Southern Michigan Bancorp, Inc.

2009 Annual Report

Your Community. Your Bank.

Financial Summary

For the Year	2009	2008
Net interest income	$ 16,538,000	$ 17,740,000
Provision for loan losses	2,725,000	5,080,000
Non-interest income	7,172,000	6,363,000
Non-interest expense	18,970,000	18,970,000
Net income	1,936,000	813,000
Per Share		
Basic earnings	$0.84	$0.36
Diluted earnings	0.84	0.36
Cash dividends declared	0.20	0.80
At Year End		
Assets	$ 462,409,000	$ 474,996,000
Gross loans	333,079,000	335,310,000
Allowance for loan loss	6,075,000	7,104,000
Deposits	380,905,000	394,043,000
Other borrowings	10,832,000	12,492,000
Shareholders' equity	45,734,000	44,416,000
Ratios		
Return on average assets	0.41%	0.17%
Return on average equity	4.29%	1.77%
Total risk-based capital ratio	11.91%	10.98%
ALLL as percentage of loans	1.82%	2.12%

Southern Michigan Bancorp, Inc. is a bank holding company. The Company's wholly-owned subsidiary, Southern Michigan Bank & Trust (SMB&T) offers individuals, businesses, institutions and governmental agencies a full range of commercial banking services primarily in the southern Michigan communities in which they are located and in areas immediately surrounding these communities.

To Our Shareholders

Last year at this time our country was in the midst of a severe economic crisis, the likes of which we had not witnessed for at least several decades. The financial services industry was in an equally fragile state as we confronted the effects of rising unemployment, escalating defaults on loan obligations, government bailouts and an uncertain future.

Notwithstanding the particular challenges for restoring Michigan's economic vitality, our nation's overall economic conditions appear to be stabilizing. The financial services industry, slowly and deliberately, is adjusting to the new realities of the distressed balance sheets of commercial borrowers, punitive and costly new regulatory burdens and more restrictive credit and capital markets.

Southern's 2009 financial results

Southern's board and management team established a strategic approach last year that focused on improving operational efficiencies, reducing expenses and identifying selective revenue opportunities. Their efforts and diligence resulted in Southern earning $1,936,000, or $.84 per share for 2009. Our 2009 earnings more than doubled 2008 results of $813,000, or $.36 per share. Net income for the fourth quarter of 2009 totaled $685,000, or $.29 per share, compared with a net loss of $758,000, or $.33 per share for the same period in 2008. Southern's net interest margin, at 4.14 percent for 2009, was exceptional when compared with its peers.

Our successes throughout 2009 were the result of carefully identified and implemented strategies that encompassed:

- a fully phased-in integration of our FNB affiliate bank that eliminated approximately $500,000 of redundant expenses;
- continuation of wage and benefits freezes resulting in a reduction of $780,000, or 7.4 percent, in salaries and benefits costs;
- elimination of $14.2 million of high cost, non-core deposits that enabled Southern to maintain its traditionally strong net interest margin; and
- working with business and individual borrowers to mitigate potential problems, resulting in a reduction of non-performing loans to $7.6 million, or 2.28 percent of loans at year-end 2009, compared with $9.2 million, or 2.73 percent of loans at year-end 2008.

Southern's expense control initiatives offset higher costs associated with managing non-performing assets. Our financial performance throughout 2009 was all the more noteworthy given that FDIC deposit insurance premiums increased $676,000 to $855,000, an increase of 378 percent over 2008 premium costs of $179,000. Banks categorized as "well capitalized", such as Southern, experienced dramatic increases in deposit insurance assessments. In addition, the FDIC required a three year prepayment by Southern of deposit insurance premiums at year end of $2.4 million to cover the costs of bank failures.

Overall asset quality continued to improve throughout 2009. Non-performing loans declined by 17 percent, or $1.6 million, to $7.6 million as of year-end 2009. We added $2,725,000 to the provision for loan losses during the year resulting in a year-end allowance of $6,075,000, or 1.82 percent of loans. Southern's allowance at year-end 2008 was $7,104,000, or 2.12 percent of loans. The reduction was attributable to declines in non-performing loans and to improvements in overall credit quality that enabled decreases in specific reserves.

Marshall Branch
Marshall, Michigan

Coldwater Main Office
Coldwater, Michigan

Consolidated assets as of December 31, 2009 were $462 million compared with $475 million at year-end 2008. For 2009, the return on average assets was .41 percent while return on average equity was 4.29 percent, both of which substantially exceeded last year's totals of .17 percent and 1.77 percent, respectively. Equally important, Southern's Tier 1 Capital Ratio of 10.65 percent and Total Risk-Based Capital Ratio of 11.91 percent at December 31, 2009 far exceeded the minimum thresholds to be categorized as "well-capitalized" under applicable regulations.

Three Rivers Main Office
Three Rivers, Michigan

Where we go from here

The volatility and uncertainty of our economy does not afford us the luxury of planning too far into the future. However, Southern's management team and directors are preparing for the potential impact of inordinately higher federal budget deficits, minimal near-term job growth, changes in banking competition and greater regulatory costs and oversight. Our efforts throughout 2010 will emphasize:

- exploring options to further control expenses and to maximize operational efficiencies;
- leveraging our personalized service capabilities with development of value-added products to meet the financial service needs of underserved individual and business clients; and
- evaluating strategic expansion opportunities that are likely to emerge with additional bank failures and forced consolidations.

Our 2009 Annual Report spotlights Southern's banking relationships with three different clients. Radiology Consultants, PLC is one of our newest banking clients and wanted to refinance their commercial real estate debt which led to additional bank services as well. Crossroads Veterinary Clinic and Dr. Sands have been a part of the Southern banking family for three decades. This relationship is testimony to the importance of trust in the banker-client partnership. Hoffman Ag Service and Duane Hoffman required a bank which understood his business needs and its future; Southern's personalized approach to service delivery was what he was looking for. I invite you to read about how they built their successful businesses and the role Southern played in partnering with them.

I continue to value your confidence, especially during these challenging and unsettling times.

Sincerely,

John H. Castle
Chairman and Chief Executive Officer

“They gave us better rates, a better plan and have been easier to work with. The numbers were there, and this move saved a significant amount of money. Switching was not a hard choice to make.”

—Rocky Baxter,
office manager, Radiology Consultants, PLC

When Radiology Consultants, PLC wanted to refinance the mortgage on their Battle Creek medical building, they didn’t look beyond their own back yard – literally.

That’s where they discovered a branch of Southern Michigan Bank & Trust adjacent to their growing medical practice. The group of seven radiologists and eleven staff members provide a wide variety of radiology services, including CT scans, general diagnostic X-rays, ultrasounds, mammograms, MRIs and related services in partnership with two area hospitals.

When the group wanted to refinance their medical building, their longtime bank was unable to come up with a suitable program.

“But Southern did,” said Rocky Baxter, business manager of Radiology Consultants. “They gave us better rates, a better plan and have been easier to work with. The numbers were there, and this move saved a significant amount of money. Switching was not a hard choice to make.”

Since Radiology Consultants moved their bank relationship in July 2009, Southern has handled all of their business accounts, as well as commercial loans and a new health savings account program. Baxter thinks the practice may be a little high maintenance, but Vice President and Commercial Lender Deb Davis and her team at Southern disagree.

“This is a good situation for both of us; a win-win for the bank and the customer,” said Deb. “We are able to offer competitive terms and make decisions efficiently, in a manner that bigger banks just cannot.” She continued, “We are a Michigan bank. Businesses like this are our bread and butter, and we work hard to treat them right.”

Baxter agrees, saying that someone from the practice is at Southern every day, and that Deb and her team have been “...hands down very responsive.” Whether right next door like Radiology Consultants or across town, customers find they have a good neighbor in Southern Michigan Bank & Trust.

Opposite page:
Deb Davis, vice president/commercial lender, meets with (from left) Dr. Steven Yuill, Dr. James Timmons, Dr. Robert Zick, and Dr. William Coughlin at Radiology Consultants, PLC.

“Hometown community banks are very important. They understand their customers. They understand the business of their customers, and they become friends of yours.”

—William C. Sands, DVM
owner, Crossroads Veterinary Clinic

hen Dr. William Sands built his first veterinary clinic in Three Rivers more than 30 years ago, his father bought him the land and a local community bank financed the building.

Three years ago, when he and his team – two other veterinarians and 10 employees – realized they had outgrown the original clinic, they again wanted to work with their local community bank, Southern Michigan Bank & Trust.

The new Crossroads Veterinary Clinic, which opened its doors in September 2007, is nearly four times the square footage of that original clinic and boasts five exam rooms, an in-house lab and pharmacy area, two surgical suites with a large treatment area, large recovery facility, spacious waiting area and a “comfort room” where clients can sit with pets before they are put to sleep.

Sands is delighted with the new space – and working with Southern to make it a reality.

“Everyone was helpful in getting us going,” he recalled. “They understood where I was coming from, what I was doing, and the loan process was easy.”

That’s just what Robert Hungerford, vice president at Southern likes to hear. He notes that Dr. Sands had a dream and Southern was proud to help turn it into reality.

“Bill had a vision to have a new and updated facility in order to better serve clients in the Three Rivers area,” Hungerford explained. “He looked to us to put it together for him. With that in mind, we got to work. Today, he and his staff enjoy a first-rate facility that provides high quality veterinary care to area families.”

Sands also relies on Southern for a revolving line of credit, cash management services and checking and savings accounts. He appreciates the ease of online banking, saying that he is “constantly” online transferring money, paying bills, or otherwise managing business accounts.

“Hometown community banks are very important,” he said. “They understand their customers. They understand the business of their customers, and they become friends of yours. They are people you know and they know you – and they know they can trust you and you can trust them. That relationship is critical.”

Opposite page:
Robert Hungerford, vice president / commercial lender and Sally Cotton, first vice president / senior branch administration officer meet with Dr. Sands (center) at Crossroads Veterinary Clinic.

“Agriculture is cyclical...Farmers make a big investment in the spring, but don’t get paid until fall, so there’s a lot riding on the table and a lot at risk. Being able to work with someone like Doug who has that background makes it so much easier.”

—Duane Hoffman
vice president, Hoffman Ag Service, Ltd.

Hoffman Ag Service, Ltd. supplies area farmers with seed, fertilizer and chemicals and operates an elevator, providing a market for delivery and sale of grain for local producers.

A third-generation agribusinessman, Duane Hoffman knows that agriculture is fundamentally different than most businesses. Banks know it, too.

That’s why when it came time for Hoffman Ag Service to invest in a new seed warehouse, they turned to Southern Michigan Bank & Trust and Doug Kiessling, vice president and a farmer himself.

“Agriculture is cyclical,” noted Hoffman, who began his banking relationship with Southern in 2008. “Farmers make a big investment in the spring, but don’t get paid until fall, so there is a lot riding on the table and a lot at risk. Being able to work with someone like Doug who has that background makes it so much easier.”

The result has been a new, 9,000-square foot seed warehouse that allows the company to add new capabilities and services for customers, including seed treatment areas. The new facility, which opened last year, features five bulk bins where the company can store different varieties of bulk seed.

“It was a pretty big capital investment for us,” Hoffman said. “It’s our second spring and we love it.”

And Kiessling certainly understands how he feels. A self-proclaimed farm boy at heart, he is pleased to be involved in agriculture through the lending side. He has known Duane and his father, Vaughn, all his life and, as a farmer, brings a thorough understanding of the industry to the table.

“Agricultural lending has been a very important part of Southern’s loan portfolio for years,” Kiessling said. “We have provided credit to local agribusinesses and farmers for over a century, even when many commercial banks would not.”

Kiessling noted, “at Southern we have experts who understand how it’s done. We are proud to be an integral part of agriculture in Southwest Michigan.”

Opposite page:
Doug Kiessling, vice president / commercial lender (on right) meets with Duane Hoffman and tours the facilities at Hoffman Ag Service with Duane and his father, Vaughn Hoffman.


USC LLC
LP2000

Cassopolis Branch
Cassopolis, Michigan

Battle Creek Branch
Battle Creek, Michigan

Southern Michigan Bancorp, Inc. Board of Directors

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Cequent Electrical Products, Inc.

Dean Calhoun
Coldwater Veneer, Inc.

John S. Carton
Retired Business Executive

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Chairman & CEO of SMB, Inc. and SMB&T

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Robert L. Hance
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Nolan E. (Rick) Hooker
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Thomas D. Meyer
Meyer Ventures, LLC

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

Freeman E. Riddle
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Chairman & Chief Executive Officer

Kurt G. Miller
President

Danice L. Chartrand
Senior Vice President /
Chief Financial Officer

Executive Officers of Southern Michigan Bank & Trust

John H. Castle
Chairman & Chief Executive Officer

Kurt G. Miller
President

Danice L. Chartrand
Senior Vice President /
Chief Financial Officer

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Sarah Headley
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Jason Williams
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Cindy Woolner
Assistant Vice President /
Special Assets Manager

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Senior Vice President /
Head of Residential
& Consumer Lending

Rick Feller
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Phyllis Wingate
Vice President / Head of Retail
Loan Operations

DeAnne Hawley
Assistant Vice President /
Retail Loan Officer

Shari Kline
Assistant Vice President /
Retail Loan Officer

Diane Krimmel
Retail Loan Officer

Judie Ratering
Mortgage Officer

Desiree Kauffman
Mortgage Originator*

Connie Swain
Collections Manager*

Debbie Leer
Collections Officer

LOAN REVIEW

Trisha Pawloski
Assistant Vice President/
Loan Review Officer

TRUST DEPARTMENT

Mary Guthrie
Senior Vice President /
Senior Trust Officer

David Rumsey
Vice President /
Senior Investment Officer

Jean Winans
Vice President /
Senior Trust Officer

Susan White
Vice President /
Trust Officer

INVESTMENTS

Melissa Barlow
Vice President/
Senior Investment Officer

Jared Hoffmaster
Investment Sales Officer

RETAIL BANKING SERVICES

Sally Cotton
First Vice President /
Senior Branch Administration Officer

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Marcia Carman
Branch Manager

BATTLE CREEK BRANCH

Claudia Murch
Assistant Vice President /
Branch Manager

CAMDEN BRANCH

Lori Neill
Branch Supervisor*

COLDWATER MAIN & EAST CHICAGO BRANCHES

Veronica Hannah
Assistant Vice President /
Branch Manager

CASSOPOLIS BRANCH

Janet Nosich
Branch Manager

CENTREVILLE BRANCH

Paul Harker
Branch Manager

CONSTANTINE BRANCH

Lorraine Fifer
Branch Manager

HILLSDALE BRANCH

Ann Marie Bentley
Assistant Vice President/
Regional Branch Manager

MARSHALL BRANCH

Annette Campau
Assistant Vice President /
Community Bank Officer

MENDON BRANCH

Doreen Tobin
Assistant Vice President /
Regional Branch Manager

NORTH ADAMS BRANCH

Leonce Towers
Branch Supervisor*

TEKONSHA BRANCH

Dawn Copas
Branch Manager

THREE RIVERS MAIN BRANCH

Sharon Bachinski
Assistant Vice President /
Regional Branch Manager

THREE RIVERS WESTLAND BRANCH

Lynette Lorenz
Branch Manager

UNION CITY BRANCH

Ken Brooks
Vice President /
Regional Branch Manager

ACCOUNTING

Sara Herrmann
Vice President / Finance

INFORMATION SYSTEMS

Jeff Kiersey
First Vice President /
Network and Systems Manager

Matt Siefken
Network and Systems Officer

OPERATIONS

Kelli Talbot
First Vice President Operations

Christine Hagaman
Vice President /
Compliance Officer

Paul Mahle
Assistant Vice President/
Senior Data Processing Officer

Vikki Kline
Information Systems Officer

Jamie Tobalske
Electronic Services Officer

MARKETING

Patty Parker
Vice President

*Non Officer Position

Shareholder Information

Annual Meeting

The annual meeting of Southern Michigan Bancorp, Inc. will be held on May 13, 2010 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 and dividend paying agent for the Company's stock. For information concerning the Company's stock, call the Trust Department at (517) 279-5503 or (800) 379-7628.

Market Makers

Boenning & Scattergood
Powell, Ohio
(866) 326-8113

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

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

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

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

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Forward Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Southern Michigan Bancorp, Inc. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, statements related to real estate valuation, future levels of non-performing loans, the rate of asset dispositions, dividends, future growth and funding sources, future profitability levels, the effects on earnings of changes in interest rates and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including goodwill, mortgage servicing rights and deferred tax assets) and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Management's assumptions regarding pension and other post retirement plans involve judgments that are inherently forward-looking. Our ability to successfully implement new programs and initiatives, increase efficiencies, respond to declines in collateral values and credit quality, and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Southern Michigan Bancorp, Inc., specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") 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. Southern Michigan Bancorp, Inc. does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in Item 1A of Southern's Annual Report on Form 10-K for the year ending December 31, 2009 filed with the Securities Exchange Commission on March 26, 2010; the timing and level of asset growth; changes in market interest rates; changes in banking laws and regulations; changes in tax laws; changes in prices, levies and assessments; the impact of technological advances and issues; governmental and regulatory policy changes; opportunities for acquisitions and the effective completion of acquisitions and integration of acquired entities; the possibility that anticipated cost savings and revenue enhancements from acquisitions, restructurings, reorganizations and bank consolidations may not be realized at amounts projected, at all or within expected time frames; the local and global effects of the ongoing war on terrorism and other military actions; changes in value and credit quality of investment securities; and current uncertainties and fluctuations in the financial markets and stocks of financial services providers due to concerns about credit availability and concerns about the Michigan economy in particular. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement. We undertake no obligation to update or revise our forward-looking statements to reflect developments that occur or information obtained after the date of this report.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion is designed to provide a review of the consolidated financial condition and results of operations of Southern Michigan Bancorp, Inc. ("Southern") and its wholly owned subsidiary, Southern Michigan Bank & Trust ("SMB&T"). This discussion should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements.

Economic Trends

The global and U.S. economies are experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system during the past two years. Dramatic declines in the housing market during this time, along with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of residential-related loans and mortgage-backed securities, but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets, many national and regional lenders have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. The availability of credit, confidence in the financial sector, and level of volatility in the financial markets have been significantly adversely affected as a result.

Market Developments

Substantially all of the deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund ("DIF") of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a matrix that takes into account a bank's capital level and supervisory rating.

On February 27, 2009, the FDIC adopted a final rule modifying the risk-based assessment system and setting initial base assessment rates beginning April 1, 2009, at 12 to 45 basis points; and due to extraordinary circumstances, extended the time within which the reserve ratio must be returned to 1.15 percent from five to seven years. On May 22, 2009, the FDIC adopted a final rule imposing a 5 basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009. The Bank incurred expenses of $217,000 as a result of the special assessment in the second quarter of 2009.

On November 12, 2009, the FDIC amended its regulations requiring certain insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. The prepaid assessment for these periods was collected on December 30, 2009, along with each institution's regular quarterly risk-based deposit insurance assessment for the third quarter of 2009. The total amount of FDIC prepayments for the Bank was $2.4 million. The prepayment relating to 2010 – 2012 has been treated as a prepaid expense on the books of SMB&T, and will be recognized as expense in the period for which the assessments are effective.

Results of Operations

Southern's net income for 2009 was $1,936,000 compared to $813,000 in 2008, an increase of $1,123,000, or 138.1%. Provision for loan losses in the amount of $2,725,000 was expensed in 2009; down from $5,080,000 in 2008. Non-interest income of Southern, increased 12.7% to $7,172,000 in 2009. Non-interest expense of $18,970,000 in 2009 was equal to the 2008 expense.

	Percent Change from Prior Year	
	2009	**2008**
Net interest income	-6.78%	19.01%
Provision for loan losses	-46.36%	581.88%
Non-interest income	12.71%	53.66%
Non-interest expense	0.00%	48.98%
Net income	138.13%	-80.33%

	Percent Change from Prior Year	
	2009	**2008**
Assets	-2.65%	-1.08%
Securities available for sale	-13.34%	-15.22%
Gross loans	-0.67%	-0.20%
Allowance for loan losses	-14.48%	37.78%
Deposits	-3.33%	-1.28%
Other borrowings	-13.29%	-15.33%
Shareholders' equity	2.97%	0.45%

Results of operations can be measured by various ratio analyses. Two widely recognized performance indicators are return on average equity and return on average assets. Southern’s return on average equity was 4.29% in 2009, 1.77% in 2008 and 12.72% in 2007. The return on average assets was 0.41 % in 2009, 0.17% in 2008 and 1.18% in 2007.

Acquisition of FNB Financial Corporation and Consolidation of Banks

On December 1, 2007, Southern acquired FNB Financial Corporation. The 2009 and 2008 results of operations include twelve months of combined financial results. The 2007 results of operations include one month of combined financial results after completion of the acquisition. The 2009 and 2008 year end balance sheets include all of the assets acquired and liabilities assumed from FNB Financial Corporation. Therefore, a comparison of 2008 to 2007 results of operations is materially affected as a result of the acquisition. For more detailed information concerning the acquisition, see Note C to the consolidated financial statements.

In April 2009, FNB Financial (formerly, The First National Bank of Three Rivers) was consolidated with and into SMB&T.

Net Interest Income

Interest income is the total amount earned on funds invested in loans, investment securities and federal funds sold. Interest expense is the amount of interest paid on interest bearing checking and savings accounts, time deposits, short term advances, subordinated debentures and other long-term borrowings. Net interest income, on a fully taxable equivalent (FTE) basis, is the difference between interest income and interest expense adjusted for the tax benefit received on tax-exempt loan and investment securities. Net interest margin is calculated by dividing net interest income (FTE) by average interest earning assets. Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Because non-interest bearing sources of funds also support earning assets, the net interest margin exceeds the net interest spread.

The presentation of net interest income on a FTE basis is not in accordance with GAAP but is customary in the banking industry. This non-GAAP measure ensures comparability of net interest income arising from both taxable and tax-exempt loans and investment securities. The adjustments to determine tax equivalent net interest income are itemized in Table 1 below.

Net interest income is the most important source of Southern’s earnings. Changes in Southern’s net interest income are influenced by a number of factors, including changes in the level of interest earning assets, changes in the mix of interest earning assets and interest bearing liabilities, the level and direction of interest rates and the steepness of the yield curve.

For 2009, Southern's net interest margin (FTE) was 4.14% compared to 4.36% for 2008 and 4.83% for 2007. Beginning with a 50 basis point drop in September 2007, the Federal Reserve began a campaign of decreasing overnight borrowing rates to stimulate the economy. Through December 2008, the Federal Reserve had decreased the overnight borrowing rate 5%, to its lowest level of all time, a range of 0% to .25%. For the entire year of 2009, these rate decreases impacted Southern's net interest margin. Southern's interest rate spread and margin both further decreased as yields on earning assets decreased 0.86%, from 6.31% to 5.45%, while deposit yields were down 0.71%, from 2.20% to 1.49%.

In 2009, the lower interest margin resulted in $1,256,000 less net interest income than in 2008. The 2009 decrease was a result of lower rates being in effect for the entire year and reduced balances in loans and investment securities. Despite the lower net interest margin in 2008 and 2007, net interest income increased during both years by $3,055,000 and $508,000, respectively. The increase in both years primarily resulted from the acquisition of FNB.

The 2008 increase was a result of $2,606,000 improvement in interest income and $449,000 reduction of interest expense. The increase in interest income was the result of $104.1 million of additional average earning assets, primarily from FNB, which was enough to overcome the rate decrease. Despite adding $103.6 million of average interest bearing deposits, primarily from FNB, interest expense decreased $449,000 in 2008 as Southern closely monitored deposit rates.

The following table presents a summary of net interest income (FTE) for 2009, 2008 and 2007.

Table 1. Average Balances and Tax Equivalent Interest Rates

(Dollars in Thousands)	2009			2008			2007		
	Average Balance	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**
ASSETS									
Interest earning assets:									
Loans(1)(2)(3)	$ 333,397	$ 19,966	5.99%	$ 334,873	$ 22,665	6.77%	$ 259,811	$ 20,824	8.02%
Taxable investment securities(4)	38,329	1,134	2.96	44,341	2,100	4.74	31,586	1,648	5.22
Tax-exempt investment securities(1)	23,044	1,338	5.81	24,272	1,429	5.89	16,189	982	6.07
Federal funds sold and other(5)	18,487	69	0.37	17,624	358	2.03	9,419	492	5.22
Total interest earning assets	413,257	22,507	5.45	421,110	26,552	6.31	317,005	23,946	7.55
Non-interest earning assets:									
Cash and due from banks	11,059			13,795			8,940		
Other assets(6)	49,505			49,797			28,156		
Less allowance for loan losses	(6,548)			(5,339)			(3,474)		
Total assets	$ 467,273			$ 479,363			$ 350,627		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Demand deposits	$ 142,931	$ 612	0.43%	$ 159,576	$ 2,072	1.30%	$ 119,118	$ 3,106	2.61%
Savings deposits	51,450	108	0.21	54,480	375	0.69	31,874	188	0.59
Time deposits	135,781	3,952	2.91	129,358	4,546	3.51	103,819	4,464	4.30
Securities sold under agreements to repurchase and overnight borrowings	14,899	41	0.28	10,423	156	1.50	3,235	114	3.52
Other borrowings	12,284	490	3.99	13,138	721	5.49	5,340	362	6.78
Subordinated debentures	5,155	197	3.82	5,155	319	6.19	5,155	404	7.84
Total interest bearing liabilities	362,500	5,400	1.49	372,130	8,189	2.20	268,541	8,638	3.22
Non-interest bearing liabilities:									
Demand deposits	55,934			55,557			42,618		
Other	2,852			4,343			4,887		
Common stock subject to repurchase obligation	836			1,379			2,089		
Shareholders' equity	45,151			45,954			32,492		
Total liabilities and shareholders' equity	$ 467,273			$ 479,363			$ 350,627		
Net interest income		$ 17,107			$ 18,363			$ 15,308	
Interest rate spread			3.96%			4.11%			4.33%
Net margin on interest earning assets			4.14%			4.36%			4.83%

(1) Includes tax equivalent adjustment of interest (assuming a 34% tax rate) for securities and loans of $455,000 and $114,000, respectively for 2009; $486,000 and $137,000, respectively for 2008; and $334,000 and $68,000, respectively for 2007.
(2) Average balance includes average nonaccrual loan balances of $8,135,000 in 2009; $7,946,000 in 2008; and $3,373,000 in 2007.
(3) Interest income includes loan fees of $365,000 in 2009; $602,000 in 2008; and $353,000 in 2007.
(4) Average balance includes average unrealized gain of $976,000 in 2009; $684,000 in 2008; and $14,000 in 2007 on available for sale securities.
(5) Includes $15,771,000 in 2009 of federal reserve deposit accounts.
(6) Includes $15,967,000 in 2009 and $16,333,000 in 2008 relating to goodwill and other intangible assets.
(7) Amounts in 2007 include FNB for month of December.

The next table sets forth for the periods indicated a summary of changes in interest income and interest expense, based upon a tax equivalent basis, resulting from changes in volume and changes in rates:

Volume Variance – change in volume multiplied by the previous year's rate.

Rate Variance – change in rate multiplied by the previous year's volume.

Rate/Volume Variance – change in volume multiplied by the change in rate. This variance was allocated to volume variance and rate variance in proportion to the relationship of the absolute dollar amount of the change in each.

Table 2. Changes in Tax Equivalent Net Interest Income

(Dollars in Thousands)

	2009 Compared to 2008 Increase (Decrease) Due To			**2008 Compared to 2007 Increase (Decrease) Due To**		
Interest income on:	**Rate**	**Volume**	**Net**	**Rate**	**Volume**	**Net**
Loans	$ (2,600)	$ (99)	$ (2,699)	$ (3,567)	$ 5,408	$ 1,841
Taxable investment securities	(710)	(256)	(966)	(164)	616	452
Tax-exempt investment securities	(19)	(72)	(91)	(30)	477	447
Federal funds sold and other	(306)	17	(289)	(409)	275	(134)
Total interest earning assets	$ (3,635)	$ (410)	$ (4,045)	$ (4,170)	$ 6,776	$ 2,606
Interest expense on:						
Demand deposits	$ (1,263)	$ (197)	$ (1,460)	$ (1,875)	$ 841	$ (1,034)
Savings deposits	(247)	(20)	(267)	36	151	187
Time deposits	(811)	217	(594)	(901)	983	82
Securities sold under agreements to repurchase and overnight borrowings	(163)	48	(115)	(96)	138	42
Other borrowings	(187)	(44)	(231)	(81)	440	359
Subordinated debentures	(122)	-	(122)	(85)	-	(85)
Total interest bearing liabilities	$ (2,793)	$ 4	$ (2,789)	$ (3,002)	$ 2,553	$ (449)
Net interest income	$ (842)	$ (414)	$ (1,256)	$ (1,168)	$ 4,223	$ 3,055

Provision 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 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 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 $2,725,000 in 2009, compared to $5,080,000 in 2008 and $745,000 in 2007. The 2009 provision for loan losses was lower than the 2008 provision due primarily to reduced specific reserves required in 2009 as a result of the level of charge-offs in 2009 and a reduction in nonperforming loans at December 31, 2009.

During 2009, real estate mortgage net charge-offs increased $1,360,000 to $2,058,000, or 196.0%, over 2008 levels. In 2008, the increase was 554.7%, or $588,000, over 2007 levels. Prior to the current economic difficulties faced in Michigan, as well as around the country, losses on residential real estate were less frequent. Depressed real estate values have significantly impacted loss levels.

During 2008, the provision was increased to account for higher specific reserves and increased charge-offs. In July 2008, a change in management at FNB occurred. New management rehired a special assets manager and began re-analyzing potential problem credits in the portfolio. As of December 31, 2008, specific reserves totaling $3,308,000 were identified. In addition, during the fourth quarter of 2008, a large commercial credit was charged-off. The results of these actions were a fourth quarter provision for loan losses of $2,350,000.

In 2007, the provision for loan losses reflected net charge-off experience, the growth of the commercial portfolio and the continued decline in the Michigan economy and the local real estate market. Net charge-offs were $349,000 for 2007. Commercial loans increased $52 million in 2007 with approximately $43 million coming from the FNB acquisition.

Non-Interest Income

Non-interest income increased $809,000, or 12.7%, in 2009 and $2,222,000, or 53.7%, in 2008. The 2009 increase was primarily a result of $682,000 of net securities gains being recorded during the year compared to $15,000 in 2008. The 2008 increase was due to the acquisition of FNB, which provided $2,255,000 of non-interest income in 2008.

In order to reduce the risk associated with changing interest rates, Southern regularly sells fixed rate real estate mortgage loans in the secondary market. Southern recognizes a profit at the time of the sale. Southern originated real estate mortgage loans of $41,586,000 in 2009 compared to $17,455,000 in 2008 and $17,015,000 during 2007. Net gains on loan sales increased $420,000 in 2009 as early in the year rates moved lower causing an increase in refinancing. Net gains on loan sales decreased $54,000 in 2008 as residential mortgage refinancing activity declined as rates moved up from 2004 historic lows.

Net securities gains of $682,000, $15,000 and $13,000 were recognized in 2009, 2008 and 2007, respectively. During 2009, Southern sold $26.4 million of securities which significantly reduced the level of mortgage-backed securities it held.

Trust fees were down 9.4%, or $103,000, in 2009 compared to the 2008. This decline in income reflected a decline in market value of assets managed despite an increase in new accounts. Trust fees increased in 2008 compared to 2007, primarily due to the FNB acquisition.

In 2008, Southern recorded a $390,000 gain from life insurance proceeds.

Non-Interest Expense

Non-interest expenses were flat in 2009 and increased $6,237,000, or 49.0%, in 2008.

Salaries and employee benefits expense decreased $780,000, or 7.4%, comparing 2009 to 2008 and increased $2,930,000 or 38.3% comparing 2008 to 2007. Southern has been able to reduce staff in 2009 through attrition and has reduced contributions to the 401(k) plan. At December 31, 2009, Southern had 196 full-time equivalent positions compared to 202 at December 31, 2008. Effective December 31, 2009, The Southern Michigan Bank & Trust Pension Plan was fully frozen. The plan was partially frozen in 2006 for participants who did not meet certain age and years of service requirements. Participants who met the age and years of service requirements continued accruing benefits until the plan was fully frozen in 2009. 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 2008 increase in salaries and employee benefits was mainly attributable to a larger workforce following the FNB acquisition. The FNB acquisition added 60 full time equivalent employees in December 2007, which added $247,000 of salaries and benefits expense.

Equipment expense decreased $317,000 in 2009 compared to 2008. Depreciation expense declined in 2009 compared to 2008 as certain assets became fully depreciated. Occupancy expense and equipment expense in 2008 increased $429,000 and $395,000, respectively, over 2007. The increases were primarily due to the increase in number of locations following the acquisition of FNB.

Printing, postage and supplies decreased $44,000 in 2009 compared to 2008. These costs increased in 2008 over 2007 resulting from the FNB acquisition.

Professional and outside services decreased $221,000 in 2009 over 2008 and increased $828,000 in 2008 over 2007. The decrease in 2009 resulted from Southern being able to reduce fees paid for outside consulting relating to system conversions. $618,000 of the 2008 increase related to FNB activity. The remaining 2008 increase primarily reflected increases in auditing and legal fees relating to being an SEC reporting company.

Amortization of intangibles was flat in 2009, but increased $343,000 in 2008 compared to 2007 due to amortization of the core deposit intangible asset from the FNB acquisition.

ATM expense increased $224,000 in 2009 and $145,000 in 2008. The 2009 increase was a result of conversion costs incurred relating to converting FNB and SMB&T ATM processing to a common system.

FDIC insurance expense increased $676,000, or 377.7%, in 2009 as a result of increased premiums. 2009 was also impacted by a second quarter special assessment against all FDIC insured depository institutions and the elimination of credits at the end of 2008. The 2008 increase was due to the FNB acquisition.

Other real estate owned expense and loss on other real estate owned both increased in 2008 and 2009. The 2008 increase is due partially to the acquisition of FNB, but also, as with the 2009 increase, due to the depressed real estate market which has resulted in a significant increase in the number of properties held by Southern.

Income Taxes

Income taxes were an expense of $79,000 in 2009, a credit of $760,000 in 2008, and an expense of $1,436,000 in 2007. Because of the significant decline in 2008 income before income taxes, a federal income tax credit resulted for 2008 after consideration of tax-exempt interest income, non-taxable life insurance income and other normal tax reconciling items. Tax-exempt income continues to have a major impact on Southern'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 $351,000 in 2009, $363,000 in 2008, and $234,000 in 2007.

The information under Note L to the consolidated financial statements is here incorporated by reference.

Financial Condition

Total assets at December 31, 2009 totaled $462,409,000, a decrease of $12,587,000, or 2.6%, from December 31, 2008. Cash and cash equivalents decreased $3,175,000 and investments decreased $8,770,000 compared to December 31, 2008, due to $14.2 million of non-core deposits being eliminated from the balance sheet in the first quarter of 2009.

Cash and Cash Equivalents

Cash and cash equivalents decreased $3,175,000, or 11.3%, over the 2008 balances. At December 31, 2009, Southern had balances of $11,961,000 with the Federal Reserve, compared to $16,165,000 at December 31, 2008. During 2008, the Federal Reserve began paying banks interest on balances maintained at the Federal Reserve. At December 31, 2009 and 2008, the interest rate paid by the Federal Reserve exceeded the overnight federal funds rate paid by Southern's primary correspondent bank.

Securities Available for Sale

The securities available for sale portfolio decreased by $8,770,000, or 13.3%, from December 31, 2008 to December 31, 2009. Southern sold $26.4 million of securities in 2009 reducing the level of mortgage backed securities held. In addition, $37.7 million of securities were called or matured in 2009. The portfolio is monitored and securities or federal funds are purchased as deemed prudent by the Asset Liability Management Committee (ALCO). Southern elected not to replace some maturing investments to meet liquidity needs.

The securities available for sale portfolio decreased by $11,797,000, or 15.2%, from December 31, 2007 to December 31, 2008. Approximately $76 million of securities matured or were called in 2008 as compared to $31 million in 2007.

The securities available for sale portfolio had net unrealized gains of $635,000 at December 31, 2009 and $997,000 at December 31, 2008. Management has concluded that unrealized gains and losses within the investment portfolio are temporary because management believes they are a result of market changes, rather than a reflection of credit quality.

Loans

Substantially all loans are granted to customers located in Southern's service area, which is primarily southern Michigan (excluding southeast Michigan). Gross loans decreased by $2,231,000, or 0.7%, and $668,000, or 0.2%, in 2009 and 2008, respectively. The decreases resulted from net charge offs and payments received on loans exceeding the new loan volume as Southern is actively controlling growth during the current difficult economic times.

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 $59,823,000 and $69,271,000 at December 31, 2009 and 2008, respectively. A high percentage of these commitments are priced at a variable interest rate, thus minimizing Southern's risk in a changing interest rate environment.

Nonperforming Assets

Nonperforming assets include nonaccrual loans, accruing loans past due 90 days or more, and other real estate owned, which includes real estate acquired through 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 2009	2008	2007
	(Dollars in thousands)		
Nonaccrual loans:			
Commercial, financial and agricultural	$ 5,576	$ 5,512	$ 3,032
Real estate mortgage	1,933	3,178	1,342
Installment	76	25	31
	7,585	8,715	4,405
Loans contractually past due 90 days or more and still on accrual:			
Commercial, financial and agricultural	14	353	411
Real estate mortgage	-	75	-
Installment	-	9	18
	14	437	429
Total nonperforming loans	7,599	9,152	4,834
Other real estate owned	1,187	1,119	866
Total nonperforming assets	$ 8,786	$ 10,271	$ 5,700
Nonperforming loans to year-end loans	2.28%	2.73%	1.44%
Nonperforming assets to total assets	1.90%	2.16%	1.19%

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated for in the allowance for loan losses where appropriate. The decrease in nonperforming loans from December 31, 2008 to December 31 2009 was primarily a reflection of loans being transferred to foreclosed assets or charged-off. At December 31, 2009, 2008 and 2007, Southern had loans of $11,135,000, $15,257,000 and $9,144,000, respectively, which were considered impaired.

Holdings of other real estate owned at December 31, 2009 increased by $68,000 since the end of 2008. Other real estate owned includes properties that were acquired through foreclosure or by deed in lieu of foreclosure. The properties include residential homes and lots and commercial properties. During 2009 and 2008, $3,197,000 and $1,987,000, respectively, was transferred from loans to foreclosed assets. The increase in other real estate owned reflects the increased level of foreclosure activity due to the poor economic conditions in Michigan.

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: Accounting Standards Codification (ASC) 450-10, "Accounting for Contingencies" and ASC 310-10, "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 historical loss experience for each loan category. The component may be adjusted for significant factors that, in management's judgment, 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. As of December 31, 2009, specific reserves totaled $1,550,000 compared to $3,308,000 at December 31, 2008, a decrease of 53.1%.

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 lending personnel.

The allowance for loan losses was $6,075,000 or 1.82% of loans at December 31, 2009 compared to $7,104,000 or 2.12% of loans at December 31, 2008.

The allowance for loan losses at December 31, 2009 consisted of $2,916,000 from the historical loss experience component and specifically allocated reserves, leaving $3,159,000 from the other factors. This compares to $4,800,000 from the historical loss experience component and specifically allocated reserves and $2,304,000 from other factors at December 31, 2008.

At December 31, 2009, management was not aware of any problem loan that would have a material effect on loan delinquency or loan charge-offs. Loans are subject to continual review and are given management's attention whenever a problem situation appears to be developing.

The allowance is maintained at a level, which in management's judgment is believed 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 the allowance may be necessary due to economic, operating or regulatory conditions beyond Southern's control.

Deposits

Deposits have traditionally represented Southern's principal source of funds. Total deposits decreased 3.3%, or $13,138,000, in 2009 and decreased 1.3%, or $5,126,000, in 2008. The 2009 decrease included one non-core deposit relationship, totaling $14.2 million, which was eliminated during the first quarter of 2009. The majority of deposits are derived from core client sources, relating to long term relationships with local personnel, business and public clients. A small amount of brokered deposits, $10.6 million at December 31, 2009, are maintained, but are not used to support growth. Attracting and keeping traditional deposit relationships will continue to be a focus of Southern.

Subordinated Debentures

In March 2004, Southern Michigan Bancorp Capital Trust I, a Delaware statutory trust formed by Southern, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of $1,000 per security. Southern issued $5,155,000 of subordinated debentures to the trust in exchange for ownership of all of the common securities of the trust and the proceeds of the preferred securities sold by the trust. Southern may redeem the subordinated debentures, in whole or in part, in a principal amount with integral multiples of $1,000 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. Southern has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed five consecutive years. Southern's investment in the common stock of the trust was $155,000 and is included in other assets.

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, 2009 was 3.03%.

Capital Resources

Southern obtains funds for operating expenses and dividends to shareholders through dividends from the Bank. In general, the Bank pays only those amounts required to meet the liquidity requirements of Southern, while maintaining appropriate capital levels at the Bank. Capital is maintained at the Bank to support its current operations and projected future growth. See additional discussion under the section titled "Liquidity."

Shareholders' equity increased $1,318,000, or 3.0%, from December 31, 2008 to December 31, 2009. It was relatively flat at $44,416,000 at December 31, 2008 compared to $44,219,000 at December 31, 2007. The increase in 2009 was primarily attributable to 2009 net income offset by dividends to shareholders.

The Federal Reserve Board (FRB) has imposed risk-based capital guidelines applicable to Southern. These guidelines require that banks and bank holding companies maintain capital levels 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 percent 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 total 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 the requirements of ASC 320-10 should not be included in Tier 1 capital. As such, the net unrealized gain or loss on available for sale securities is not included in the ratios listed in Note V to the consolidated financial statements. The ratios include the common stock subject to repurchase obligation in Southern's employee stock ownership plan (ESOP). As discussed in Note V, Southern and SMB&T both exceeded the minimum requirements to be categorized as "well capitalized" at December 31, 2009. The information in Note V to the consolidated financial statements is here incorporated by reference.

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. Southern 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. Liquidity is monitored and closely managed by the Asset/Liability Management Committee (ALCO), whose members are comprised of senior management.

Historically, Southern has maintained correspondent accounts with regional and national 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, Southern is a participant in the federal funds market. Federal funds are generally borrowed or sold for one-day periods. During 2009 and 2008, federal funds were sold with an average balance of $2,716,000 and $17,624,000, respectively. During 2009, Southern also averaged $15,771,000 on deposit at the Federal Reserve.

In the past, Southern has used overnight federal funds lines of credit with correspondent banks as a short term source of liquidity. The recent events within the financial industry have caused correspondent banks to eliminate these lines of credit that were previously available to Southern. As a result, in an effort to ensure adequate liquidity, collateral is pledged at the Federal Reserve Bank “Discount Window.” At December 31, 2009, $5 million of securities were pledged that could be used for future borrowings. In addition, Southern has $3.2 million of securities which are available to be pledged for future borrowings. Southern also has the ability to borrow $33.6 million from the Federal Home Loan Bank based on FHLB stock owned and collateral pledged.

Southern’s principal source of funds to pay cash dividends is the earnings and dividends paid by SMB&T, which are restricted under current banking laws and regulations. Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law limit the amount of cash dividends the Bank can pay to Southern. At January 1, 2010, using the most restrictive of these conditions, SMB&T can pay Southern $3.7 million in aggregate dividends without prior regulatory approval.

The information in Note I of the consolidated financial statements is here incorporated by reference.

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.

Commitments and Off-Balance Sheet Risk

Southern 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, Southern 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. Because 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, 2009, Southern had commitments of $59,823,000 for lines of credit, $1,457,000 in standby letters of credit and no commitments under commercial letters of credit outstanding.

These arrangements have credit risk essentially the same as that involved in extending loans to customers and are subject to Southern'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.

Interest Rate Sensitivity

Net interest income is the largest component of Southern'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 Southern's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to Southern'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. With the current Federal Reserve target rate at 0% - .25%, no further decrease in rates was modeled at December 31, 2009. Assumptions in the simulation are based on management's 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. The income simulation indicated if rates increased one percent, net interest income would decrease \$176,000, or -1.05%, if rates increased two percent, net interest income would decrease \$133,000, or -0.79% and if rates increased three percent, net interest income would increase \$162,000, or 0.96%.

The market value of equity analysis estimates the change in the market value of equity using interest rate change scenarios from +3% to –3% in 1% increments. As with the income simulation analysis, no further rate reductions were assumed as of December 31, 2009. The following table illustrates the percent change in equity based on changes in market interest rates:

	change in market value of equity
3% increase in market rates	11.45%
2% increase in market rates	7.79%
1% increase in market rates	3.99%
No change	0.00%
1% decrease in market rates	NA%
2% decrease in market rates	NA%
3% decrease in market rates	NA%

The results of the simulations at December 31, 2009 are within the guidelines set and approved by Southern's Board of Directors.

Critical Accounting Policies

The discussion and analysis of the financial condition and results of operations are based upon Southern's 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 Southern 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 could result in materially different results under different assumptions and conditions.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level management believes is adequate to absorb probable incurred credit losses inherent in Southern'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 require the use of significant management estimates.

Fair Value Measurements

We use fair value measurements to record certain financial instruments and to determine fair value disclosures. Available for sale securities are financial instruments recorded at fair value on a recurring basis. Additionally, we may be required to record at fair value other financial assets on a nonrecurring basis. These nonrecurring fair value adjustments typically involve write-downs of, or specific reserves against, individual assets. ASC 820-10-55 (formerly SFAS 157, Fair Value Measurements), establishes a three level hierarchy for disclosure of assets and liabilities recorded at fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used in the measurement are observable or unobservable. Observable inputs reflect market driven or market based information obtained from independent sources, while unobservable inputs reflect management estimates about market data.

The degree of management judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market data. For financial instruments that trade actively and have quoted market prices or observable market data, there is minimal subjectivity involved in measuring fair value. When observable market prices and data are not fully available, management's judgment is necessary to estimate fair value. In addition, changes in the market conditions may reduce the availability of quoted prices or observable data. When market data is not available, management uses valuation techniques that require more judgment to estimate the appropriate fair value measurement. Fair value is discussed further in Note A under the heading "Fair Values of Financial Instruments" and in Note U, "Fair Value Measurements", of notes to consolidated financial statements.

Mortgage Servicing Rights

Mortgage servicing rights represent the allocated value of servicing loans that are sold with servicing retained by Southern. Servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues. Management's accounting treatment of loan servicing rights is estimated utilizing a discounted cash flow model to determine the value of its servicing rights. The valuation model utilizes mortgage prepayment speeds, the remaining life of the mortgage pool, delinquency rates, our cost to service loans, and other factors to determine the cash flow that we will receive from serving each grouping of loans. These cash flows are then discounted based on current interest rate assumptions to arrive at the fair value for the right to service those loans.

Acquisition Intangibles

Generally accepted accounting principles require a determination of the fair value of all of the assets and liabilities of an acquired entity, and recording of their fair value on the date of acquisition. A variety of means are employed in determination of fair value, including the use of discounted cash flow analysis, market comparisons, and projected future revenue streams. Once valuations have been adjusted, the net difference between the price paid for the acquired company and the value of its balance sheet is recorded as goodwill. Goodwill is subject to an impairment analysis, performed at least annually. Prior to 2009, the Company elected to perform its annual goodwill impairment test as of December 31 each year. Such test was performed by management utilizing various industry data available for other financial institutions. As a result of the significant changes in economic conditions in 2008 and continuing in 2009, management believed the use of an independent third-party to perform the annual valuation would be beneficial. The Company selected November 30 as the annual impairment test date to allow the third party valuation firm adequate time to complete the annual valuation and impairment testing process. This change will allow the Company sufficient time to incorporate the impairment testing results in the Company's annual December 31 financial reporting requirements.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

Management of Southern Michigan Bancorp, Inc. has prepared and is responsible for the accompanying consolidated 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 2009 consolidated financial statements have been audited by the independent accounting firm of Clifton Gunderson LLP 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. Management believes that all representations made to the independent auditors during their audit were valid and appropriate. Clifton Gunderson LLP's auditor's report is presented on the following page.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Southern Michigan Bancorp, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting. Southern's internal control system is designed to provide reasonable assurance regarding reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. The system of internal control includes policies and procedures pertaining to Southern's ability to record, process, and report reliable information. Actions are taken to correct any deficiencies as they are identified through internal and external audits, regular examinations by bank regulatory agencies, Southern's formal risk management process, and other means.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Further, because of changes in conditions, the effectiveness of internal control may change over time.

Southern's management assessed the effectiveness of internal control over financial reporting as of December 31, 2009. In making this assessment, it used the criteria for effective internal control over financial reporting set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control-Integrated Framework." Based on our assessment, management believes that as of December 31, 2009, Southern's internal control over financial reporting was effective based on those criteria.

This annual report does not include an attestation report of Southern's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Southern's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit Southern to provide only management's report in this annual report.

John H. Castle Chairman and Chief Executive Officer	Danice Chartrand Danice L. Chartrand Chief Financial Officer

February 12, 2010

Southern Michigan Bancorp, Inc.
Report of Independent Registered Public Accounting Firm

Clifton Gunderson LLP
Certified Public Accountants & Consultants

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

We have audited the accompanying consolidated balance sheets of Southern Michigan Bancorp, Inc. and its subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2009. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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. and its subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

Clifton Gunderson LLP

Toledo, Ohio
March 26, 2010

Southern Michigan Bancorp, Inc.
Consolidated Balance Sheets
(In thousands, except share data)

	December 31, 2009	December 31, 2008
ASSETS		
Cash	$ 3,862	$ 4,455
Due from banks	20,952	23,534
Cash and cash equivalents	24,814	27,989
Federal funds sold	2,540	3,320
Securities available for sale	56,948	65,718
Loans held for sale, net of valuation allowance of $0 in 2009 and 2008	605	121
Loans, net of allowance for loan losses of $6,075 - 2009 ($7,104 - 2008)	327,004	328,206
Premises and equipment, net	12,914	13,286
Accrued interest receivable	2,054	2,614
Net cash surrender value of life insurance	9,881	9,523
Goodwill	13,422	13,422
Other intangible assets, net	2,355	2,717
Other assets	9,872	8,080
Total Assets	$ 462,409	$ 474,996
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	$ 55,250	$ 57,216
Interest bearing	325,655	336,827
Total deposits	380,905	394,043
Securities sold under agreements to repurchase and overnight borrowings	14,799	13,890
Accrued expenses and other liabilities	4,039	4,272
Other borrowings	10,832	12,492
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in Employee Stock Ownership Plan, 101,999 shares outstanding in 2009 (100,392 shares in 2008)	945	728
Total Liabilities	416,675	430,580
Shareholders' equity		
Preferred stock, 100,000 shares authorized; none issued or outstanding	-	-
Common stock, $2.50 par value:		
Authorized – 4,000,000 shares		
Issued – 2,323,410 shares in 2009 (2,311,740, shares in 2008)		
Outstanding (other than ESOP shares) – 2,221,411 shares in 2009 (2,211,348 shares in 2008)	5,553	5,528
Additional paid-in capital	18,363	18,473
Retained earnings	22,062	20,593
Accumulated other comprehensive income, net	193	413
Unearned Employee Stock Ownership Plan shares	(437)	(591)
Total Shareholders' Equity	45,734	44,416
Total Liabilities and Shareholders' Equity	$ 462,409	$ 474,996

The accompanying notes are an integral part of the consolidated financial statements.

Southern Michigan Bancorp, Inc.
Consolidated Statements of Income
(In thousands, except per share data)

	Year ended December 31, 2009	2008	2007
Interest income:			
Loans, including fees	$ 19,852	$ 22,528	$ 20,756
Securities:			
Taxable	1,134	2,100	1,648
Tax-exempt	883	943	648
Other	69	358	492
Total interest income	21,938	25,929	23,544
Interest expense:			
Deposits	4,671	6,992	7,758
Other	729	1,197	880
Total interest expense	5,400	8,189	8,638
Net Interest Income	16,538	17,740	14,906
Provision for loan losses	2,725	5,080	745
Net Interest Income after Provision for Loan Losses	13,813	12,660	14,161
Non-interest income:			
Service charges on deposit accounts	2,746	2,744	1,990
Trust fees	987	1,090	791
Net securities gains	682	15	13
Net gains on loan sales	756	336	390
Earnings on life insurance assets	358	363	286
Income from automated teller machines	703	624	352
Brokerage income	246	249	11
Gain on life insurance proceeds	-	390	-
Other	694	552	308
Total non-interest income	7,172	6,363	4,141
Non-interest expense:			
Salaries and employee benefits	9,802	10,582	7,652
Occupancy, net	1,351	1,383	954
Equipment	917	1,234	839
Printing, postage and supplies	615	659	378
Telecommunication	372	379	229
Professional and outside services	1,354	1,575	747
Software maintenance	415	396	253
Amortization of other intangibles	362	374	31
Automated teller machines	521	297	152
FDIC deposit assessments	855	179	47
Other real estate owned expense	319	201	96
Loss (gain) on sale of other real estate owned	318	213	(95)
Other	1,769	1,498	1,450
Total non-interest expense	18,970	18,970	12,733
Income before income taxes	2,015	53	5,569
Income tax provision (credit)	79	(760)	1,436
Net Income	$ 1,936	$ 813	$ 4,133
Basic Earnings Per Common Share	$ 0.84	$ 0.36	$ 2.29
Diluted Earnings Per Common Share	$ 0.84	$ 0.36	$ 2.28

The accompanying notes are an integral part of the consolidated financial statements.

Southern Michigan Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity

(In thousands, except number of shares and per share data)
Years ended December 31, 2009, 2008 and 2007

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2007	$ 4,200	$ 5,446	$ 19,021	$ (42)	$ (143)	$ 28,482
Comprehensive income:						
Net income for 2007			4,133			4,133
Net change for the year in other comprehensive income items				223		223
Total comprehensive income						4,356
Cash dividends declared - $.80 per share			(1,525)			(1,525)
Issuance of 535,936 shares in merger with FNB	1,340	11,371				12,711
Issuance of restricted stock (2,740 shares of common stock at $24.58 per share)	7	(7)				-
Vesting of restricted stock		12				12
Change in common stock subject to repurchase	(8)	127				119
Reduction of ESOP obligation					40	40
Stock option expense		83				83
Adjustment to initially apply SFAS 158 net of tax				(59)		(59)
Balance at December 31, 2007	5,539	17,032	21,629	122	(103)	44,219
Comprehensive income:						
Net income for 2008			813			813
Net change for the year in other comprehensive income items				291		291
Total comprehensive income						1,104
Cash dividends declared - $.80 per share			(1,849)			(1,849)
Common stock repurchased and retired (819 shares)	(2)	(10)				(12)
Issuance of restricted stock (5,535 shares of common stock at $18 per share)	14	(14)				-
Vesting of restricted stock		24				24
Restricted stock forfeiture (900 shares)	(3)	3				-
Change in common stock subject to repurchase	(20)	1,321				1,301
Purchase of 28,500 shares by ESOP					(609)	(609)
Reduction of ESOP obligation					121	121
Stock option expense		117				117
Balance at December 31, 2008	5,528	18,473	20,593	413	(591)	44,416
Comprehensive income:						
Net income for 2009			1,936			1,936
Net change for the year in other comprehensive income items				(220)		(220)
Total comprehensive income						1,716
Cash dividends declared - $.20 per share			(467)			(467)
Issuance of restricted stock (12,230 shares of common stock at $7.40 per share)	30	(30)				-
Vesting of restricted stock		47				47
Restricted stock forfeiture (560 shares)	(1)	1				-
Change in common stock subject to repurchase	(4)	(213)				(217)
Reduction of ESOP obligation					154	154
Stock option expense		85				85
Balance at December 31, 2009	$ 5,553	$ 18,363	$ 22,062	$ 193	$ (437)	$ 45,734

The accompanying notes are an integral part of the consolidated financial statements.

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

	Year ended December 31, 2009	2008	2007
Operating Activities			
Net income	$ 1,936	$ 813	$ 4,133
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	2,725	5,080	745
Depreciation	1,054	1,228	835
Amortization of other intangible assets	362	374	31
Net amortization (accretion) of investment securities	389	214	(33)
Stock option and restricted stock grant compensation expense	132	141	95
Net securities gains	(682)	(15)	(13)
Loans originated for sale	(41,586)	(17,455)	(17,015)
Proceeds on loans sold	41,858	17,936	17,140
Net gains on loan sales	(756)	(336)	(390)
Proceeds on other real estate owned sales	2,456	1,513	1,762
Net loss (gain) on other real estate owned sales	318	213	(95)
Gain on life insurance proceeds	-	(390)	-
Net loss on sale of equipment	9	46	1
Net change in obligation under ESOP	154	121	40
Net change in:			
Accrued interest receivable	560	773	(52)
Cash surrender value	(358)	(363)	(286)
Other assets	(1,256)	(919)	(626)
Accrued expenses and other liabilities	145	(1,075)	(821)
Net cash from operating activities	7,460	7,899	5,451
Investing Activities			
Bank acquisition, net of $4,199 cash assumed	-	-	(9,565)
Activity in available for sale securities:			
Proceeds on securities sold	26,366	-	-
Proceeds from maturities and calls	37,683	75,750	30,733
Purchases	(55,348)	(63,427)	(32,007)
Net change in federal funds sold	780	3,129	9,495
Proceeds from life insurance	-	1,241	67
Loan originations and payments, net	(4,720)	(4,093)	(7,438)
Proceeds from sale of equipment	-	2	2
Additions to premises and equipment	(691)	(1,227)	(2,564)
Net cash from investing activities	4,070	11,375	(11,277)
Financing Activities			
Net change in deposits	(13,138)	(5,126)	(1,938)
Net change in securities sold under agreements to repurchase and overnight borrowings	909	4,114	9,592
Proceeds from other borrowings	8,000	600	9,084
Repayments of other borrowings	(9,663)	(2,873)	(4,286)
Purchase of ESOP shares	-	(609)	-
Cash dividends paid	(813)	(1,849)	(1,525)
Repurchase of common stock	-	(12)	-
Net cash from financing activities	(14,705)	(5,755)	10,927
Net change in cash and cash equivalents	(3,175)	13,519	5,101
Beginning cash and cash equivalents	27,989	14,470	9,369
Ending cash and cash equivalents	$ 24,814	$ 27,989	$ 14,470

The accompanying notes are an integral part of the consolidated financial statements.

Note A - Nature of Operations and Significant Accounting Policies

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. (the Company) is a bank holding company. The Company's business is concentrated in the banking industry segment. The subsidiary 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 and residential real estate, and consumer assets. There are no foreign loans.

Principles of Consolidation: The consolidated financial statements include the accounts of Southern Michigan Bancorp, Inc. and its wholly-owned subsidiary, Southern Michigan Bank & Trust (SMB&T or the Bank) after elimination of significant inter-company balances and transactions. During 2009, both FNB Financial and SMB Mortgage Company were consolidated with and into SMB&T. SMB&T owns FNB Financial Services, which conducts a brokerage business and is consolidated into SMB&T's financial statements. During 2004, the Company formed a special purpose trust, Southern Michigan Bancorp Capital Trust I for the sole purpose of issuing trust preferred securities. Under generally accepted accounting principles, the trust is not consolidated into the financial statements of the Company.

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, 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, 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) whether the Company has the intention to sell the security prior to recovery. Prior to April 1, 2009, factor (3) was based on the Company's intent and ability to hold the security until recovery.

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.

Note A - Nature of Operations and Significant Accounting Policies (continued)

Loans (Continued): 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.

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 effective 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 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 is 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 straight line or 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, included in other assets, 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.

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

Note A - Nature of Operations and Significant Accounting Policies (continued)

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.

Goodwill and Other Intangible Assets: Goodwill results from 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. Prior to 2009, the Company elected to perform its annual goodwill impairment test as of December 31 each year. Such test was performed by management utilizing various industry data available for other financial instituitions. As a result of the significant changes in economic conditions in 2008 and continuing in 2009, management believed the use of an independent third-party to perform the annual valuation would be beneficial. The Company selected November 30 as the annual impairment test date to allow the third-party valuation firm adequate time to complete the annual valuation and impairment testing process. This change will allow the Company sufficient time to incorporate the impairment testing results in the Company's annual December 31 financial reporting requirements. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the Company's balance sheet.

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

Other Real Estate: Other real estate was $1,187,000 and $1,119,000 at December 31, 2009 and 2008 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 fair value less cost to sell at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and real estate is carried at the lower of carrying amount or fair value less estimated cost of disposal. Expenses, gains and losses on disposition, and reductions in carrying value are reported in other expense.

Stock Compensation: Effective January 1, 2006, the Company adopted the requirements of "share-based payment transactions", using the modified prospective transition method. Under this method, the Company began recognizing compensation cost for equity-based compensation for all new or modified grants after the date of adoption. Awards issued prior to 2006 that have not been modified were not affected by the new method of accounting.. 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 was reflected in net income for the years prior to 2006 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.

See Note N regarding the various assumptions used in computing the compensation expense.

Advertising Costs: Advertising costs are expensed as incurred.

Note A - Nature of Operations and Significant Accounting Policies (continued)

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. Benefits from tax positions taken or expected to be taken in a tax return are not recognized if the likelihood that the tax position would be sustained upon examination by a taxing authority is considered to be 50% or less.

The Company adopted FASB's requirements for accounting for uncertain tax positions effective January 1, 2007. The requirements prescribe the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. The requirements also provide clear criteria for subsequently recognizing, derecognizing, and measuring such tax positions for financial statement purposes as well as provide guidance on accrual of interest and penalties, accounting in interim periods, disclosure, and transition. The adoption did not have a material impact on the consolidated financial statements.

Cash Flow Definition: 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.

Stock Dividends: The Company issued 84,355 common shares in connection with a 5% stock dividend effected in February 2006.

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 issuable under stock options. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

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 and the changes in the funded status of the pension plan, each net of tax, which are 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, as more fully disclosed in a separate note. 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.

Note A - Nature of Operations and Significant Accounting Policies (continued)

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 67% of the loan portfolio at December 31, 2009 and the loans are expected to be repaid from cash flow from operations of businesses. Residential mortgage loans make up approximately 30% of the loan portfolio at December 31, 2009 and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 3% of the loan portfolio at December 31, 2009 and are primarily collateralized by consumer assets.

Operating Segments: While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company wide basis. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

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. Commitments may include interest rates determined prior to funding the loan (rate lock commitments). Rate lock commitments on loans intended to be sold are considered to be derivatives. Such commitments were not material at December 31, 2009 and 2008.

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 any such matters that will have a material effect on the consolidated financial statements as of December 31, 2009.

Subsequent Events: Management evaluated subsequent events through the date the financial statements were issued. Events or transactions occurring after December 31, 2009, but prior to when the financial statements were issued, that provided additional evidence about conditions that existed at December 31, 2009, have been recognized in the financial statements for the year ended December 31, 2009. Events or transactions that provided evidence about conditions that did not exist at December 31, 2009, but arose before the financial statements were issued, have not been recognized in the financial statements for the year ended December 31, 2009.

Reclassifications: Certain items in the 2008 and 2007 consolidated financial statements have been reclassified to conform to the current year presentation.

Adoption of New Accounting Standards: In June 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-01 (formerly FAS No. 168), *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles.* The Accounting Standards Codification (ASC) is the single source of authoritative non governmental U.S. generally accepted accounting principles (GAAP). Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents are superseded and all other accounting literature not included in the Codification is considered non-authoritative. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this ASU did not have a material impact on the results of operations or financial position of the Company as it only required changes to GAAP references in our financial statements.

Note A - Nature of Operations and Significant Accounting Policies (continued)

Adoption of New Accounting Standards (Continued):

ASC 805-10 (formerly Statement of Financial Accounting Standards No. 141 (Revised 2007), *Business Combinations*) was issued in December 2007. ASC 805-10 establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. ASC 805 applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after December 15, 2008. The Company had no transactions in 2009 applicable to ASC 805.

ASC 810-10 (formerly SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements* - an amendment of ARB No. 51) was issued in December 2007 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statement, but separate from the parent's equity. ASC 810-10 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Since the Company owns 100% of all subsidiaries, ASC 810-10 has no impact on the Company's consolidated financial condition or results of operations.

ASC 815-10 (formerly SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* - an amendment of FASB Statement No. 133) was issued in March 2008 and requires qualitative disclosures about objectives and strategies for using derivative instruments, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. ASC 815-10 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Adoption of ASC 815-10 did not have a material impact on the consolidated financial statements.

ASC 320-10 (formerly Staff Position (FSP) No. 115-2 and No. 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*), amends existing guidance for determining whether impairment is other-than-temporary (OTTI) for debt securities. The ASC requires an entity to assess whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of these criteria is met, the entire difference between amortized cost and fair value is recognized in earnings. For securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. Additionally, the ASC expands and increases the frequency of existing disclosures about other-than-temporary impairments for debt and equity securities. ASC 320-10 was effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of the ASC on April 1, 2009 did not have a material impact on the results of operations or financial position of the Company because the Company did not hold any other-than-temporary impaired debt securities.

ASC 820-10 (formerly FSP No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*), emphasizes that even if there has been a significant decrease in the volume and level of activity, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants. ASC 820-10 provides a number of factors to consider when evaluating whether there has been a significant decrease in the volume and level of activity for an asset or liability in relation to normal market activity. In addition, when transactions or quoted prices are not considered orderly, adjustments to those prices based on the weight of available information may be needed to determine the appropriate fair value. The ASC also requires increased disclosures. ASC 820-10 was effective for interim and annual reporting periods ending after June 15, 2009, and was applied prospectively. The adoption of ASC 820-10 as of April 1, 2009 did not have a material impact on the results of operations or financial position of the Company.

Note A - Nature of Operations and Significant Accounting Policies (continued)

Adoption of New Accounting Standards (Continued):

ASC 825-10 (formerly FSP No. 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*), requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies that were previously only required in annual financial statements. ASC 825-10 is effective for interim reporting periods ending after June 15, 2009. The adoption of ASC 825-10 as of April 1, 2009 did not have a material impact on the results of operations or financial position of the Company as it only required disclosures which were already disclosed on an annual basis in Note T.

ASC 855-10 (formerly FAS No. 165, *Subsequent Events*), establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, ASC 855-10 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. An entity must apply the requirements to interim or annual financial periods ending after June 15, 2009. The adoption of ASC 855-10 did not significantly impact the consolidated financial statements of the Company.

ASC 260-10 (formerly FASB Staff Position EITF 03-6-1–*Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*) addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, included in the earnings allocation in computing earnings per share (EPS) under the two-class method. ASC 260-10 provides that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method. This ASC was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented were to be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform to the provisions of this ASC. The effect of adopting this new guidance did not impact the Company's EPS computation.

ASC 715-20 (formerly FASB Staff Position No. 132(R)-1, *Employers' Disclosures about Postretirement Benefit Plan Assets*) provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other post-retirement plan. These additional disclosures include disclosure of investment policies and fair value disclosures of plan assets, including fair value hierarchy. The ASC also includes a technical amendment that requires a nonpublic entity to disclose net periodic benefit cost for each annual period for which a statement of income is presented. This ASC is effective for fiscal years ending after December 15, 2009. Upon initial application, provisions of the ASC are not required for earlier periods that are presented for comparative purposes. The new disclosures for 2009 have been presented in the Note M to the consolidated financial statements.

In August 2009, the FASB issued ASU No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value*. This ASU provides amendments for fair value measurements of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more techniques. ASU 2009-05 also clarifies that when estimating a fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after August 26, 2009. The adoption of ASU 2009-05 did not have any impact on the Company's consolidated financial statements.

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

Effect of Newly Issued But Not Yet Effective Accounting Standards: ASC 860-10-65 (formerly FAS No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*), removes the concept of a qualifying special-purpose entity and removes the exception from applying *Consolidation of Variable Interest Entities*, to qualifying special-purpose entities. The objective in issuing ASC 860-10-65 is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. The requirements of ASC 860-10-65 must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. The impact of adoption is not expected to be material.

ASC 810-10-65 (formerly FAS No. 167, *Amendments to FASB Interpretation No. 46(R)*), seeks to improve financial reporting by enterprises involved with variable interest entities. ASC 810-10-65 addresses (1) the effects of provisions which result from the elimination of the qualifying special-purpose entity concept and (2) constituent concerns about the application of the accounting and disclosures which do not always provide timely and useful information about an enterprise's involvement in a variable interest entity. ASC 810-10-65 is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. The impact of adoption is not expected to be material since the Company currently has no variable interest entities.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements*. This ASU requires presentation of activities within the Level 3 roll forward, and adds a new requirement to disclose transfers in and out of Level 1 and 2 measurements. It also clarifies two existing disclosure requirements. The ASU is effective the first interim or annual reporting period beginning after December 15, 2009, except for the gross presentation of the Level 3 roll forward information, which is required for annual reporting periods beginning after December 15, 2010 and for interim reporting periods within those years. The adoption of ASU 2010-06 will only impact the disclosure requirements of fair value information and will not impact the Company's consolidated financial statements.

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, 2009, 2008 and 2007 is presented below:

	2009	2008	2007
Basic Earnings Per Common Share			
Net income (in thousands)	$ 1,936	$ 813	$ 4,113
Weighted average common shares outstanding	2,322,642	2,310,303	1,813,003
Less: Unallocated ESOP shares	(31,090)	(29,538)	(5,090)
Weighted average common shares outstanding for basic earnings per common share	2,291,552	2,280,765	1,807,913
Basic earnings per common share	$ 0.84	$ 0.36	$ 2.29
Diluted Earnings Per Common Share			
Net income (in thousands)	$ 1,936	$ 813	$ 4,133
Weighted average common shares outstanding for basic earnings per common share	2,291,552	2,280,765	1,807,913
Add: Dilutive effects of assumed exercises of stock options	349	279	5,393
Average shares and dilutive potential of common shares outstanding	2,291,901	2,281,044	1,813,306
Diluted earnings per common share	$ 0.84	$ 0.36	$ 2.28

Stock options for 214,822, 207,348 and 131,145 shares of common stock were not considered in computing diluted earnings per share for 2009, 2008 and 2007, respectively, because they were anti-dilutive.

NOTE C - ACQUISITION OF FNB FINANCIAL

On December 1, 2007, the Company completed a merger with FNB Financial Corporation, parent company of First National Bank of Three Rivers. Upon completion of the merger, the name of First National Bank of Three Rivers was changed to FNB Financial (FNB). The merger was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based upon the estimated fair values as of the date of merger. For federal income tax purposes, the tax basis of the assets and liabilities of FNB at November 30, 2007 carryover. The purchase provided the Company the strategic opportunity to expand into adjacent markets since the opportunity to grow organically within the Company's existing market was limited by competition and economic conditions.

NOTE C - ACQUISITION OF FNB FINANCIAL (CONTINUED)

The aggregate purchase price was $26,475,000, representing $13,764,000 of cash and acquisition costs and issuance of 535,936 shares of the Company's common stock valued at $12,711,000, net of $125,000 of offering costs. The cash portion of the acquisition was financed with a $5,000,000 special dividend from SMB&T, the proceeds from a $7,000,000 five-year term loan with a correspondent bank and $1,000,000 from a line of credit with the same correspondent bank, as described in note I.

The following table summarizes the estimated fair values of the assets acquired and the liabilities assumed at the date of the merger with FNB (in thousands):

		Fair Value
Cash and cash equivalents	$	4,199
Federal funds sold		5,515
Securities		40,218
Loans, net of $1,458 allowance		76,828
Premises & equipment		2,944
Cash surrender value of bank owned life insurance		2,294
Core deposit intangible asset		3,122
Goodwill		12,802
Other assets		2,484
Total assets acquired		150,406
Deposits		118,598
Advances from Federal Home Loan Bank		2,982
Other liabilities		2,351
Total liabilities assumed		123,931
Net assets acquired	$	26,475

The purchase accounting fair value adjustments are being amortized under various methods and over the estimated lives of the corresponding assets and liabilities. Goodwill recorded from the merger amounted to $12,802,000 bringing total goodwill for the Company to $13,422,000 at December 31, 2007. Goodwill is not being amortized but is subject to an annual impairment test. A core deposit intangible asset of $3,122,000 was recorded as part of the deposits assumed and is being amortized using an accelerated basis over a period of 10 years. Amortization of the core deposit intangible asset for the years ended December 31, 2009 and 2008 and the month of December 2007 was $362,000, $374,000 and $31,000, respectively, resulting in an unamortized balance of $2,355,000 and $2,717,000 at December 31, 2009 and 2008, respectively. The estimated amortization expense for each of the next five years ending December 31 is as follows: 2010, $350,000; 2011, $339,000; 2012, $325,000; 2013, $296,000 and 2014, $284,000.

The following summarizes pro forma information for the year ended December 31, 2007, assuming the merger occurred at the beginning of the year (in thousands, except share data):

Net interest income after provision for loan losses	$	18,253
Net income		4,155
Basic earnings per common share		1.77
Diluted earnings per common share		1.77

The pro forma information includes purchase accounting adjustments relating to interest income on loans acquired, amortization of intangible assets arising from the transaction, depreciation expense on property acquired, interest expense on deposits acquired and debt borrowings and related tax effects. The pro forma results do not necessarily represent results which would have occurred if the merger had taken place on the basis assumed above, nor are they indicative of the results of future combined operations.

NOTE D - SECURITIES

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

Available for Sale, December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury and Federal agencies	$ 19,259	$ 99	$ (14)	$ 19,344
U.S. government sponsored entities and agencies	10,908	59	-	10,967
States and political subdivisions	25,367	530	(58)	25,839
Mortgage-backed securities	779	20	(1)	798
Total	$ 56,313	$ 708	$ (73)	$ 56,948

Available for Sale, December 31, 2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury and Government agencies	$ 23,547	$ 294	$ -	$ 23,841
States and political subdivisions	27,079	418	(26)	27,471
Mortgage-backed securities	14,095	341	(30)	14,406
Total	$ 64,721	$ 1,053	$ (56)	$ 65,718

Included above for 2008 are $1,900,000 of floating rate securities that were putable on a weekly basis. The securities matured in 2009.

Securities with unrealized losses at year end 2009 and 2008 that have not been recognized in income are as follows (in thousands):

2009	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 Federal agencies	$ 11,142	$ (14)	$ -	$ -	$ 11,142	$ (14)
U.S. government sponsored entities and agencies	-	-	-	-	-	-
States and political subdivisions	3,624	(57)	159	(1)	3,783	(58)
Mortgage-backed securities	-	-	93	(1)	93	(1)
Total temporarily impaired	$ 14,766	$ (71)	$ 252	$ (2)	$ 15,018	$ (73)

2008	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	$ -	$ -	$ -	$ -	$ -	$ -
States and political subdivisions	714	(13)	917	(13)	1,631	(26)
Mortgage-backed securities	1,656	(29)	127	(1)	1,783	(30)
Total temporarily impaired	$ 2,370	$ (42)	$ 1,044	$ (14)	$ 3,414	$ (56)

NOTE D - SECURITIES (CONTINUED)

Unrealized losses have not been recognized into income as management believes the issuers are of high credit quality, management has no intent to sell the securities, and the decline in fair value is largely due to changes in market interest rates. The fair value is expected to recover as the notes and bonds approach their maturity date.

The proceeds from sales of securities and the associated gains are listed below (in thousands):

	2009	2008	2007
Proceeds	$ 26,366	$ -	$ -
Gross gains	678	-	-
Gross losses	-	-	-

The tax benefit (provision) related to these net realized gains and losses was $(231,000), $0 and $0 for 2009, 2008 and 2007, respectively.

Gains on calls of securities were $4,000, $15,300 and $13,000 for 2009, 2008 and 2007, respectively.

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Contractual maturities of debt securities at year-end 2009 were as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 11,178	$ 11,238
Due from one to five years	31,784	32,225
Due from five to ten years	8,254	8,390
Due after ten years	4,318	4,297
Mortgage-backed securities	779	798
Total	$ 56,313	$ 56,948

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.

Securities with a carrying value of $29,857,000 and $38,883,000 were pledged as collateral for public deposits and for other purposes at year-end 2009 and 2008.

At year-end 2009 and 2008, the market value of securities issued by the state of Michigan and all its political subdivisions totaled $15,466,000 and $16,872,000, respectively. No other securities of any state (including all its political subdivisions) were greater than 10% of shareholders' equity.

Investments in the Federal Home Loan Bank totaled $2,057,000 at December 31, 2009 and 2008 and are included in other assets since such investments are considered restricted. Such investments are recorded at cost and evaluated for impairment.

Southern Michigan Bancorp, Inc.
Notes To Consolidated Financial Statements (continued)

Note E - Loans

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

	2009	2008
Commercial	$ 61,855	$ 74,446
Real estate - commercial	148,806	131,180
Real estate - construction	10,522	10,446
Consumer	11,889	14,917
Real estate mortgage	100,007	104,321
	333,079	335,310
Less allowance for loan losses	(6,075)	(7,104)
Loans, net	$ 327,004	$ 328,206

At December 31, 2009 and 2008, certain directors and executive officers of the Company, including their associates and companies in which they are principal owners, were indebted to the Bank.

The following is a summary of loans (in thousands) exceeding $60,000 in the aggregate to these individuals and their associates. Other changes include adjustments for loans applicable to one reporting period that are excludable from the other reporting period.

	2009	2008
Balance at January 1	$ 10,278	$ 10,995
New loans, including renewals	12,672	8,705
Repayments	(6,354)	(10,171)
Other changes, net	(18)	749
Balance at December 31	$ 16,578	$ 10,278

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $127,917,000 and $124,607,000 at December 31, 2009 and 2008, respectively.

Activity for capitalized mortgage servicing rights, included in other assets, was as follows (in thousands):

	2009	2008	2007
Balance at January 1	$ 708	$ 749	$ 399
Additions	269	162	157
Acquisition of servicing rights from FNB	-	-	308
Amortized to expense	(224)	(203)	(115)
Balance at December 31	$ 753	$ 708	$ 749

No valuation allowance for capitalized mortgage servicing rights was necessary at December 31, 2009, 2008 or 2007 since the fair value of such rights approximated or exceeded the carrying value.

NOTE F - ALLOWANCE FOR LOAN LOSSES

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

	2009	2008	2007
Balance at January 1	$ 7,104	$ 5,156	$ 3,302
Provision for loan losses	2,725	5,080	745
Addition resulting from FNB acquisition	-	-	1,458
Loans charged off	(3,926)	(3,343)	(525)
Recoveries	172	211	176
Net charge-offs	(3,754)	(3,132)	(349)
Balance at December 31	$ 6,075	$ 7,104	$ 5,156

Information regarding impaired loans at December 31 follows (in thousands):

	2009	2008
Year end loans with allowance for loan losses allocated	$ 5,439	$ 10,481
Year end loans with no allowance for loan losses allocated	5,696	4,776
Total impaired loans	$ 11,135	$ 15,257
Amount of allowance allocated to these loans	$ 1,550	$ 3,308

	2009	2008	2007
Average balance of impaired loans during the year	$ 11,754	$ 17,100	$ 9,362
Cash basis interest income recognized during the year	$ 409	$ 866	$ 364
Interest income recognized during the year	$ 367	$ 881	$ 366

Nonperforming loans at December 31 were as follows (in thousands):

	2009	2008
Loans past due over 90 days still on accrual	$ 14	$ 437
Nonaccrual loans	7,585	8,715

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.

The Company has allocated $215,000 of specific reserves to customers whose loan terms have been modified as of December 31, 2009. The Company has committed to lend no additional amounts to these customers.

NOTE G - PREMISES AND EQUIPMENT, NET

Premises and equipment, net at December 31 consisted of (in thousands):

	2009	2008
Land	$ 2,373	$ 2,150
Buildings and improvements	15,087	14,902
Furniture and equipment	7,701	7,453
	25,161	24,505
Less accumulated depreciation	(12,247)	(11,219)
Totals	$ 12,914	$ 13,286

Depreciation and amortization expense charged to operations was approximately $1,054,000, $1,228,000 and $835,000 in 2009, 2008 and 2007, respectively.

Lease commitments under noncancelable operating equipment leases at December 31, 2009 were as follows (in thousands):

2010	$ 30
2011	11
2012	4
Total	$ 45

NOTE H - DEPOSITS

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

	2009	2008
Non-interest bearing checking	$ 55,250	$ 57,216
Interest bearing checking	86,606	97,613
Savings	46,346	53,090
Money market accounts	57,776	54,066
Time deposits	134,927	132,058
Totals	$ 380,905	$ 394,043

The carrying amount of time deposits $100,000 and over was $49,896,000 and $44,283,000 at December 31, 2009 and 2008, respectively. Interest expense on time deposits $100,000 and over was $1,336,000, $1,435,000 and $1,835,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

At year-end 2009, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2010	$ 87,780
2011	24,323
2012	9,095
2013	9,308
2014	2,329
Thereafter	2,092
Total	$ 134,927

Related party deposits were $14,271,000 and $10,941,000 at December 31, 2009 and 2008, respectively.

NOTE I - OTHER BORROWINGS

Other borrowings at December 31, 2009 included $7,343,000 in advances from the Federal Home Loan Bank (FHLB) of Indianapolis. The advances require payments from December 2010 through December 2013 with fixed interest rates ranging from 2.12% to 4.57%, with a weighted average rate of 2.77%. Principal is due at maturity for $6,998,000 of the advances. The remaining $345,000 FHLB advance is at a fixed rate of 4.57% with decreasing annual principal payments.

All of the advances are secured by blanket collateral agreements with the FHLB, which gives the FHLB an unperfected security interest in certain one-to-four family mortgage, home equity, and commercial real estate loans. Eligible FHLB loan collateral at December 31, 2009 and 2008 was approximately $93,148,000 and $65,887,000, respectively.

At December 31, 2008, FHLB fixed rate advances of $5,447,000 were outstanding. They had a weighted average interest rate of 3.97%. Advances with principal due at maturity totaled $4,995,000 and the remaining $452,000 FHLB advance is at a fixed rate of 4.57% with decreasing annual principal payments.

On November 20, 2007, the Company entered into a Business Loan agreement with Bank of America, consisting of two credit facilities. The first consisted of a $3,000,000 secured revolving line of credit, maturing in three years with a LIBOR plus 150 basis point interest rate (3.72% at December 31, 2008). Repayment terms were interest only on a quarterly basis with the principal due at maturity. The second was a $7,000,000 secured term loan, with a maturity of five years subject to a twelve year amortization with an interest rate of LIBOR plus 145 basis points (3.67% at December 31, 2008). Repayment terms were interest and principal on a quarterly basis (based on a 12 year amortization), with the remaining principal amount due at maturity. Both credit facilities were secured by a pledge of 100% of the stock of SMB&T. Both credit facilities with Bank of America were paid off and closed in December 2009. At December 31, 2008, $0 was outstanding on the line of credit and $6,416,000 was outstanding on the term note.

On December 29, 2009 the Company entered into a Business Loan agreement with Great Lakes Bankers Bank (GLBB), consisting of a $3,000,000 term loan, subject to sub-participation of at least $2,100,000 with banks mutually acceptable to both parties, maturing in five years with a variable rate equal to the New York Prime, as published in the Wall Street Journal, with a floor of four and one-half (4.5%) percent. Repayment terms require monthly principal and interest payments amortized over five years. The loan requires compliance with various specified financial covenants and is secured by 100% of the stock of SMB&T. At December 31, 2009, $3,000,000 was outstanding.

Other borrowings also include a loan from a local community bank with a balance at December 31, 2009 and 2008 of $489,000 and $629,000, respectively. The loan matures on February 28, 2013 and is unsecured.

At year-end 2009, scheduled principal reductions on other borrowings were as follows for the years ending December 31 (in thousands):

	FHLB	GLBB	Other	Total
2010	$ 110	$ 547	$ 145	$ 802
2011	1,117	572	150	1,839
2012	5,077	598	155	5,830
2013	1,039	626	39	1,704
2014	-	657	-	657
Total other borrowings	$ 7,343	$ 3,000	$ 489	$ 10,832

NOTE J - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OVERNIGHT BORROWINGS

Securities sold under agreements to repurchase (repurchase agreements) are direct obligations and are secured by securities held in safekeeping at a correspondent bank. Repurchase agreements are offered primarily to certain large deposit customers as deposit equivalent investments. Information relating to securities sold under agreements to repurchase is as follows (in thousands):

	2009	2008
At December 31:		
Outstanding balance	$ 14,799	$ 13,890
Average interest rate	0.26%	0.45%
Daily average for the year:		
Outstanding balance	$ 14,789	$ 10,089
Average interest rate	0.28%	1.56%
Maximum outstanding at any month end	$ 14,799	$ 13,890

At December 31, 2009, the Bank had no line of credit arrangements available to purchase federal funds. At December 31, 2008, such lines of credit arrangements totaled $19,000,000, subject to quarterly and annual reviews, with no borrowing outstanding.

NOTE K - 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 securities of the trust and the proceeds of the preferred securities sold by the trust. The Company is not considered the primary beneficiary of this trust, therefore the trust is not consolidated in the Company's financial statements, but rather the subordinated debentures are shown as a liability. The Company may redeem the subordinated debentures, in whole or in part, in a principal amount with integral multiples of $1,000 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, 2009 was 3.03%. The Company's investment in the common stock of the trust was $155,000 and is included in other assets.

NOTE L - INCOME TAXES

Income tax provision (credit) consists of (in thousands):

	2009	2008	2007
Current	$ (427)	$ 283	$ 1,460
Deferred	506	(1,043)	(24)
Totals	$ 79	$ (760)	$ 1,436

Deferred income tax provision (credit) consist of the tax effect of temporary differences, including a credit of $23,000 in 2009 and $204,000 in 2008 relating from utilization of a portion of a net operating loss carryforward.

NOTE L - INCOME TAXES (CONTINUED)

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

	2009	2008	2007
Income tax at statutory rate	$ 685	$ 18	$ 1,893
Tax-exempt interest income, net	(351)	(363)	(234)
Earnings on life insurance assets, including gain from proceeds in 2008	(122)	(256)	(97)
Low income housing partnership tax credit	(127)	(127)	(127)
Other items, net	(6)	(32)	1
Totals	$ 79	$ (760)	$ 1,436

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

	2009	2008
Deferred tax assets:		
Allowance for loan losses	$ 1,342	$ 1,882
Deferred compensation and supplemental retirement liability	731	726
Net operating loss carryforward	207	230
Intangible asset amortization	24	37
Pension liability – SFAS 158	117	126
Write off of investment	60	60
Nonaccrual loan interest	272	322
Tax credit carryforwards	483	399
Other	311	240
	3,547	4,022
Valuation allowance	(54)	(54)
Total deferred tax assets, net of valuation allowance	3,493	3,968
Deferred tax liabilities:		
Mortgage servicing rights	(256)	(241)
Goodwill	(170)	(149)
Purchase accounting adjustments	(887)	(920)
Net unrealized gain on available for sale securities	(216)	(339)
Other	(202)	(165)
Total deferred tax liabilities	(1,731)	(1,814)
Net deferred tax assets, included in other assets	$ 1,762	$ 2,154

At December 1, 2007, FNB had a net operating loss carryforward (NOL) of approximately $1,378,000 for federal income tax purposes. At December 31, 2009, the NOL has been reduced to approximately $609,000 and is available to reduce the Company's future taxable income through 2027.

At December 31, 2009, the Company has available alternative minimum tax credit carryforwards of approximately $356,000, which may be utilized in the future to the extent computed regular tax exceeds the alternative minimum tax. The Company also has a low income housing credit of $127,000 at December 31, 2009, which is available to reduce future federal income taxes through 2029.

A valuation allowance against deferred tax assets of $54,000 was considered necessary at December 31, 2009 and 2008 as the likelihood of receiving a tax benefit on a portion of the capital loss on the write off of an investment is considered doubtful. Management believes remaining deferred tax assets are more likely than not to be realized.

The Company and its subsidiaries file income tax returns in the U.S. federal and certain state jurisdictions. Such returns are no longer subject to tax examinations by tax authorities for years before 2006.

NOTE M - BENEFIT PLANS

Defined Benefit Pension Plan:

Effective December 31, 2009, The Southern Michigan Bank & Trust Pension Plan was fully frozen. Employees who had been grandfathered in when the plan was partially frozen in 2006 had their benefit frozen in 2009. The curtailment resulted in a $125,000 reduction in the projected benefit obligation during 2009. 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):

	2009	2008
Change in benefit obligation:		
Beginning benefit obligation	$ (2,418)	$ (2,200)
Service cost	(29)	(32)
Interest cost	(145)	(142)
Settlement adjustment	125	-
Actuarial loss	(44)	(171)
Benefits paid	239	127
Ending benefit obligation	(2,272)	(2,418)
Change in plan assets, at fair value:		
Beginning plan assets	2,147	2,161
Actual return	47	38
Employer contributions	10	75
Benefits paid	(239)	(127)
Plan expenses paid	(28)	-
Ending plan assets	1,937	2,147
Net amount recognized in other liabilities – funded status	$ (335)	$ (271)

The accumulated benefit obligation for the defined benefit pension plan was $2,273,000 and $2,319,000 at December 31, 2009 and 2008, respectively.

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

	2009	2008	2007
Components of net periodic benefit cost:			
Service cost	$ 29	$ 32	$ 37
Interest cost	145	142	130
Expected return on plan assets	(147)	(151)	(129)
Recognized net actuarial loss	39	2	-
Settlement adjustment	42	-	-
Net periodic benefit cost	$ 108	$ 25	$ 38

At December 31, 2009, a net actuarial loss of $343,000 has not yet been recognized as a component of net periodic benefit cost. The estimated net loss that will be amortized from accumulated other comprehensive income into net periodic benefit cost for 2010 is estimated to be $9,000.

NOTE M - BENEFIT PLANS (CONTINUED)

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

	2009	2008	2007
Discount rate on benefit obligation	6.0%	6.0%	6.0%
Long-term expected rate of return on plan assets	7.0%	7.0%	7.0%
Rate of compensation increase	N/A	4.0%	4.0%

Asset Category	Target Allocation 2010	Percentage of Plan Assets at Year-end 2009	Percentage of Plan Assets at Year-end 2008	Weighted Average Expected Long-Term Rate of Return - 2009
Equity securities	0%	0%	0%	0.0%
Debt securities	1%	1%	2%	5.6%
Cash and time certificates	99%	99%	98%	1.1%
	100%	100%	100%	1.2%

The pension plan assets are managed by the Bank's Trust Department. A written investment policy which meets the standards of the prudent investor rule is followed. In addition, the Northern Trust Company and Main Street Advisors, both of Chicago, have provided investment advisory services, guidance and expertise.

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

The plan's investment objective at December 31, 2009 is primarily fixed income investments with a target of 70% time certificates and 30% cash. The allocation percentages may be reduced or increased depending upon market conditions and interest rates. Due to the plan 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.

Fair Value of Plan Assets: Fair value is the exchange price that would be received for an asset in the principal or most advantageous market for the asset in an orderly transaction between market participants on the measurement date.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Debt Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

NOTE M - BENEFIT PLANS (CONTINUED)

The fair value of the plan assets at December 31, 2009, by asset category, is as follows:

		Fair Value Measurements at December 31, 2009 Using:		
(Dollars in thousands)	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Plan Assets				
Debt securities	$ 25	$ 25	$ -	$ -
Cash and time certificates	1,912	213	1,699	-
Total Plan Assets	$ 1,937	$ 238	$ 1,699	$ -

There were no plan assets measured at fair value using significant unobservable inputs (Level 3) for the year ended or as of December 31, 2009.

The Company does not expect to contribute to its pension plan in 2010.

At year-end 2009, estimated future benefit payments from the plan were as follows for the years ending December 31 (in thousands):

2010	$ 51
2011	52
2012	55
2013	84
2014	99
2015 – 2019	771

Note M - Benefit Plans (continued)

Employee Stock Ownership Plan: The Company has an employee stock ownership plan (ESOP) for substantially all full-time employees. The Plan includes a 401(k) provision with the Company's matching contribution provided in Company stock. The Board of Directors determines the Company's contribution level annually. Assets of the plan are held in trust by SMB&T and administrative costs of the plan are borne by the plan participants. Expense charged to operations for contributions to the plan totaled $388,000, $610,000 and $426,000 in 2009, 2008 and 2007, respectively.

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

	2009	2008
Allocated shares	101,999	100,392
Unallocated shares	29,649	31,256
Total ESOP shares	131,648	131,648

The fair value of the allocated shares held by the ESOP is approximately $945,000 and $728,000 at December 31, 2009 and 2008, 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 2008, the ESOP obtained a loan for $609,000 to purchase 28,500 shares. The balance of the loan at December 31, 2009 and 2008 was $416,000 and $529,000, respectively. In 2005, the ESOP obtained a loan for $204,000 to purchase 7,568 shares. The balance of the loan at December 31, 2009 and 2008 was $21,000 and $62,000, respectively.

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 6.08% - 12.98%. Deferred compensation expense was $237,000, $246,000 and $225,000 in 2009, 2008 and 2007, respectively. The liability for vested benefits was $1,913,000 and $1,863,000 at December 31, 2009 and 2008, respectively, and is included in accrued expenses and other liabilities.

Supplemental Retirement Plan: The Bank also maintains a supplemental retirement plan to provide annual payments to particular executives subsequent to their retirement. Expense associated with this plan totaled $12,000, $77,000 and $11,000 in 2009, 2008 and 2007, respectively. Liabilities associated with this plan totaled $232,000 and $255,000 at December 31, 2009 and 2008.

Note N - Stock Options

The Company has stock based compensation plans as described below. Total compensation cost that has been charged against income for those plans was $132,000, $141,000 and $95,000 in 2009, 2008 and 2007.

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 300,000 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. At December 31, 2009, 117,158 shares were 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. At December 31, 2009, 46,218 shares were available under the plan.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the weighted average assumptions noted in the following table. The expected volatility and life assumptions are based on historical experience. The interest rate is based on the U.S. Treasury yield curve and the dividend yield assumption is based on the Company's history and expected dividend payouts.

	2009	2008	2007
Risk-free interest rate	3.58%	2.94%	4.75%
Expected option life	8 years	8 years	8 years
Expected stock price volatility	22.39%	14.48%	14.05%
Dividend yield	3.58%	3.51%	3.59%
Weighted-average fair value of options granted during year	$0.97	$1.96	$3.58

NOTE N - STOCK OPTIONS (CONTINUED)

A summary of the activity in the plans for 2009 follows:

	Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term		Aggregate Intrinsic Value
Outstanding at beginning of year	215,118	$	22.72			
Granted	14,660		7.40			
Exercised	-		-			
Forfeited	(4,508)		17.04			
Outstanding at end of year	225,270	$	21.83	6.8 years	$	$25,000
Options exercisable at year-end	119,520	$	22.72	5.3 years	$	-

	2009	2008	2007
Intrinsic value of options exercised	-	-	-
Cash received from option exercise	-	-	-
Tax benefit realized from option exercises	-	-	-

As of December 31, 2009, there was $140,000 of total unrecognized compensation cost related to nonvested stock options granted under the plans. The cost is expected to be recognized over a weighted average period of 1.9 years.

Restricted Stock – Restricted shares may be issued under the plans described above. Compensation expense is recognized over the vesting period of the shares based on the market value of the shares on the issue date. The total fair value of shares vested during the years ended December 31, 2009, 2008 and 2007 was $29,000, $13,000 and $0. As of December 31, 2009, there was $153,000 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted average period of 3.8 years.

	Shares		Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	6,827	$	20.11
Granted	12,230		7.40
Vested	(1,435)		20.51
Forfeited	(560)		11.19
Nonvested at December 31, 2009	17,062	$	11.26

NOTE O - 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, 2009 and 2008, the Company had $0 and $21,000, respectively, of commitments under commercial letters of credit, used to facilitate customers' trade transactions.

Under standby letter of credit agreements, the Company agrees to honor certain commitments in the event that its customers are unable to do so. At December 31, 2009 and 2008, commitments under outstanding standby letters of credit were $1,457,000 and $2,035,000, respectively.

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

	2009	2008
Fixed rate	$ 2,765	$ 3,167
Variable rate	57,058	66,104
Totals	$ 59,823	$ 69,271

The fixed rate commitments have stated interest rates ranging from 4.50% to 14.00%. The terms of the above commitments range from 1 to 120 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.

Certain executives of the Bank have employment contracts which have change of control clauses. The employment contracts provide for the payment of 2.99 times the officer's base salary and bonus if the officer is terminated in the event of a change of control.

NOTE P - ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income amounted to $193,000 at December 31, 2009 and $413,000 at December 31, 2008 and is summarized as follows (in thousands):

	2009	2008
Unrealized gain on available-for-sale securities, net of income taxes of $216 in 2009 and $339 in 2008	$ 419	$ 658
Pension liability, net of income taxes of $117 in 2009 and $126 in 2008	(226)	(245)
Total	$ 193	$ 413

NOTE P - ACCUMULATED OTHER COMPREHENSIVE INCOME (CONTINUED)

The changes in the components of accumulated comprehensive income (loss), excluding the impact in 2007 of initially applying SFAS 158 pension accounting, and related tax effects for the years ended December 31, 2009, 2008 and 2007 are as follows (in thousands):

	2009	2008	2007
Unrealized gain on available for sale securities	$ 320	$ 741	$ 347
Reclassification adjustments for net realized gains included in net income	(682)	(15)	(13)
Accrued pension liability	29	(281)	-
Net unrealized gain (loss) arising during the year	(333)	445	334
Tax effect	113	(154)	(111)
Other comprehensive income (loss) for the year	$ (220)	$ 291	$ 223

NOTE Q - RESTRICTIONS ON TRANSFERS FROM SUBSIDIARY

Capital guidelines adopted by federal and state regulatory agencies and restrictions imposed by law limit the amount of cash dividends the Bank can pay to the Company. At January 1, 2010, using the most restrictive of these conditions, the aggregate cash dividends that the Bank could pay the Company without prior regulatory approval was $3.7 million.

NOTE R - SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION

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

Balance Sheets	December 31, 2009	December 31, 2008
Assets		
Cash and cash equivalents	$ 616	$ 640
Investment in subsidiary banks	53,301	55,400
Investment in non banking subsidiary	190	192
Premises and equipment, net	908	944
Other	528	833
Total Assets	$ 55,543	$ 58,009
Liabilities and Shareholders' Equity		
Dividends payable	$ 116	$ 462
Other liabilities	104	202
Other borrowings	3,489	7,046
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in ESOP	945	728
Shareholders' equity	45,734	44,416
Total Liabilities and Shareholders' Equity	$ 55,543	$ 58,009

NOTE R - SOUTHERN MICHIGAN BANCORP, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION (CONTINUED)

Statements of Income	Year ended December 31, 2009	2008	2007
Dividends from subsidiary banks	$ 1,113	$ 4,088	$ 7,459
Interest income	34	33	18
Interest expense	(351)	(693)	(458)
Other income	137	148	209
Other expenses	(269)	(320)	(175)
	664	3,256	7,053
Federal income tax credit	(153)	(283)	(139)
	817	3,539	7,192
Equity in net income, less dividends received, of:			
Subsidiary banks	1,121	(2,725)	(3,057)
Non-banking subsidiary	(2)	(1)	(2)
Net Income	$ 1,936	$ 813	$ 4,133

Statements of Cash Flows	Year ended December 31, 2009	2008	2007
Operating Activities			
Net income	$ 1,936	$ 813	$ 4,133
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received, of:			
Subsidiary banks	(1,121)	2,725	3,057
Non-banking subsidiary	2	1	2
Stock option and restricted stock grant compensation expense	132	141	95
Depreciation	32	32	35
Net change in obligation under ESOP	154	121	40
Other, net	211	(9)	43
Net cash from operating activities	1,346	3,824	7,405
Investing Activities			
Subsidiary bank acquisition	-	-	(13,764)
Retirement of bank stock	3,000	-	-
Additions to premises and equipment	-	(4)	-
Net cash from investing activities	3,000	(4)	(13,764)
Financing Activities			
Proceeds from other borrowings	3,000	600	8,000
Repayments of other borrowings	(6,557)	(1,687)	(43)
Cash dividends paid	(813)	(1,849)	(1,525)
Purchase of ESOP shares	-	(609)	-
Repurchase of common stock	-	(12)	-
Net cash from financing activities	(4,370)	(3,557)	6,432
Net change in cash and cash equivalents	(24)	263	73
Beginning cash and cash equivalents	640	377	304
Ending cash and cash equivalents	$ 616	$ 640	$ 377

NOTE S - SUPPLEMENTAL CASH FLOW DISCLOSURES

The following supplemental cash flow disclosures are provided for the years ended December 31, 2009, 2008 and 2007 (in thousands):

	2009	2008	2007
Cash paid during the year for:			
Interest	$ 5,692	$ 8,280	$ 8,595
Income taxes	-	480	1,305
Non-cash operating activities:			
Change in deferred income taxes on net unrealized gain on available for sale securities	123	(249)	(111)
Change in deferred income taxes on pension liability	(10)	95	31
Change in pension liability	29	(281)	(90)
Non-cash investing activities:			
Change in unrealized gain on available for sale securities	(362)	726	334
Transfers from loans to foreclosed assets	3,197	1,987	1,863
Non-cash financing activities:			
Issuance of common stock, net of issuance cost	-	-	12,711

NOTE T - 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. For all other securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things.

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.

NOTE T - FAIR VALUE INFORMATION (CONTINUED)

Securities sold under agreements to repurchase, overnight borrowings and federal funds sold: 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 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 appropriate factors, there is no assurance that if the Company had disposed of such items at December 31, 2009 and 2008, 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, 2009 and 2008 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.

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

	2009		2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 24,814	$ 24,814	$ 27,989	$ 27,989
Federal funds sold	2,540	2,540	3,320	3,320
Securities available for sale	56,948	56,948	65,718	65,718
Loans held for sale	605	605	121	121
Loans, net of allowance for loan losses	327,004	329,961	328,206	332,567
Accrued interest receivable	2,054	2,054	2,614	2,614
Financial liabilities:				
Deposits	$ (380,905)	$ (382,166)	$ (394,043)	$ (396,237)
Securities sold under agreements to repurchase and overnight borrowings	(14,799)	(14,799)	(13,890)	(13,890)
Other borrowings	(10,832)	(10,983)	(12,492)	(12,690)
Subordinated debentures	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	(228)	(228)	(520)	(520)

The preceding table does not include net cash surrender value of life insurance and dividends payable which are also considered financial instruments. The estimated fair value of such items is considered to be their carrying amount.

Southern has also unrecognized financial instruments which relate to commitments to extend credit and standby letters of credit, as described in Note O. The contract amount of such instruments is considered to be the fair value.

NOTE U - FAIR VALUE MEASUREMENTS

The Fair Value Measurements Topic of ASC 820-10 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820-10-20 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact.

ASC 820-10 requires the use of valuation techniques that are consistent with the market approach, the income approach, and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, ASC Topic 820-10-55 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.), or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, follows. These valuation methodologies were applied to all of the Company's financial and nonfinancial assets and liabilities carried at fair value.

Note U - Fair Value Measurements (continued)

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Securities Available for Sale. Securities classified as available for sale are reported at fair value utilizing Level 1, Level 2 and Level 3 inputs. Unadjusted quoted prices in active markets for identical assets are utilized to determine fair value at the measurement date for Level 1 securities. For all other securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things. When there are unobservable inputs, such securities are classified as Level 3.

Securities available for sale classified as Level 3 inputs represent non-publicly traded municipal issues with limited trading activity from entities within the Company's market area. The fair value of these investments was determined using Level 3 valuation techniques, as there is no market available to price these investment securities. The method used for determining the fair value for these investment securities included a comparison to the fair value of other investment securities valued with Level 2 inputs with similar characteristics (credit, time to maturity, call structure, etc.) and the interest yield curve for comparable debt investment securities.

Impaired Loans. The Company does not record impaired loans at fair value on a recurring basis. However, periodically, a loan is considered impaired and is reported at the fair value of the underlying collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Impaired loans measured at fair value typically consist of loans on nonaccrual status and loans with a portion of the allowance for loan losses allocated specific to the loan. Some loans may be included in both categories whereas other loans may only be included in one category. Collateral values are estimated using level 2 inputs, including recent appraisals, and Level 3 inputs based on customized discounting criteria. Due to the significance of the level 3 inputs, impaired loans have been classified as level 3.

Other Real Estate Owned (OREO). The Company values OREO at the fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach.

NOTE U - FAIR VALUE MEASUREMENTS (CONTINUED)

The following table summarizes financial and nonfinancial assets (there were no financial or nonfinancial liabilities) measured at fair value as of December 31, 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Recurring:				
Securities available for sale	$ 31,109	$ 22,740	$ 3,099	$ 56,948
Nonrecurring:				
Impaired loans	$ -	$ -	$ 9,585	$ 9,585
Other real estate owned	$ -	$ -	$ 1,187	$ 1,187

Impaired loans are reported net of a $1,550,000 allowance for loan losses.

Other real estate owned, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of $1,187,000, which is made up of the balance of $1,382,000, net of a valuation allowance of $195,000 at December 31, 2009. Write-downs of other real estate owned amounted to $183,000 for the year ending December 31, 2009 and are included in loss on sale of other real estate owned.

The following table summarizes financial assets (there were no financial liabilities) measured at fair value as of December 31, 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Recurring:				
Securities available for sale	$ 58,701	$ 4,015	$ 3,002	$ 65,718
Nonrecurring:				
Impaired loans	$ -	$ -	$ 11,949	$ 11,949

Impaired loans are reported net of a $3,308,000 allowance for loan losses.

Note U - Fair Value Measurements (continued)

The following is a reconciliation of the beginning and ending balances of securities available for sale which are measured at fair value on a recurring basis using significant unobservable (Level 3) inputs during the year ending December 31, 2009 (in thousands):

Balance at January 1, 2009	$ 3,002
Net maturities and calls	(316)
Unrealized net losses included in other comprehensive income	(2)
Net transfers in/out of level 3	415
Balance at December 31, 2009	$ 3,099

Note V - Regulatory Matters

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, 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. Failure to meet capital requirements can initiate regulatory action that could have a direct material adverse effect on the consolidated financial statements. Prompt corrective action provisions are not applicable to bank holding companies.

The prompt corrective action regulations provide five capital categories, 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.

At year-end 2009 and 2008, the most recent regulatory notifications categorized the Company as “well capitalized” under applicable regulations.

NOTE V - REGULATORY MATTERS (CONTINUED)

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

	Actual		Minimum Required For Capital Adequacy Purposes		Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
2009						
Total capital (to risk weighted assets)						
Consolidated	$40,733	11.9%	$27,367	8.0%	N/A	N/A
SMB&T	42,259	12.4	27,235	8.0	$34,044	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	36,435	10.7	13,683	4.0	N/A	N/A
SMB&T	37,982	11.2	13,617	4.0	20,426	6.0
Tier 1 capital (to average assets)						
Consolidated	36,435	8.1	18,084	4.0	N/A	N/A
SMB&T	37,982	8.4	18,078	4.0	22,598	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**
2008						
Total capital (to risk weighted assets)						
Consolidated	$38,938	11.0%	$28,366	8.0%	N/A	N/A
SMB&T	31,913	12.3	20,789	8.0	$25,986	10.0%
FNB	12,263	13.2	7,456	8.0	9,320	10.0
Tier 1 capital (to risk weighted assets)						
Consolidated	34,473	9.7	14,183	4.0	N/A	N/A
SMB&T	28,658	11.0	10,395	4.0	15,592	6.0
FNB	11,071	11.9	3,728	4.0	5,592	6.0
Tier 1 capital (to average assets)						
Consolidated	34,473	7.9	17,361	4.0	N/A	N/A
SMB&T	28,658	8.9	12,961	4.0	16,201	5.0
FNB	11,071	7.9	5,600	4.0	7,000	5.0

As previously stated, FNB was consolidated with and into SMB&T in 2009.

NOTE W - QUARTERLY FINANCIAL DATA (IN THOUSANDS, EXCEPT PER SHARE DATA) (UNAUDITED)

	Interest Income	Net Interest Income	Provision for Loan Losses	Net Income (Loss)	Earnings (Loss) Per Share Basic	Earnings (Loss) Per Share Fully Diluted
2009						
First Quarter	$ 5,572	$ 4,089	$ 1,450	$ (271)	$ (.12)	$ (.12)
Second Quarter	5,483	4,131	500	751	.33	.33
Third Quarter	5,447	4,177	350	771	.34	.34
Fourth Quarter	5,436	4,141	425	685	.29	.29
2008						
First Quarter	$ 7,152	$ 4,702	$ 350	$ 1,201	$ .52	$ .52
Second Quarter	6,403	4,359	800	349	.16	.16
Third Quarter	6,391	4,523	1,580	21	.01	.01
Fourth Quarter	5,983	4,156	2,350	(758)	(.33)	(.33)

Selected Financial Data

(in thousands, except per share data)

	Year Ended December 31				
	2009	2008	2007	2006	2005
Total interest income	$ 21,938	$ 25,929	$ 23,544	$ 21,454	$ 18,808
Net interest income	16,538	17,740	14,906	14,495	13,437
Provision for loan losses	2,725	5,080	745	500	750
Net income	1,936	813	4,133	4,009	3,802
Per share data*:					
Basic earnings per share	.84	.36	2.29	2.27	2.13
Diluted earnings per share	.84	.36	2.28	2.26	2.12
Cash dividends	.20	.80	.80	.78	.67
Balance sheet data:					
Gross loans	333,079	335,310	335,978	252,825	242,714
Deposits	380,905	394,043	399,169	282,509	268,078
Other borrowings	10,832	12,492	14,753	6,973	12,164
Common stock subject to repurchase	945	728	2,029	2,148	1,911
Equity	45,734	44,416	44,219	28,482	26,110
Total assets	462,409	474,996	480,178	329,891	317,952
Return on average assets	.41%	.17%	1.18%	1.25%	1.19%
Return on average equity (1)	4.29	1.77	12.72	14.54	14.81
Dividend payout ratio (2)	24.13	227.33	36.90	34.44	31.69
Average equity to average assets (1)	9.66	9.59	9.27	8.56	8.06

* Per share data for 2005 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.

(3) The 2007 and after information reflects the purchase of FNB, effective December 1, 2007, as described in Note C to the Consolidated Financial Statements.

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 441 shareholders of record at March 12, 2010.

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:

	2009			2008		
	Bid Price		Cash Dividends	Bid Price		Cash Dividends
Quarter Ended	High Bid	Low Bid	Declared	High Bid	Low Bid	Declared
March 31	$ 8.10	$ 5.10	$ .05	$ 22.00	$ 17.00	$ .20
June 30	14.00	5.50	.05	19.60	16.50	.20
September 30	9.00	6.80	.05	16.55	12.05	.20
December 31	10.05	8.30	.05	14.00	7.05	.20

There are restrictions that currently limit the Company's ability to pay cash dividends. Information regarding dividend payment restrictions is described in Note Q to the consolidated financial statements.