	$ 4,085
Nonperforming loans to year-end loans	1.39%	1.48%	1.45%
Nonperforming assets to total assets	1.28%	1.35%	1.30%

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated for in the allowance for loan losses where appropriate. At December 31, 2006, 2005 and 2004, the Company had loans of $3,518,000, $2,590,000 and $2,228,000, which were considered impaired.

In management's evaluation of the loan portfolio risks, any significant future increases in nonperforming loans is dependent to a large extent on the economic environment. In a deteriorating or uncertain economy, management applies more conservative assumptions when assessing the future prospects of borrowers and when estimating collateral values. This may result in a higher number of loans being classified as nonperforming.

Allowance for Loan Losses

The allowance for loan losses is based on regular, quarterly assessments of the probable estimated incurred losses inherent in the loan portfolio. The allowance is based on two principles of accounting, Statement of Financial Accountings Standards (SFAS) No. 5 "Accounting for Contingencies", and SFAS No. 114, "Accounting by Creditors for Impairment of a Loan". The methodology used relies on several key features, including historical loss experience, specific allowances for identified problem loans and a number of other factors recommended in regulatory guidance.

The historical loss component of the allowance is based on considering the three and five year historical loss experience for each loan category. The component may be adjusted for significant factors that, in management's opinion, will affect the collectibility of the portfolio. The resulting loss estimate could differ from the losses actually incurred in the future.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a specific loan credit. These allowances are calculated in accordance with SFAS No. 114.

The final components of the allowance are based on management's evaluation of conditions that are not directly measured in the historical loss component or specific allowances. The evaluation of the inherent incurred loss with respect to these conditions is subject to a higher degree of uncertainty. The conditions evaluated in connection with these components of the allowance include current economic conditions, delinquency and charge off trends, loan volume, portfolio mix, concentrations of credit and lending policies, procedures and personnel.

The allowance is maintained at a level, which in management's opinion, is adequate to absorb probable incurred loan losses in the loan portfolio. While management uses the best information available to make these estimates, future adjustments to allowances may be necessary due to economic, operating or regulatory conditions beyond the Company's control.

The allowance for loan losses was $3,302,000 or 1.31% of loans at December 31, 2006 compared to $3,167,000 or 1.30% of loans at December 31, 2005. The December 31, 2006 allowance consists of $1,880,000 in the historical loss experience component and specifically allocated reserves, leaving $1,422,000 from the other factors. This compares to $2,245,000 and $922,000 at December 31, 2005, respectively.

Commitments and Off-Balance Sheet Risk
The Bank maintains off balance sheet financial instruments in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, letters of credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer at any time, as the customer's needs vary, as long as there is no violation of any condition established in the contract. Letters of credit are used to facilitate customers' trade transactions. Under standby letters of credit agreements, the Bank agrees to honor certain commitments in the event that its customers are unable to do so. 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. At December 31, 2006 the Bank had commitments of $57,141,000 for lines of credit and $2,400,000 in standby letters of credit outstanding.

These arrangements have credit risk essentially the same as that involved in extending loans to customers and are subject to the Bank's normal credit policies. Collateral generally consists of receivables, inventory and equipment and is obtained based on management's credit assessment of the customer. These financial instruments are recorded when they are funded.

The following tables represent the Company's contractual obligations at December 31, 2006:

Contractual Obligations:	Payments Due By Period				
	Within 1 year	1 – 3 years	4 – 5 years	After 5 years	Total
FHLB advances	$ 3,098	$ 2,209	$ 229	$ 115	$ 5,651
Other borrowing	1,373	94	39	-	1,506
Operating leases	49	50	10	-	109
Totals	$ 4,520	$ 2,353	$ 278	$ 115	$ 7,266

Regulatory Matters
Representatives of the Federal Deposit Insurance Corporation (FDIC) completed an examination at the Company's subsidiary bank using financial information as of September 30, 2006. The purpose of the examination was to determine the safety and soundness of the bank.

Examination procedures require individual judgments about a borrower's ability to repay loans, sufficiency of collateral values and the effects of changing economic circumstances. These procedures are similar to those employed by the Company in determining the adequacy of the allowance for loan losses and in classifying loans. Judgments made by regulatory examiners may differ from those made by management. The Company's level and classification of identified potential problem loans was not revised significantly as a result of this regulatory examination process.

Management and the Board of Directors evaluate existing practices and procedures on an ongoing basis. In addition, regulators often make recommendations during the course of their examination that relate to the operations of the Company and the Bank. As a matter of practice, management and the Board of Directors consider such recommendations promptly.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL INFORMATION

Management of Southern Michigan Bancorp, Inc. has prepared and is responsible for the accompanying financial statements and for their integrity and objectivity. In the opinion of management, the financial statements, which necessarily include amounts based on management's estimates and judgments, have been prepared in conformity with accounting principles generally accepted in the United States of America, on a consistent basis. Management also prepared the other information in the Annual Report and is responsible for its accuracy and consistency with the financial statements.

The Company maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with the Company's authorizations and policies. Further, such a system provides reasonable assurances as to the integrity and reliability of the financial statements which fairly present financial position and results of operations in conformity with accounting principles generally accepted in the United States of America. Internal accounting controls are augmented by written policies covering standards of personal and business conduct and an organizational structure providing for division of responsibility and authority.

Management monitors the effectiveness of and compliance with established control systems through a continuous program of internal audit and credit examinations and recommends possible improvements thereto. Management believes that, as of December 31, 2006, the Company's system of internal controls has prevented or detected on a timely basis any occurrences that could be material to the financial statements and that timely corrective actions have been initiated when appropriate.

The Board of Directors exercises its responsibility for the financial statements and related information through the Audit Committee, which is composed entirely of outside directors. The Audit Committee meets regularly with management and Crowe Chizek and Company LLC. Crowe Chizek and Company LLC has direct and confidential access to the Audit Committee to discuss the results of their audit.

The 2006 financial statements have been audited by the independent accounting firm of Crowe Chizek and Company LLC which was given unrestricted access to all financial records and related data, including minutes of all meetings of shareholders, the board of directors and committees of the board. The Company believes that all representations made to the independent auditors during their audit were valid and appropriate. Crowe Chizek and Company LLC's audit report is presented on the following page.

JH Castle

John H. Castle
Chief Executive Officer

SOUTHERN MICHIGAN BANCORP, INC.
REPORT OF INDEPENDENT AUDITORS

Shareholders and Board of Directors
Southern Michigan Bancorp, Inc.
Coldwater, Michigan

We have audited the accompanying consolidated balance sheets of Southern Michigan Bancorp, Inc. as of December 31, 2006 and 2005 and the related consolidated statements of income and comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Southern Michigan Bancorp, Inc. as of December 31, 2006 and 2005 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

South Bend, Indiana
February 23, 2007

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except number of shares)

	December 31, 2006	December 31, 2005
ASSETS		
Cash	**$ 3,211**	$ 3,080
Due from banks	**6,158**	7,418
Cash and cash equivalents	**9,369**	10,498
Federal funds sold	**10,429**	7,436
Securities available for sale	**36,796**	37,165
Loans held for sale, net of valuation of –0- in 2006 & 2005	**-**	435
Loans, net of allowance for loan losses of $ 3,302 - 2006 ($3,167 – 2005)	**249,523**	239,547
Premises and equipment, net	**8,665**	7,195
Accrued interest receivable	**2,506**	2,111
Net cash surrender value of life insurance	**7,502**	7,540
Goodwill	**620**	620
Other intangible assets	**-**	22
Other assets	**4,481**	5,383
Total Assets	**$ 329,891**	$ 317,952
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	**$ 42,281**	$ 44,196
Interest bearing	**240,228**	223,882
Total deposits	**282,509**	268,078
Accrued expenses and other liabilities	**4,440**	4,534
Other borrowings	**7,157**	12,164
Subordinated debentures	**5,155**	5,155
Common stock subject to repurchase obligation in Employee Stock Ownership Plan, 89,122 shares outstanding in 2006 (79,575 in 2005)	**2,148**	1,911
Shareholders' equity		
Preferred stock, 100,000 shares authorized; none issued or outstanding		
Common stock, $2.50 par value:		
Authorized - 4,000,000 shares		
Issued – 1,769,248 shares in 2006 (1,689,362, shares in 2005)		
Outstanding – 1,680,126 shares in 2006 (1,609,787 shares in 2005)	**4,200**	4,025
Additional paid-in capital	**5,446**	3,974
Retained earnings	**19,021**	18,419
Accumulated other comprehensive loss, net	**(42)**	(124)
Unearned Employee Stock Ownership Plan shares	**(143)**	(184)
Total Shareholders' Equity	**28,482**	26,110
Total Liabilities and Shareholders' Equity	**$ 329,891**	$ 317,952

See accompanying notes to consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Year ended December 31,		
	2006	2005	2004
Interest income:			
Loans, including fees	**$ 19,475**	$ 17,208	$ 14,887
Securities:			
Taxable	**1,424**	1,081	1,127
Tax-exempt	**555**	519	624
	1,979	1,600	1,751
Total interest income	**21,454**	18,808	16,638
Interest expense:			
Deposits	**6,083**	4,042	2,868
Other	**876**	1,329	1,506
Total interest expense	**6,959**	5,371	4,374
Net Interest Income	**14,495**	13,437	12,264
Provision for loan losses	**500**	750	-
Net Interest Income after Provision for Loan Losses	**13,995**	12,687	12,264
Non-interest income:			
Service charges on deposit accounts	**1,838**	1,953	2,021
Trust fees	**709**	652	619
Net securities gains	**1**	4	-
Net gains on loan sales	**627**	796	854
Earnings on life insurance assets	**272**	293	297
Gain on life insurance proceeds	**124**	-	-
Other	**534**	528	476
	4,105	4,226	4,267
Non-interest expense:			
Salaries and employee benefits	**7,041**	6,998	6,653
Occupancy, net	**766**	759	716
Equipment	**756**	837	814
Printing, postage and supplies	**373**	351	366
Advertising and marketing	**284**	236	250
Professional and outside services	**951**	588	818
Amortization of other intangibles	**22**	39	47
Other	**2,407**	1,993	1,998
	12,600	11,801	11,662
Income before income taxes	**5,500**	5,112	4,869
Federal income taxes	**1,491**	1,310	1,265
Net Income	**4,009**	3,802	3,604
Other comprehensive income:			
Unrealized appreciation (depreciation) on available for sale securities	**124**	(352)	(638)
Reclassification adjustments for gains included in net income	**(1)**	(4)	-
Net unrealized gains (losses) on securities arising during the year	**123**	(356)	(638)
Tax effect	**(41)**	121	216
Other comprehensive income (loss)	**82**	(235)	(422)
Comprehensive Income	**$ 4,091**	$ 3,567	$ 3,182
Basic Earnings Per Common Share	**$ 2.27**	$ 2.13	$ 1.87
Diluted Earnings Per Common Share	**$ 2.26**	$ 2.12	$ 1.86

See accompanying notes to consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(In thousands, except number of shares and per share data)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	**Total**
Balance at January 1, 2004	$ 4,404	$ 8,259	$ 13,446	$ 533	$ (284)	$ 26,358
Net income for 2004			3,604			3,604
Cash dividends declared - $.61 per share			(1,228)			(1,228)
Common stock repurchased and retired (19,323 shares)	(48)	(411)				(459)
Change in common stock subject to repurchase	(3)	(580)				(583)
Tax effect of benefit plan		26				26
Reduction of ESOP obligation		(81)			244	163
Stock options exercised (311 shares)	1	5				6
Net change in unrealized gain (loss) on available for sale securities, net of tax				(422)		(422)
Balance at December 31, 2004	4,354	7,218	15,822	111	(40)	27,465
Net income for 2005			3,802			3,802
Cash dividends declared - $.67 per share			(1,205)			(1,205)
Common stock repurchased and retired (142,765 shares)	(357)	(3,733)				(4,090)
Change in common stock subject to repurchase	23	465				488
Purchase of shares by ESOP (7,568 shares)					(204)	(204)
Reduction of ESOP obligation					60	60
Stock options exercised (1,811 shares)	5	24				29
Net change in unrealized gain (loss) on available for sale securities, net of tax				(235)		(235)
Balance at December 31, 2005	4,025	3,974	18,419	(124)	(184)	26,110
Net income for 2006			4,009			4,009
Cash dividends declared - $.78 per share			(1,381)			(1,381)
Common stock repurchased and retired (10,050 shares)	(25)	(215)				(240)
Issuance of shares for 5% stock dividend, net of fractional shares (84,355 shares)	211	1,813	(2,026)			(2)
Change in common stock subject to repurchase	(25)	(212)				(237)
Reduction of ESOP obligation					41	41
Stock options exercised (5,581 shares)	14	86				100
Net change in unrealized gain (loss) on available for sale securities, net of tax				82		82
Balance at December 31, 2006	**$ 4,200**	**$ 5,446**	**$ 19,021**	**$ (42)**	**$ (143)**	**$ 28,482**

See accompanying notes to consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year ended December 31, 2006	2005	2004
Operating Activities			
Net income	**$ 4,009**	$ 3,802	$ 3,604
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	**500**	750	-
Depreciation	**696**	643	612
Net amortization (accretion) of investment securities	**(69)**	140	309
Net securities gains	**(1)**	(4)	-
Loans originated for sale	**(26,343)**	(35,572)	(42,932)
Proceeds on loans sold	**27,195**	35,931	44,013
Net gains on loan sales	**(627)**	(796)	(854)
Net realized loss on disposal of fixed assets	**2**	-	8
Gain on life insurance proceeds	**(124)**	-	-
Amortization of other intangible assets	**22**	39	47
Net change in obligation under ESOP	**41**	(144)	163
Net change in			
Accrued interest receivable	**(395)**	(170)	(31)
Cash surrender value	**38**	(293)	(297)
Other assets	**1,693**	(232)	938
Accrued expenses and other liabilities	**(144)**	187	248
Net cash from operating activities	**6,493**	4,281	5,828
Investing Activities			
Activity in available-for-sale securities:			
Proceeds from sales	**-**	105	-
Proceeds from maturities and calls	**20,628**	18,289	24,367
Purchases	**(20,066)**	(10,561)	(16,612)
Net change in federal funds sold	**(2,993)**	(7,436)	-
Proceeds from life insurance	**-**	-	109
Loan originations and payments, net	**(10,974)**	(3,375)	(8,107)
Additions to premises and equipment	**(2,168)**	(1,247)	(610)
Net cash from investing activities	**(15,573)**	(4,225)	(853)
Financing Activities			
Net change in deposits	**14,431**	16,210	(2,833)
Net change in federal funds purchased	**-**	(625)	(6,375)
Proceeds from other borrowings	**1,127**	400	6,014
Repayments of other borrowings	**(6,134)**	(10,139)	(11,732)
Proceeds from subordinated debentures	**-**	-	5,155
Cash dividends paid	**(1,331)**	(901)	(1,524)
Cash paid in lieu of fractional shares for 5% stock dividend	**(2)**	-	-
Stock options exercised	**100**	29	6
Repurchase of common stock	**(240)**	(4,090)	(459)
Net cash from financing activities	**7,951**	(884)	(11,748)
Net change in cash and cash equivalents	**(1,129)**	940	(6,773)
Beginning cash and cash equivalents	**10,498**	9,558	16,331
Ending cash and cash equivalents	**$ 9,369**	$ 10,498	$ 9,558
Cash paid for interest	**$ 6,906**	$ 5,313	$ 4,373
Cash paid for income taxes	**1,465**	1,445	1,140
Transfers from loans to foreclosed assets	**498**	1,003	191

See accompanying notes to consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. is a bank holding company. The Company's business is concentrated in the banking industry segment. The business of commercial and retail banking accounts for more than 90% of its revenues, operating income and assets. While the Company's chief decision makers monitor the revenue stream of various company products and services, operations are managed and financial performance is evaluated on a company-wide basis. Accordingly, all of the Company's banking operations are considered by management to be aggregated into one operating segment. The Bank offers individuals, businesses, institutions and government agencies a full range of commercial banking services primarily in the southern Michigan communities in which the Bank is located and in areas immediately surrounding these communities. The Bank grants commercial and consumer loans to customers. The majority of loans are secured by business assets, commercial real estate, and consumer assets. There are no foreign loans. SMB Mortgage Company was established in August 2000 as a wholly-owned subsidiary of the Bank. All residential real estate loans are transacted through this subsidiary. The majority of loans are secured by residential real estate.

Principles of Consolidation: The consolidated financial statements include the accounts of Southern Michigan Bancorp, Inc. (the Company) and its wholly-owned subsidiary, Southern Michigan Bank & Trust (the Bank) and its wholly-owned subsidiary, SMB Mortgage Company, after elimination of significant inter company balances and transactions.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates that are more susceptible to change in the near term include the allowance for loan losses, loss contingencies, deferred tax assets, fair values of securities and other financial instruments and pension and post retirement benefit obligations.

Securities: Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold securities until maturity, they are classified as held to maturity and carried at amortized historical cost. Securities to be held for indefinite periods of time and not intended to be held to maturity are classified as available for sale and carried at fair value, with unrealized gains and losses reported in other comprehensive income or loss and shareholders' equity, net of tax. Securities classified as available for sale include securities that management intends to use as part of its asset/liability management strategy and that may be sold in response to changes in interest rates, prepayment risk, and other factors.

Premiums and discounts on securities are recognized in interest income using the level yield method over the estimated life of the security. Gains and losses on the sale of available for sale securities are determined using the specific identification method. Securities are written down to fair value and reflected as a loss when a decline in fair value is not temporary. In estimating other than temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

Loans Held for Sale: Loans held for sale are reported at the lower of cost or market value in the aggregate. Net unrealized losses are recorded in a valuation allowance by charges to income.

Loans: Loans are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term.

Interest income is not reported when full loan repayment is in doubt, typically when payments are past due over 90 days, unless the loan is both well secured and in the process of collection. Past due status is based on the contractual terms of the loan. All interest accrued but not received for these loans is reversed against interest income. Payments received on such loans are reported as principal reductions until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest contractually due are brought current and future payments are reasonably assured.

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Estimating the risk of loss and the amount of loss on any loan is necessarily subjective. Accordingly, management estimates the allowance balance based on past loan loss experience, nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, information in regulatory examination reports, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

Loan impairment is reported when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage and consumer loans and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans are evaluated for impairment when payments are delayed, typically 90 days or more, or when it is probable that all principal and interest amounts will not be collected according to the original terms of the loan.

Consumer loans are typically charged-off no later than 120 days past due. Real estate mortgage loans which are well secured and in the process of collection are charged-off on or before they become 365 days past due. Commercial loans are charged-off promptly upon the determination that all or a portion of any loan balance in uncollectible. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed principally using accelerated methods over their estimated useful lives. The estimated useful lives are 10 to 40 years for buildings and improvements and 3 to 10 for furniture and equipment. These assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur. Major improvements are capitalized. Land is carried at cost.

Mortgage Servicing Rights: Mortgage servicing rights represent the allocated value of mortgage servicing rights retained on loans sold. Mortgage servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues.

Impairment is evaluated based on the fair value of the rights, using groupings of the underlying loans as to interest rates and then, secondarily, as to geographic and prepayment characteristics. Any impairment of a grouping is reported as a valuation allowance.

Goodwill and Other Intangible Assets: Goodwill results from prior business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment will be recognized in the period identified.

Other intangible assets consist of core deposit intangible assets arising from branch acquisitions. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives, which is 10 years.

Other Real Estate: Other real estate was $693,000 and $706,000 at December 31, 2006 and 2005 and is included in other assets. Other real estate is comprised of properties acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure. These properties are initially recorded at the lower of the loan balance or fair value at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and real estate is carried at fair value less estimated cost of disposal. Expenses, gains and losses on disposition, and changes in any valuation allowance are reported in other expense.

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Stock Compensation: Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123R, Share-based Payment, using the modified prospective transition method. For 2006 no stock based employee cost was recorded as no options were granted in 2006 and all prior options were fully vested prior to January 1, 2006.

Prior to January 1, 2006 employee compensation expense under stock option plans was reported using the intrinsic value method. No stock-based compensation cost is reflected in net income for the years ending December 31, 2005 and 2004 as all options granted had an exercise price equal to or greater than the market price of the underlying common stock at date of grant. The following table illustrates the effect on net income and earnings per share if expense was measured using the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock Based Compensation*.

	2005	2004
	(In thousands, except per share data)	
Net income as reported	$ 3,802	$ 3,604
Deduct: stock based compensation expense determined under fair value based method	(144)	(32)
Pro forma net income	$ 3,658	$ 3,572
Basic earnings per share as reported	$ 2.13	$ 1.87
Pro forma basic earnings per share	2.05	1.85
Diluted earnings per share as reported	2.12	1.86
Pro forma diluted earnings per share	2.04	1.84

The pro forma effects are computed using option pricing models, using the following weighted-average assumptions as of grant date.

	2005	2004
Risk-free interest rate	3.00%	3.00%
Expected option life	8 years	8 years
Expected stock price volatility	13.49%	15.99%
Dividend yield	2.72%	3.62%
Weighted-average fair value of options granted during year	$3.13	$2.51

Company Owned Life Insurance: The Company has purchased life insurance policies on certain key executives. Company owned life insurance is recorded at its net cash surrender value, or the amount that can be realized.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

Stock Dividends: The Company issued 84,355 common shares in connection with a 5% stock dividend effected in February 2006. All prior year information relating to earnings and dividends per share has been restated to reflect these dividends.

Earnings and Dividends Per Common Share: Basic earnings per common share is based on net income divided by the weighted average number of common shares outstanding during the period. ESOP shares are considered outstanding for this calculation unless unearned. Diluted earnings per common share reflects the dilutive effect of any additional potential common shares. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issue of the financial statements.

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Cash Flow Information: For purposes of the consolidated statements of cash flows, the Company considers cash and due from banks as cash and cash equivalents. The Company reports net cash flows for customer loan and deposit transactions and short term borrowings with a maturity of 90 days or less.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income or loss. Other comprehensive income or loss includes the net change in unrealized gains and losses on securities available for sale, net of tax, which is also recognized as a separate component of shareholders' equity.

Employee Stock Ownership Plan (ESOP): The cost of shares issued to the ESOP but not yet allocated to participants is shown as a reduction to shareholders equity. Compensation expense is based on the market price of shares as they are committed to be released to participants' accounts. Dividends on allocated ESOP shares reduce retained earnings; dividends on unearned ESOP shares reduce debt and accrued interest.

Fair Values of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions. 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 such estimates. The fair value estimates of existing on- and off-balance-sheet financial instruments does not include the value of anticipated future business or values of assets and liabilities not considered financial instruments.

Concentrations of Credit Risk: The Company grants commercial, real estate and installment loans to customers mainly in Southern Michigan. Commercial loans include loans collateralized by commercial real estate, business assets and agricultural loans collateralized by crops and farm equipment. Commercial, financial and agricultural loans make up approximately 68% of the loan portfolio and the loans are expected to be repaid from cash flow from operations of businesses. Residential mortgage loans make up approximately 26% of the loan portfolio and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 6% of the loan portfolio and are primarily collateralized by consumer assets.

Financial Instruments with Off-Balance-Sheet Risk: Financial instruments include off-balance-sheet credit instruments, such as commitments to make loans and standby letters of credit issued to meet customer needs. The face amount for these items represents the exposure to loss before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Adoption of New Accounting Standards: Effective January 1, 2006, the Company adopted FSAS No. 123R, "Share Based Payments". SFAS 123R requires companies to record compensation cost for stock options provided to employees in return for employment service. The cost is measured at the fair value of the options when granted, and this cost is expensed over the employment service period, which is normally the vesting period of the options. This applies to awards granted or modified in fiscal years beginning in 2006. See "Stock Compensation" above for further discussion of the effect of adopting this standard.

Effect of Newly Issued But Not Yet Effective Accounting Standards: In February 2006, the Financial Accounting Standards Board ("FASB") issued Statement No. 155, "Accounting for Certain Hybrid Financial Instruments- an amendment to FASB Statements No. 133 and 140". This Statement permits fair value re-measurement for any hybrid financial instruments, clarifies which instruments are subject to the requirements of Statement No. 133, and establishes a requirement to evaluate interests in securitized financial assets and other items. The new standards is effective for financial assets acquired or issued after the beginning of the entity's first fiscal year that begins after September 15, 2006. Management does not expect the adoption of this statement to have a material impact on its consolidated financial position or results of operations.

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Effect of Newly Issued But Not Yet Effective Accounting Standards: (continued)
In March 2006, the FASB issued Statement No. 156, "Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140". This Statement provides the following: 1) revised guidance on when a servicing asset and servicing liability should be recognized; 2) requires all separately recognized servicing assets and servicing liabilities to be initially measured at faire value, if practicable; 3) permits an entity to elect to measure servicing assets and servicing liabilities at fair value each reporting date and report changes in fair value in earnings in the period in which the changes occur; 4) upon initial adoption, permits a onetime reclassification of available-for-sale securities to trading securities for securities which are identified as offsetting the entity's exposure to changes in the fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value; and 5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional footnote disclosures. This standard is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006 with the effects of initial adoption being reported as a cumulative-effect adjustment to retained earnings. Management does not expect the adoption of this statement will have a material impact on its consolidated financial position or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), which was issued to require that all tax positions be evaluated using consistent criteria and measurement and further supplemented by enhanced disclosure. FIN 48, an interpretation of FASB Statement No. 109, "Accounting for Income Taxes," prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. This interpretation provides clear criteria for subsequently recognizing, derecognizing, and measuring such tax positions for financial statement purposes as well as provides guidance on accrual of interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe the adoption of this issue will have a material impact on the financial statements.

In September 2006, the FASB issued SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," that requires companies to recognize the funded status of its defined benefit pension and postretirement plans as an asset or liability on the balance sheet rather than being disclosed in the notes to the financial statements. The over-funded or under-funded status (asset or liability) would be measured as the difference between the fair value of plan assets and the projected benefit obligation for pensions and the accumulated post-retirement benefit obligation for other post-retirement benefits. The requirement to recognize the funded status in the balance sheet is effective for fiscal years ending after June 15, 2007. The Company will adopt the balance sheet recognition requirement for its year ending December 31, 2007 financial statements. The Company is currently evaluating the impact of the statement on its financial position.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. The Company has not completed its evaluation of the impact of the adoption of this standard.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-05, "Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 Accounting for Purchases of Life Insurance". This issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the issue discusses whether the cash surrender value should be discounted when the policy holder is contractually limited in its ability to surrender a policy. This issue is effective for fiscal years beginning after December 15, 2006. The Company does not believe the adoption of this issue will have a material impact on the financial statements.

SOUTHERN MICHIGAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are such matters that will have a material effect on the consolidated financial statements as of December 31, 2006.

Reclassifications: Some items in the prior year consolidated financial statements have been reclassified to conform with the current year presentation.

NOTE B – BASIC AND DILUTED EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the years ended December 31, 2006, 2005 and 2004 is presented below:

	2006	2005	2004
Basic Earnings Per Common Share			
Net income (in thousands)	**$ 4,009**	$ 3,802	$ 3,604
Weighted average common shares outstanding	**1,771,211**	1,787,346	1,927,592
Less: Unallocated ESOP shares	**(6,679)**	(2,810)	(4,868)
Weighted average common shares outstanding for basic earnings per common share	**1,764,532**	1,784,536	1,922,724
Basic earnings per common share	**2.27**	$ 2.13	$ 1.87
Diluted Earnings Per Common Share			
Net income (in thousands)	**$ 4,009**	$ 3,802	$ 3,604
Weighted average common shares outstanding for basic earnings per common share	**1,764,532**	1,784,536	1,922,724
Add: Dilutive effects of assumed exercises of stock options	**6,303**	7,185	6,763
Average shares and dilutive potential of common shares outstanding	**1,770,835**	1,791,721	1,929,487
Diluted earnings per common share	**$ 2.26**	$ 2.12	$ 1.86

Stock options for 28,560, 28,770 and -0- shares of common stock were not considered in computing diluted earnings per share for 2006, 2005 and 2004 because they were antidilutive.

NOTE C – SECURITIES

Year end investment securities were as follows (in thousands):

Available for sale, 2006	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
U.S. Treasury and Government agencies	**$ 13,997**	**$ 10**	**$ (70)**
States and political subdivisions	**17,741**	**52**	**(57)**
Corporate securities	**3,000**	**-**	**-**
Mortgage-backed securities	**864**	**1**	**-**
Total debt securities	**35,602**	**63**	**(127)**
Equity securities	**1,194**	**-**	**-**
Total	**$ 36,796**	**$ 63**	**$ (127)**

Available for sale, 2005	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
U.S. Treasury and Government agencies	$ 13,989	$ 6	$ (166)
States and political subdivisions	20,525	63	(91)
Mortgage-backed securities	1,161	1	-
Total debt securities	35,675	70	(257)
Equity securities	1,490	-	-
Total	$ 37,165	$ 70	$ (257)

Included above for 2006 and 2005 are $4,200,000 and $2,000,000 floating rate securities that are putable on a weekly basis.

Securities with unrealized losses at year end 2006 and 2005 not recognized in income are as follows (in thousands):

2006	**Continued Unrealized Loss for Less than 12 Months**		**Continued Unrealized Loss for 12 Months or More**		**Total**	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. Treasury and Government agencies	**$ 6,160**	**$ (9)**	**$ 5,417**	**$ (61)**	**$ 11,577**	**$ (70)**
States and political subdivisions	**1,696**	**(9)**	**6,452**	**(48)**	**8,148**	**(57)**
Total temporarily impaired	**$ 7,856**	**$ (18)**	**$19,725**	**$ (109)**	**$ 19,725**	**$ (127)**

2005	**Continued Unrealized Loss for Less than 12 Months**		**Continued Unrealized Loss for 12 Months or More**		**Total**	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. Treasury and Government agencies	$ 5,971	$ (82)	$ 5,428	$ (84)	$ 11,399	$ (166)
States and political subdivisions	8,007	(63)	3,025	(28)	11,032	(91)
Total temporarily impaired	$ 13,978	$ (145)	$ 8,453	$ (112)	$ 22,431	$ (257)

Unrealized losses have not been recognized into income as the issuers are of high credit quality, management has the intent and ability to hold for a time necessary to recover the unrealized loss, and the decline in fair value is largely due to increased market interest rates. The fair value is expected to recover as the bonds approach their maturity date.

NOTE C – SECURITIES (CONTINUED)

Sales of available for sale securities were (in thousands):

	2006	2005	2004
Proceeds	**$ -**	$ 105	$ -
Gross gains	**-**	4	-
Gross losses	**-**	-	-

Gains on calls of securities were $1,000 for 2006. There were no such gains or losses for 2005 or 2004. Contractual maturities of debt securities at year-end 2006 were as follows (in thousands). Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Fair Value
Due in one year or less	**$ 9,445**
Due from one to five years	**15,934**
Due from five to ten years	**4,246**
Due after ten years	**5,113**
Mortgage-backed securities	**864**
	$ 35,602

Securities with a carrying value of $7,234,000 and $8,416,000 were pledged as collateral for public deposits and for other purposes at year end 2006 and 2005.

Except as indicated, total securities of any state (including all its political subdivisions) were less than 10% of shareholders' equity. At year-end 2006 and 2005, the market value of securities issued by the state of Michigan and all its political subdivisions totaled $11,383,000 and $11,366,000, respectively.

NOTE D – LOANS

Loans at year-end were as follows (in thousands):

	2006	2005
Commercial	**$ 170,878**	$ 152,399
Consumer	**15,745**	18,316
Real estate mortgage	**66,202**	71,999
	252,825	242,714
Less allowance for loan losses	**(3,302)**	(3,167)
Loans, net	**$ 249,523**	$ 239,547

At December 31, 2006 and 2005, certain directors and executive officers of the Company and the Bank, including their associates and companies in which they are principal owners, were indebted to the Bank in the aggregate of $11,927,000 and $7,474,000, respectively.

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $56,399,000 and $41,566,000 at December 31, 2006 and 2005, respectively.

Activity for capitalized mortgage servicing rights was as follows (in thousands):

	2006	2005	2004
Balance at January 1	$ **274**	$ 102	$ 57
Additions	**210**	235	97
Amortized to expense	**(85)**	(63)	(52)
Balance at December 31	**$ 399**	$ 274	$ 102

No valuation allowance for capitalized mortgage servicing rights was necessary at December 31, 2006, 2005 or 2004. The fair value was $399,000 and $274,000 at year end 2006 and 2005.

NOTE E – ALLOWANCES FOR LOAN LOSSES

Changes in the allowance for loan losses for the years ended December 31 were as follows (in thousands):

	2006	2005	2004
Balance at January 1	**$ 3,167**	$ 3,459	$ 3,252
Provision for loan losses	**500**	750	-
Loans charged off	**(485)**	(1,171)	(262)
Recoveries	**120**	129	469
Net charge-offs	**365**	1,042	207
Balance at December 31	**$ 3,302**	$ 3,167	$ 3,459

Information regarding impaired loans follows (in thousands):

	2006	2005
Year end loans with allowance for loan losses allocated	**$ 1,302**	$ 1,635
Year end loans with no allowance for loan losses allocated	**2,216**	955
Total impaired loans	**$ 3,518**	$ 2,590
Amount of allowance allocated to these loans	**$ 438**	$ 776

	2006	2005	2004
Average balance of impaired loans during the year	**$ 4,231**	$ 3,215	$ 2,392
Cash basis interest income recognized during the year	**$ 187**	$ 91	$ 38
Interest income recognized during the year	**$ 172**	$ 81	$ 38

Nonperforming loans were as follows (in thousands):

	2006	2005
Loans past due over 90 days still on accrual	**$ 6**	$ 996
Nonaccrual loans	**3,518**	2,590

Nonperforming loans and impaired loans are defined differently. Some loans may be included in both categories, whereas other loans may only be included in one category.

NOTE F – PREMISES AND EQUIPMENT, NET

Premises and equipment, net consist of (in thousands):

	2006	2005
Land	**$ 1,322**	$ 1,322
Buildings and improvements	**10,903**	9,151
Furniture and equipment	**5,677**	5,345
	17,902	15,818
Less accumulated depreciation	**(9,237)**	(8,623)
Totals	**$ 8,665**	$ 7,195

Depreciation and amortization expense charged to operations was approximately $696,000, $643,000 and $612,000 in 2006, 2005 and 2004, respectively.

NOTE F – PREMISES AND EQUIPMENT, NET (CONTINUED)

Equipment rental expense was $54,000, $158,000 and $171,000 for 2006, 2005 and 2004. Lease commitments under noncancelable operating equipment leases were as follows (in thousands):

2007	$ **49**
2008	**30**
2009	**20**
2010	**10**
Total	**$ 109**

NOTE G – GOODWILL AND INTANGIBLE ASSETS

Goodwill
There was no change in the $620,000 carrying amount of goodwill for the year.

Acquired Intangible Assets
Acquired intangible assets were as follows as of year end (in thousands):

	December 31, 2006			December 31, 2005		
	Gross Carrying Amount	**Accumulated Amortization**	**Net Carrying Amount**	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortized intangible assets:						
Core deposit intangibles	**$ 559**	**$ 559**	**$ 0**	$ 559	$ 537	$ 22

Aggregate amortization expense was $22,000, $39,000 and $47,000 for 2006, 2005 and 2004, respectively.

The acquired intangible assets are fully amortized. No further amortization expense will be recorded.

NOTE H – DEPOSITS

The carrying amount of domestic deposits at year-end follows (in thousands):

	2006	**2005**
Non-interest bearing checking	**$ 42,281**	**$** 44,196
Interest bearing checking	**50,177**	48,694
Savings	**28,693**	31,942
Money market accounts	**60,835**	51,373
Time deposits	**100,523**	91,873
Totals	**$ 282,509**	**$** 268,078

NOTE H – DEPOSITS (CONTINUED)

The carrying amount of time deposits over $100,000 was $42,153,000 and $37,485,000 at December 31, 2006 and 2005, respectively. Interest expense on time deposits over $100,000 was $1,691,000, $1,125,000 and $831,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

At year-end 2006, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2007	$ **63,591**
2008	**11,923**
2009	**12,714**
2010	**5,506**
2011	**984**
Thereafter	**5,805**
Totals	**$ 100,523**

Related party deposits were $17,197,000 and $10,279,000 at December 31, 2006 and 2005, respectively.

NOTE I – OTHER BORROWINGS

Other borrowings include advances obtained by the Bank from the Federal Home Loan Bank (FHLB) of Indianapolis. The Bank has $5,000,000 in fixed rate advances with a weighted average interest rate of 3.81%. Principal is due at maturity. The remaining $651,000 FHLB advance is at a fixed rate of 4.57% with principal payments beginning in December of 2003 and continuing through December of 2013.

All of the advances are secured by a blanket collateral agreement with the FHLB which gives the FHLB an unperfected security interest in the Bank's one-to-four family mortgage and SBA loans. Eligible FHLB mortgage and SBA loan collateral at December 31, 2006 and 2005 was approximately $40,049,000 and $43,855,000.

At December 31, 2005, The Bank had $11,000,000 in fixed rate advances from the FHLB with a weighted average interest rate of 3.23%. In addition, the Bank had $745,000 in fixed rate FHLB advances at a fixed rate of 4.57% with principal payments beginning in December of 2003 and continuing through December of 2013.

At year-end 2006, scheduled principal reductions on these FHLB advances were as follows for the years ending December 31 (in thousands):

2007	**$ 3,098**
2008	**102**
2009	**2,107**
2010	**112**
2011	**117**
Thereafter	**115**
Total FHLB advances	**$ 5,651**

Other borrowings also include loans with balances at December 31, 2006 and 2005 of $176,000 and $216,000. The current loan matures on September 15, 2010 and is unsecured.

On February 22, 2006, the Company renewed a $2,000,000 revolving line of credit with LaSalle Bank, which matures on February 22, 2007 and is secured by the Bank's stock. At year end 2006 and 2005 the balance was $0. The line allows the Company to choose its interest rate for each draw, based on the LaSalle Bank National Association prime rate or adjusted LIBOR. (See also Note N).

Also included in other borrowings at December 31, 2006 was $1,146,000 of amounts due for overdrawn correspondent bank balances. This amount was repaid on January 2, 2007.

The Company had $184,000 and $203,000 in repurchase agreements at December 31, 2006 and 2005.

NOTE J – SUBORDINATED DEBENTURES AND TRUST PREFERRED SECURITIES

In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by the Company, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of $1,000 per security. The Company issued $5,155,000 of subordinated debentures to the trust in exchange for ownership of all of the common security of the trust and the proceeds of the preferred securities sold by the trust. The Company may redeem the subordinated debentures, in whole or in part, in a principal amount with integral multiples of $1,000, on or after April 7, 2009 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures mature on April 6, 2034. The subordinated debentures are also redeemable in whole or in part from time to time, upon the occurrence of specific events defined within the trust indenture. The Company has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed five consecutive years.

The $5,000,000 in trust preferred securities may be included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations. The trust preferred securities and subordinated debentures have a variable rate of interest equal to the sum of the three month London Interbank Offered Rate (LIBOR) and 2.75%. The rate at December 31, 2006 was 8.12%. The Company's investment in the common stock of the trust was $155,000 and is included in other assets.

NOTE K – INCOME TAXES

Income tax expense consists of (in thousands):

	2006	2005	2004
Current	**$ 1,453**	$ 1,320	$ 1,331
Deferred	**38**	(10)	(66)
Totals	**$ 1,491**	$ 1,310	$ 1,265

Income tax expense calculated at the statutory federal income tax rate of 34% differs from actual income tax expense as follows (in thousands):

	2006	2005	2004
Income tax at statutory rates	**$ 1,870**	$ 1,738	$ 1,655
Tax-exempt interest income, net	**(180)**	(170)	(207)
Increase in net cash surrender value of life insurance policies	**(135)**	(100)	(101)
Low income housing partnership tax credit	**(127)**	(127)	(120)
Other items, net	**63**	(31)	38
Totals	**$ 1,491**	$ 1,310	$ 1,265

Year-end deferred tax assets and liabilities consist of (in thousands):

	2006	2005
Deferred tax assets:		
Allowance for loan losses	**$ 800**	$ 759
Deferred compensation and supplemental retirement liability	**621**	692
Intangible asset amortization	**62**	67
Pension liability	**115**	155
Write off of viatical investment	**68**	68
Write down of other real estate	**31**	22
Deferred loan fees	**-**	7
Nonaccrual loan interest	**170**	123
Net unrealized depreciation on available for sale securities	**21**	64
Other	**134**	60
Subtotals	**2,022**	2,017
Valuation allowance against capital loss	**(54)**	(54)
Totals	**1,968**	1,963

SOUTHERN MICHIGAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE K – INCOME TAXES (CONTINUED)

	2006	2005
Deferred tax liabilities:		
Mortgage servicing rights	$ **(136)**	(93)
Goodwill	**(106)**	(85)
Other	**(81)**	(59)
Totals	**(323)**	(237)
Net deferred tax asset	**$ 1,645**	$ 1,726

An allowance against the net deferred tax asset was considered necessary at December 31, 2006 and 2005 as the likelihood of receiving a tax benefit on a portion of the capital loss on the viatical investment is considered doubtful.

NOTE L – BENEFIT PLANS

Defined Benefit Pension Plan: Effective December 31, 2006 the Southern Michigan Bank & Trust Pension Plan was frozen on a partial basis. Current plan-eligible employees who meet specific age and years of service requirements have been grand-fathered in and will continue to accrue benefits under the plan. All other employees will continue to vest in their December 31, 2006 benefit balances, however, no further benefits will accrue. This curtailment resulted in a $687,000 reduction in the projected benefit obligation during 2006. The curtailment gain was entirely used to offset the unrecognized net actuarial loss; and therefore, there was no impact of this gain on net income. The Company uses a December 31 measurement date for the plan.

Information about the pension plan was as follows (in thousands):

	2006	2005
Change in benefit obligation:		
Beginning benefit obligation	**$ (2,354)**	$ (2,792)
Service cost	**(275)**	(211)
Interest cost	**(155)**	(176)
Settlement loss	**-**	(63)
Curtailment gain	**687**	-
Actuarial loss from change in actuarial assumptions	**(233)**	80
Benefits paid	**194**	808
Ending benefit obligation	**$ (2,136)**	$ (2,354)
Change in plan assets, at fair value:		
Beginning plan assets	**$ 1,325**	$ 1,854
Actual return	**147**	34
Employer contribution	**485**	245
Benefits paid	**(194)**	(808)
Ending plan assets	**$ 1,763**	$ 1,325
Net amount recognized:		
Funded status	**$ (373)**	$ (1,029)
Unrecognized net actuarial loss	**34**	572
Accrued pension cost	**$ (339)**	$ (457)

The accumulated benefit obligation for the defined benefit pension plan was $1,935,000 and $1,595,000 at December 31, 2006 and 2005.

NOTE L – BENEFIT PLANS (CONTINUED)

The components of pension expense and related actuarial assumptions were as follows (in thousands except ratio information):

	2006	2005	2004
Components of net periodic benefit cost:			
Service cost	$ **275**	$ 211	$ 217
Interest cost	**155**	176	160
Expected return on plan assets	**(98)**	(134)	(119)
Recognized net actuarial loss	**35**	22	30
Settlement charge	**-**	194	-
Net periodic benefit cost	$ **367**	$ 469	$ 288

Weighted average assumptions for determining projected benefit obligation and net periodic benefit cost:

	2006	2005	2004
Discount rate on benefit obligation	**6.0%**	6.5%	6.5%
Long-term expected rate of return on plan assets	**7.0%**	7.0%	7.0%
Rate of compensation increase	**4.0%**	4.0%	4.0%

Asset Category	Target Allocation 2007	Percentage of Plan Assets at Year-end 2006	2005	Weighted Average Expected Long-Term Rate of Return - 2006
Equity securities	40%	56%	58%	8.4%
Debt securities	55%	31%	40%	6.2%
Cash	5%	13%	2%	3.8%
	100%	100%	100%	7.0%

The expected return on plan assets has been based upon actual historical long-term returns of the overall stock and bond markets and actual portfolio returns.

The pension plan assets are managed by the Trust Department. A written investment policy which meets the standards of the prudent investor rule is followed. In addition, the Northern Trust Company of Chicago, and Wabash Capital Management of Terre Haute, Indiana have provided investment advisory services, guidance and expertise.

The investment policy is established to provide direction for the purchase of equity and debt securities of good quality, determined by careful analysis and investigation. Factors to be considered include relative price, yield, earnings, dividends, assets, ratings and ability to repay debts.

The equity philosophy has been driven by the long term objective of growth. Diversification is achieved by diversifying by industry in order to reduce the portfolio's sensitivity to any one sector of the economy.

Debt securities (bonds), as a general rule, must have an "A" rating or better to meet the criteria as an investment of the plan. Bond maturities are laddered over several years in order to provide predictable income flow and reduce interest rate risk.

NOTE L – BENEFIT PLANS (CONTINUED)

Only trust quality investments will be allowed in the plan. Those include blue chip stocks, bonds with an A rating or better, mutual funds that meet established investment criteria and money market funds. Investments not allowed in the plan include derivatives, puts, calls, options and futures. No single issue may have a concentration greater than 10% of the total fair value.

Investments or debt obligations of Southern Michigan Bancorp, Inc. are not allowed as holdings within the plan.

The investment objective has been a balanced approach with a target of 60% stocks, 35% bonds and 5% cash. The allocation percentages may be reduced or increased depending upon market conditions and interest rates. Due to the partial freeze, the investment allocations have been reevaluated with shorter term objectives.

The investments in the plan are managed for the benefit of the participants. They are structured to meet the cash flow necessary to pay retiring employees. ERISA guidelines for diversification of the investments are followed.

During 2005, the Company distributed a lump sum distribution to a highly compensated employee which triggered a plan settlement in the amount of $194,000 in addition to the Company's expense of $275,000, bringing the total expense to $469,000 for the year.

The Company expects to contribute $159,000 to its pension plan in 2007.

At year-end 2006, estimated future benefit payments from the plan were as follows for the years ending December 31 (in thousands):

2007	**$ 21,124**
2008	**23,804**
2009	**26,279**
2010	**33,099**
2011	**39,340**
Thereafter	**406,541**

Employee Stock Ownership Plan: The Company has an employee stock ownership plan (ESOP) for substantially all full-time employees. The Board of Directors determines the Company's contribution level annually. Assets of the plan are held in trust by the Bank and administrative costs of the plan are borne by the plan participants. Expense charged to operations for contributions to the plan totaled $122,000, $117,000 and $117,000 in 2006, 2005 and 2004. Company matching is provided in Company stock.

Shares held by the ESOP at year-end are as follows:

	2006	2005
Allocated shares	**89,122**	79,575
Unallocated shares	**5,579**	6,827
Total ESOP shares	**94,701**	86,402

The fair value of the allocated shares held by the ESOP is approximately $2,148,000 and $1,911,000 at December 31, 2006 and 2005, respectively. Upon distribution of shares to a participant, the participant has the right to require the Company to purchase shares at their fair value in accordance with terms and conditions of the plan. As such these shares are not classified in shareholders' equity as permanent equity. In 2005, the ESOP obtained a loan for $204,000 to purchase 7,568 shares. The balance of the loan at December 31, 2006 and 2005 was $143,000 and $184,000.

NOTE L – BENEFIT PLANS (CONTINUED)

Deferred Compensation Plan: As an incentive to retain key members of management and directors, the Bank has a deferred compensation plan whereby participants defer a portion of current compensation. Benefits are based on salary and length of service and are vested as service is provided from the date of participation through age 65. A liability is recorded on a present value basis and discounted at current interest rates. This liability may change depending upon changes in long-term interest rates. Current rates paid on deferred compensation balances range from 5.60% - 12.98%. Deferred compensation expense was $225,000, $227,000 and $188,000 in 2006, 2005 and 2004. The liability for vested benefits was $1,780,000 and $1,719,000 at December 31, 2006 and 2005, respectively.

Supplemental Retirement Plan: The Bank also maintains a supplemental retirement plan to provide annual payments to particular executives subsequent to their retirement. The plan covers two individuals, both of whom are retired. Liabilities associated with this plan totaled $235,000 and $256,000 at December 31, 2006 and 2005. Expense associated with this plan totaled $13,000, $20,000 and $68,000 in 2006, 2005 and 2004.

NOTE M – STOCK OPTIONS

On June 6, 2005 shareholders of the Company approved the Stock Incentive Plan of 2005 to advance the interest of the Company and its shareholders by affording to directors, officers and other employees of the Company an opportunity for increased stock ownership. The plan permits the grant and award of stock options, stock appreciation rights, restricted stock and stock awards. A maximum of 157,500 shares of common stock are available under the plan. The plan will be terminated June 5, 2015 or earlier if determined by the Board of Directors. No shares were granted in 2006. At December 31, 2006, 125,107 shares are available under the plan.

On April 17, 2000, the Company approved a Stock Option Plan to advance the interests of the Company and its shareholders by affording to directors, officers and other employees of the Company an opportunity to acquire or increase their proprietary interest in the Company using stock options. Option shares authorized under the plan total 115,500. Options are to be granted with an exercise period of 10 years or less, an exercise price of not less than the fair market value of the stock on the date the options are granted and a vesting period as determined by the Board of Directors. The plan will terminate on the earliest of: (i) March 20, 2010; (ii) when all shares have been issued through exercise of options granted under this Plan; or (iii) at any earlier time that the Board of Directors may determine. No shares were granted in 2006. 45,421 shares are available under the plan.

A summary of the activity in the plans is as follows for the year ended December 31, 2006.

	Shares	**Weighted Average Price**
Outstanding at beginning of year	**102,084**	**$ 22.00**
Exercised	**(5,581)**	**17.92**
Forfeited	**(840)**	**24.23**
Outstanding at end of year	**95,663**	**$ 22.17**
Options exercisable at year-end	**95,663**	**$ 22.17**

At December 31, 2006 the weighted average remaining contractual life for all options outstanding was 7.83 years.

At December 31, 2006, the aggregate intrinsic value of options outstanding and exercisable totaled $235,000. This value represents the difference between the Company's closing stock price on the last day of trading for the year and the exercise price multiplied by the number of in-the-money options assuming all option holders had exercised their stock options on December 31, 2006. The aggregate intrinsic value of stock options exercised during 2006, 2005 and 2004 was $34,000, 14,000 and 4,000, respectively. Exercise of the options resulted in cash payments of $100,000, $29,000 and $6,000 for 2006, 2005 and 2004.

NOTE N – COMMITMENTS

There are various commitments which arise in the normal course of business, such as commitments under commercial letters of credit, standby letters of credit and commitments to extend credit. These arrangements have credit risk essentially the same as that involved in extending loans to customers and are subject to the Bank's normal credit policies. Collateral generally consists of receivables, inventory and equipment and is obtained based on management's credit assessment of the customer.

At December 31, 2006 and 2005, the Bank had $0 of commitments under commercial letters of credit, used to facilitate customers' trade transactions.

Under standby letter of credit agreements, the Bank agrees to honor certain commitments in the event that its customers are unable to do so. At December 31, 2006 and 2005, commitments under outstanding standby letters of credit were $2,400,000 and $213,000.

Loan commitments outstanding to extend credit are detailed below (in thousands):

	2006	2005
Fixed rate	**$ 5,782**	$ 3,037
Variable rate	**51,359**	41,831
Totals	**$ 57,141**	$ 44,868

The fixed rate commitments have stated interest rates ranging from 4.75% to 9.90%. The terms of the above commitments range from 1 to 60 months.

Management does not anticipate any losses as a result of the above related transactions; however, the above amount represents the maximum exposure to credit loss for loan commitments and commercial and standby letters of credit.

At December 31, 2006, the Company had a line of credit agreement with LaSalle Bank totaling $2,000,000. The balance on the line was $0 at December 31, 2006. The line of credit is secured by the Bank's stock and matures on February 22, 2007. In addition, at December 31, 2006, the Bank had line of credit arrangements to be able to purchase federal funds totaling $22,000,000, subject to quarterly and annual reviews. The balance on these lines at December 31, 2006 was $0. (See also Note I).

Certain executives of the Bank have employment contracts which have change of control clauses. The employment contracts provide for the payment of three years worth of the officers' salaries upon a change of control.

NOTE O – RESTRICTIONS ON TRANSFERS FROM SUBSIDIARY

Banking laws, regulations and regulatory agreements restrict the amount the Bank may transfer to the Company in the form of cash dividends, loans and advances. Approximately $8,034,000 of the Bank's retained earnings as of December 31, 2006 is available for transfer to the Company in 2007 in the form of dividends without prior regulatory approval.

NOTE P – SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION

Condensed financial statements of Southern Michigan Bancorp, Inc. follow (in thousands):

Balance Sheets	December 31, 2006	2005
Assets		
Cash	**$ 304**	$ 241
Investment in Subsidiary Bank	**34,357**	31,907
Investment in non banking subsidiary	**195**	196
Premises and equipment, net	**1,007**	1,038
Other	**629**	514
Total Assets	**$ 36,492**	$ 33,896
Liabilities and Shareholders' Equity		
Dividends payable	**$ 354**	**$** 304
Other liabilities	**177**	200
Other borrowings	**176**	216
Subordinated debentures	**5,155**	5,155
Common stock subject to repurchase obligation in ESOP	**2,148**	1,911
Shareholders' equity	**28,482**	26,110
Total Liabilities and Shareholders' Equity	**$ 36,492**	**$** 33,896

Statements of Income	Year ended December 31, 2006	2005	2004
Dividends from Subsidiary Bank	**$ 1,791**	$ 1,515	$ 933
Interest income	**11**	12	53
Interest expense	**(412)**	(312)	(191)
Other income	**246**	260	241
Other expenses	**(72)**	(175)	(294)
	1,564	1,300	742
Federal income tax	**(78)**	(73)	(106)
	1,642	1,373	848
Equity in undistributed net income (loss) of:			
Subsidiary Bank	**2,368**	2,431	2,783
Non-banking Subsidiary	**(1)**	(2)	(27)
Net Income	**4,009**	3,802	3,604
Net change in unrealized gains (losses) on securities available for sale, net of tax	**82**	(235)	(422)
Other comprehensive income (loss)	**82**	(235)	(422)
Comprehensive income	**$ 4,091**	$ 3,567	$ 3,182

NOTE P – SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION (CONTINUED)

Statements of Cash Flows	Year ended December 31, 2006	2005	2004
Operating Activities			
Net income	$ **4,009**	$ 3,802	$ 3,604
Adjustments to reconcile net income to net cash from operating activities:			
Equity in undistributed net (income) loss of:			
Subsidiary Bank	**(2,368)**	(2,431)	(2,783)
Non-banking Subsidiary	**1**	2	27
Investment in Non-banking Subsidiary	**-**	-	(225)
Depreciation	**31**	31	31
Net change of obligation under ESOP	**41**	(144)	163
Other	**(138)**	(244)	266
Net cash from operating activities	**1,576**	1,016	1,083
Investing Activities			
Activity in available-for-sale securities:			
Proceeds from maturities and calls	**-**	495	1,046
Purchases	**-**	-	(141)
Additions to premises and equipment	**-**	-	(6)
Net cash from investing activities	**-**	495	899
Financing Activities			
Proceeds from other borrowings	**-**	236	-
Repayments of other borrowings	**(40)**	(60)	(1,644)
Proceeds from subordinated debentures	**-**	-	5,155
Cash dividends paid	**(1,331)**	(901)	(1,524)
Cash paid in lieu of fractional shares for 5% stock dividend	**(2)**	-	-
Stock options exercised	**100**	29	6
Repurchase of common stock	**(240)**	(4,090)	(459)
Net cash from financing activities	**(1,513)**	(4,786)	1,534
Net change in cash and cash equivalents	**63**	(3,275)	3,516
Beginning cash and cash equivalents	**241**	3,516	-
Ending cash and cash equivalents	**$ 304**	$ 241	$ 3,516

NOTE Q – FAIR VALUE INFORMATION

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

Cash and cash equivalents: The carrying amount reported in the balance sheet approximates fair value.

Securities available for sale: Fair values for securities available for sale are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The fair value of restricted equity securities approximates amortized cost.

Loans and loans held for sale, net: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans are estimated using discounted cash flows analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of discount for credit quality concerns.

Accrued interest receivable: The carrying amount reported in the balance sheet approximates fair value.

Off-balance-sheet financial instruments: The estimated fair value of off-balance sheet financial instruments is based on current fees or costs that would be charged to enter or terminate the arrangements. The estimated fair value is not considered to be significant for this presentation.

Deposits: The fair values disclosed for demand deposits (e.g., 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 (i.e., their 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 to a schedule of expected monthly maturities on time deposits.

Federal funds sold and purchased: The carrying amount reported in the balance sheet approximates fair value.

Other borrowings: The fair value of other borrowings is estimated using discounted cash flows analysis based on the Bank's current incremental borrowing rate for similar types of borrowing arrangements.

Subordinated debentures: The carrying amount reported in the balance sheet approximates fair value of the variable-rate subordinated debentures.

Accrued interest payable: The carrying amount reported in the balance sheet approximates fair value.

While these estimates of fair value are based on management's judgment of the most appropriate factors, there is no assurance that if the Company had disposed of such items at December 31, 2006 and 2005, the estimated fair values would have been achieved. Market values may differ depending on various circumstances not taken into consideration in this methodology. The estimated fair values at December 31, 2006 and 2005 should not necessarily be considered to apply at subsequent dates.

In addition, other assets and liabilities that are not defined as financial instruments are not included in the following disclosures, such as property and equipment. Also, non-financial instruments typically not recognized in financial statements may have value but are not included in the following disclosures. These include, among other items, the estimated earnings power of core deposit accounts, the trained work force, customer goodwill and similar items.

NOTE Q – FAIR VALUE INFORMATION (CONTINUED)

The estimated fair values of the Company's financial instruments at year end are as follows (in thousands):

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 9,369	$ 9,369	$ 10,498	$ 10,498
Federal funds sold	10,429	10,429	7,436	7,436
Securities available for sale	36,796	36,796	37,165	37,165
Loans held for sale	-	-	435	435
Loans, net of allowance for loan losses	249,523	248,544	239,547	238,673
Accrued interest receivable	2,506	2,506	2,111	2,111
Financial liabilities:				
Deposits	$ (282,509)	$ (282,115)	$ (268,078)	$ (267,864)
Other borrowings	(7,157)	(6,995)	(12,164)	(11,795)
Subordinated debentures	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	(104)	(104)	(172)	(172)

NOTE R – REGULATORY MATTERS

The Company and Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the consolidated financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If only adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

NOTE R – REGULATORY MATTERS (CONTINUED)

At year end, actual capital levels (in thousands) and minimum required levels were:

	Actual		Minimum Required For Capital Adequacy Purposes		Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
2006						
Total capital (to risk weighted assets)						
Consolidated	**$38,313**	**14.1%**	**$21,673**	**8.0%**	**$27,091**	**10.0%**
Bank	**37,041**	**13.7**	**21,575**	**8.0**	**26,969**	**10.0**
Tier 1 capital (to risk weighted assets)						
Consolidated	**35,011**	**12.9**	**10,836**	**4.0**	**16,255**	**6.0**
Bank	**33,739**	**12.5**	**10,788**	**4.0**	**16,182**	**6.0**
Tier 1 capital (to average assets)						
Consolidated	**35,011**	**10.8**	**13,019**	**4.0**	**16,273**	**5.0**
Bank	**33,739**	**10.4**	**12,979**	**4.0**	**16,224**	**5.0**

	Actual		Minimum Required For Capital Adequacy Purposes		Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2005						
Total capital (to risk weighted assets)						
Consolidated	$35,610	14.2%	$20,061	8.0%	$25,076	10.0%
Bank	34,479	13.9	19,944	8.0	24,930	10.0
Tier 1 capital (to risk weighted assets)						
Consolidated	32,475	13.0	10,031	4.0	15,046	6.0
Bank	31,362	12.6	9,972	4.0	14,958	6.0
Tier 1 capital (to average assets)						
Consolidated	32,475	10.2	12,725	4.0	15,906	5.0
Bank	31,362	9.9	12,669	4.0	15,836	5.0

For both the Company and the Bank, at year-end 2006 and 2005, the most recent regulatory notifications categorized the institutions as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed either institution's category.

NOTE S – QUARTERLY FINANCIAL DATA (UNAUDITED)

	Interest Income	Net Interest Income	Net Income	Earnings Per Share Basic	Earnings Per Share Fully Diluted
2006					
First Quarter	**$ 5,078**	**$ 3,560**	**$ 926**	**$ .52**	**$ .52**
Second Quarter	**5,245**	**3,613**	**1,017**	**.58**	**.57**
Third Quarter	**5,563**	**3,696**	**1,029**	**.58**	**.58**
Fourth Quarter	**5,568**	**3,626**	**1,037**	**.59**	**.59**
2005					
First Quarter	$ 4,331	$ 3,150	$ 873	$ .48	$ .48
Second Quarter	4,602	3,329	966	.54	.54
Third Quarter	4,894	3,450	974	.54	.54
Fourth Quarter	4,981	3,508	989	.57	.56

SOUTHERN MICHIGAN BANCORP, INC.

SELECTED FINANCIAL DATA

	Year Ended December 31				
	2006	2005	2004	2003	2002
Total interest income	**$ 21,454**	$ 18,808	$ 16,638	$ 17,081	$ 18,754
Net interest income	**14,495**	13,437	12,264	11,865	12,307
Provision for loan losses	**500**	750	-	900	2,671
Net income	**4,009**	3,802	3,604	3,263	1,033
Per share data*:					
Basic earnings per share	**2.27**	2.13	1.87	1.68	.52
Diluted earnings per share	**2.26**	2.12	1.86	1.68	.52
Cash dividends	**.78**	.67	.63	.61	.61
Balance sheet data:					
Gross loans	**252,825**	242,714	241,384	233,070	234,166
Deposits	**282,509**	268,078	251,868	254,701	262,349
Other borrowings	**7,157**	12,164	21,903	27,621	22,646
Common stock subject to repurchase	**2,148**	1,911	2,399	1,816	1,618
Equity	**28,482**	26,110	27,465	26,358	24,873
Total assets	**329,891**	317,952	313,458	321,587	320,683
Return on average assets	**1.25%**	1.19%	1.14%	1.02%	.33%
Return on average equity (1)	**14.54**	14.81	13.34	12.69	4.04
Dividend payout ratio (2)	**34.44**	31.69	34.07	36.25	115.68
Average equity to average assets (1)	**8.56**	8.06	8.55	8.05	8.09

* Per share data has been adjusted for a 5% stock dividend declared & paid in February, 2006.

(1) Average equity used in the above table excludes common stock subject to repurchase obligation but includes average unrealized appreciation or depreciation on securities available for sale.

(2) Dividends declared divided by net income.

COMMON STOCK MARKET PRICES AND DIVIDENDS

The Company's common stock is regularly quoted on the OTC Bulletin Board (OTCBB) under the symbol SOMC.OB. The bid prices described below are quotations reflecting inter-dealer prices, without retail markup, markdown or commissions, and may not necessarily represent actual transactions. There were 177 shareholders of record at February 28, 2007.

The following table sets forth the range of high and low bid information and dividends declared for the Company's two most recent fiscal years:

	2006			2005		
	Bid Price		**Cash Dividends**	Bid Price		Cash Dividends
Quarter Ended	**High Bid**	**Low Bid**	**Declared**	High Bid	Low Bid	Declared
March 31	**$ 24.70**	**$ 22.00**	**$ .18**	$ 26.29	$ 24.86	$ .16
June 30	**23.70**	**22.90**	**.20**	25.70	23.81	.17
September 30	**23.90**	**22.95**	**.20**	25.10	23.31	.17
December 31	**24.30**	**23.80**	**.20**	23.52	22.71	.17

There are restrictions that currently limit the Company's ability to pay cash dividends. Information regarding dividend payment restrictions is described in Note O to the consolidated financial statements for the year ended December 31, 2006.

board of Directors

Freeman E. Riddle
Spoor-Parlin, Inc.

Marcia S. Albright
Cequent Electrical Products, Inc.

Brian P. McConnell
Burr Oak Tool & Gauge Company, Inc.

Dean Calhoun
Coldwater Veneer, Inc.

Gary H. Hart
Infinisource, Inc.

John H. Castle
Chairman & CEO of SMB, Inc. and SMB&T

Honorary Directors

William E. (Buzz) Galliers

James T. Grohalski

Harvey Randall

Jane L. Randall

Raymond W. Smith

Jerry L. Towns

Kurt G. Miller
President of SMB, Inc. and SMB&T

Thomas E. Kolassa
HUB International, Inc.

H. Kenneth Cole
Hillsdale College

Gregory J. Hull
Farmer

Donald J. Labrecque
Labrecque Management

Nolan E. (Rick) Hooker
Hooker Oil
Best American Car Washes

SMB, Inc. Officers

John H. Castle
Chairman & Chief Executive Officer

Kurt G. Miller
President

Danice L. Chartrand
Senior Vice President /
Chief Financial Officer

officers of Southern Michigan Bank & Trust

EXECUTIVE

John H. Castle
Chairman /
Chief Executive Officer

Kurt G. Miller
President

Danice L. Chartrand
Senior Vice President /
Chief Financial Officer

Loren V. Happel
First Vice President /
Controller

OPERATIONS

Kelli Talbot
Vice President

Christine Hagaman
Assistant Vice President /
Compliance Officer

Paul Mahle
Assistant Vice President /
Senior Data Processing Officer

INFORMATION SYSTEMS

Jeff Kiersey
Vice President /
Network and Systems Manager

Matt Siefken
Network and Systems Officer

MARKETING

Patty Parker
Vice President

Danice L. Chartrand, Loren V. Happel, Kelli Talbot, Christine Hagaman, Paul Mahle, Jeff Kiersey, Matt Siefken, Patty Parker, David Clow

COMMERCIAL LOANS

David Clow
First Vice President /
Head of Commercial Lending

Joan Trenary
Vice President

Tom Swoish
Vice President

Doug Kiessling
Vice President

Nick Grabowski
Assistant Vice President

Heidi O'Dell
Assistant Vice President

Marcia McClellan
Commercial Loans
Administration Officer

HUMAN RESOURCES

Andrew Karr
Vice President

TRUST DEPARTMENT

Mary Guthrie
First Vice President /
Senior Trust Officer

Jay Carlson
Vice President /
Trust Investment Officer

Susan White
Vice President /
Trust Officer

Joan Trenary, Tom Swoish, Doug Kiessling, Nick Grabowski, Heidi O'Dell, Marcia McClellan, Andrew Karr, Mary Guthrie, Jay Carlson

RETAIL BANKING SERVICES

Rick Feller
First Vice President /
Retail Banking Services and
Branch Administration

Jodie Johnson
Vice President /
Retail Loan Officer

DeAnne Hawley
Assistant Vice President /
Retail Loan Officer

Phyllis Wingate
Assistant Vice President /
Head of Retail Loan Operations

ATHENS BRANCH

Marcia Carman
Branch Manager

BATTLE CREEK BRANCH

Claudia Murch
Assistant Vice President /
Branch Manager

CAMDEN BRANCH

Jody Pope
Branch Supervisor*

COLDWATER MAIN &
EAST CHICAGO BRANCHES

Veronica Hannah
Assistant Vice President /
Branch Manager

Susan White
Rick Feller
Jodie Johnson
DeAnne Hawley
Phyllis Wingate
Marcia Carman
Claudia Murch
Veronica Hannah

HILLSDALE BRANCH

Jason Williams
Vice President /
Commercial Lender

Ann Marie Bentley
Assistant Vice President /
Regional Branch Manager

Shari Kline
Assistant Vice President /
Retail Loan Officer

MARSHALL BRANCH

Annette Campau
Community Bank Officer

Catherine Yates
Vice President /
Commercial Lender

Diane Davis
Retail Loan Officer

NORTH ADAMS BRANCH

Leonce Towers
Branch Supervisor*

TEKONSHA BRANCH

Dawn Copas
Branch Manager

UNION CITY BRANCH

Ken Brooks
Vice President /
Regional Branch Manager

*Non Officer Position

Jason Williams
Ann Marie Bentley
Shari Kline
Annette Campau
Catherine Yates
Diane Davis
Leonce Towers
Dawn Copas
Ken Brooks

shareholder information

Annual Meeting

The annual meeting of Southern Michigan Bancorp, Inc. will be held on April 26, 2007 at 4:00 p.m. at the Dearth Community Center on the Branch County Fairgrounds in Coldwater, Michigan.

Market Information

The Trust Department of Southern Michigan Bank & Trust acts as the transfer agent for the Company's stock. For information concerning the transfer of the Company's stock, call the Trust Department at (517) 279-5503, or call (800) 379-7628.

Market Makers

Ferris, Baker Watts, Inc.
Dublin, Ohio
(614) 718-2224 or
(866) 313-4803

Hilliard Lyons, Inc.
Coldwater, Michigan
(517) 278-4333 or
(800) 211-5257

Howe Barnes Investments, Inc.
Chicago, Illinois
(312) 655-2954 or
(800) 800-4693

Robert Baird & Company
Grand Rapids, Michigan
(616) 459-4491 or
(800) 888-6200

Stifel, Nicolaus & Company, Inc.
Grand Rapids, Michigan
(800) 676-0477

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