Southern Michigan Bancorp, Inc./ 2010 Annual Report

Southern Michigan
BANCORP, INC.
Continuous Banking Since 1872

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Financial Summary

For the Year	2010	2009
Net interest income	$ 16,245,000	$ 16,538,000
Provision for loan losses	1,375,000	2,725,000
Non-interest income	7,207,000	7,172,000
Non-interest expense	18,258,000	18,970,000
Net income	3,098,000	1,936,000
Per Share		
Basic earnings	$1.34	$0.84
Diluted earnings	1.34	0.84
Cash dividends declared	0.20	0.20
At Year End		
Assets	$ 493,880,000	$ 462,409,000
Gross loans	309,524,000	333,079,000
Allowance for loan loss	5,694,000	6,075,000
Deposits	409,901,000	380,905,000
Other borrowings	10,079,000	10,832,000
Shareholders' equity	47,843,000	45,734,000
Ratios		
Return on average assets	0.65%	0.41%
Return on average equity	6.56%	4.29%
Total risk-based capital ratio	13.69%	11.91%
ALLL as percentage of loans	1.84%	1.82%

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 southwest Michigan communities in which they are located and in areas immediately surrounding these communities.

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To Our Shareholders

Southern Michigan Bancorp, Inc. successfully concluded 2010 by reporting fourth quarter net income of $723,000 compared with $685,000 earned during the fourth quarter of 2009. For all of 2010, Southern reported net income of $3,098,000, or $1.34 per fully diluted share, an increase of 60 percent over prior year totals of $1,936,000 and $.84 per share.

Our respectable fourth quarter and 2010 annual results were attained despite the continuation of challenging economic and business climates in our market area characterized by double-digit unemployment and diminished levels of personal and corporate borrowing. As of year end 2010, total deposits grew to $410 million, the highest year-end total in Southern's history and an increase of nearly $29 million over 2009 totals. Gross loan balances at year end 2010 totaled $310 million, a decline of $23 million from the year-end 2009 total of $333 million. Total assets as of December 31, 2010 were $493.9 million, again a record high level in Southern's history.

Southern's financial performance for 2010 was driven by improvements in loan quality, our solid net interest margin and growth in non-interest income. Provision for loan losses declined to $1,375,000 for 2010 compared with $2,725,000 for 2009, a reduction of 49.5 percent. For 2010, net charge-offs were substantially reduced to $1,756,000 from the prior year total of $3,754,000. In addition, non-performing loans as of December 31, 2010 totaled $5,294,000, or 1.71 percent of total loans, which represented a sharp decline of 30 percent from year-end 2009 totals of $7,599,000. Southern's allowance for loan losses at year end 2010 totaled $5,694,000, or 1.84 percent of total loans.

Our net interest margin, which declined for the year to 3.95 percent compared with 4.14 percent for 2009, was affected by the overall reduction of our loan portfolio. However, the low deposit interest rate environment enabled us to maintain the margin at traditionally higher levels compared with many community bank peers. Non-interest income increased modestly to $7,207,000 for 2010 compared with the 2009 total of $7,172,000. Increases in gains from loan sales and from life insurance proceeds were able to offset declines in service charges and investment securities gains.

A significant amount of management's attention during 2010 was focused on identifying ways to reduce operating expenses. As a result, total non-interest expense for 2010 declined by $712,000 from 2009 totals. Many of the expense reductions were attained as a result of the 2009 consolidation of our two affiliate banks, the benefits from which were fully realized in 2010. Reductions in professional fees and outside expenses, ATM network costs and FDIC assessments all contributed to the success of our expense control initiatives. We continue to aggressively pursue ways to generate cost savings and gain efficiencies without sacrificing the quality of our customer service. Significant strides to reduce overall expenses continue to be made, much of which will not be fully integrated until the second half of 2011.

Southern earned a return on average assets of .65 percent and a return on average equity of 6.56 percent for 2010, both of which exceeded last year's results of .41 percent and 4.29 percent, respectively. Equally important, our Tier 1 Capital Ratio of 12.44 percent and Total Risk-Based Capital ratio of 13.69 percent are well above regulatory benchmarks for being well-capitalized.

Southern's strong financial performance, especially over the past three years of unprecedented stress in Michigan's economy, resulted directly from emphasizing sound credit risk management practices, controlling expenses, and most importantly, paying attention to our customers' needs. The turmoil in the banking industry makes it extremely difficult to predict future performance. However, recent passage of the Dodd-Frank Act and national health care legislation will likely impair revenue growth and increase the cost of doing business.

These challenging conditions will not deter us from identifying new ways to effectively serve our clients. We are evaluating enhancements to our electronic banking services, including Internet and mobile banking, among others, to make banking with Southern easier and more convenient. This is especially vital as the costs associated with traditional branch banking, and other familiar delivery channels continue to escalate throughout the industry.

Thank you for your continued support of Southern Michigan Bank and Trust.

Sincerely,

John H. Castle,
Chairman and Chief Executive Officer

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Investing in Relationships

When Phil Kline's parents, Paul and Joyce, bought 164 acres of lakefront property in Three Rivers in 1965, the property was little more than a fishing camp—a half-dozen or so rustic cottages where families could go to relax and fish or float around the lake in a small rowboat.

Phil remembers that his father's initial intention was to farm the property; but once he settled in, he started building. At first, it was

Robert Hungerford, vice president / commercial lender (2nd from right), visits Kline's Resort with owners Phil (far left) and Tama (far right) Kline and Phil's parents Paul and Joyce Kline.

a few new campsites each year—then roads, a sewer system, a water system including a water tower, and other amenities that would eventually grow into what is now a premier resort in southwest Michigan.

Today, Phil and his wife, Tama, oversee the sprawling resort for recreational vehicles and manufactured housing. Nestled on more than 2,500 feet of frontage on beautiful Lake Portage, Kline's is home to 245 families in the summer and more than 100 residents who maintain year-round homes. As a community that caters to individuals age 55 and older, most residents are retirees and many are "snowbirds" who leave the park for the winter.

When Phil and Tama began to manage the resort in 1995, they inherited a work in progress—and continued renovating and upgrading the resort. "Dad had built in so many different stages that our challenge was to make it more homogeneous," Phil recalled. "The roads were built to different engineering standards, the water system had been cobbled together—we needed to upgrade and standardize."

Improving the park has continued for the past 16 years, with the Klines coming to Southern Michigan Bank & Trust in 2005. What started as a favorable refinancing arrangement for a construction improvement loan has grown into a complete package of banking services, including commercial loans and online banking.

Phil credits much of this growth to their loan officer, Bob Hungerford. Bob had a long-standing business relationship with Phil's brother and a stellar reputation in the Three Rivers Community. "Bob is almost like a member of the family," Phil notes. "The relationship with a lender is so important. He has a keen understanding of our business, and understands that because of the seasonal nature of our business we get most of our revenue in the spring and fall. Bob crafted a loan package that works well for us. He is familiar with who we are and how we do business. Without him, we would not have been ready to get started building our new club house."

In October 2010, Kline began work to construct a 10,000-square-foot clubhouse that will be the cornerstone of this growing community. More than double in size from the existing club house, the new facility will feature an Internet café; a large activity room for card players, knitters and crafters; a rec room for line dancing and exercise classes; workout facilities; a main meeting area and a fully licensed kitchen with seating to accommodate 125 people.

At the same time, Phil and Tama are upgrading the water system, adding a new parking lot and making a few additional improvements to welcome their "snowbirds" back this spring.

"Several of our staff members have visited the resort, including our president and CEO, and they are all amazed at the caliber of operation that Phil and Tama have built," explains Bob Hungerford, vice president and commercial lender at Southern. "The new clubhouse project they are undertaking is significant and will be a beautiful addition to the other amenities at the resort when finished. They have made a substantial investment in their business—and Southern is proud to be a part of it."

Phil expects the clubhouse to be ready in early June 2011. One of the first parties booked? A welcome back pancake breakfast for all of the residents of the resort.

"The personal relationship we have with Southern is important to me...When I call and say I need to draw on my line of credit, I know the person I'm talking to."
—Phil Kline

"The personal relationship we have with Southern is important to me," Phil says. "When I call and say I need to draw on my line of credit, I know the person I'm talking to. For a family business like ours, it gives me great confidence to know I'm not just a number in line somewhere."

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The Business of Solutions

Over the past five years, TJ Rampit USA has grown more than four times in size, and owner Ted Short, Jr. credits Southern Michigan Bank & Trust for playing an important role in their success.

When the Coldwater Company began operations in 1992, Ted's father focused on building modular aluminum ramps for the disabled. The initial operation was modest—a few

Nick Grabowski, vice president / commercial lender, meets at TJ Rampit with chief executive officer, Ted Short, Sr. and owner Ted Short, Jr.

hundred thousand dollars in sales that first year, 3,200 square feet of manufacturing and warehousing space, and four employees.

TJ Rampit gained recognition in the industry as a provider of quality products and outstanding customer service. The company began to rapidly expand, adding a ramp rental option for large events, such as college graduations, in order to further develop its product mix. TJ Rampit later added warehouses at strategic locations across the country. In 2006, TJ Rampit expanded again to facilitate bidding on government contracts.

Ted says that the business's sales, "really started skyrocketing" at that point—and Southern was able to keep up with their financial needs. In just the last few years his customer mix has gone from mostly residential customers to about 20% residential and 80% governmental clients.

"I'm not sure that I would have been able to grow like I have without their help. Southern has never said, 'Hey, we can't do that.' The bank was willing to go out on a limb with us."

Nick Grabowski, vice president of commercial lending, says that Southern handles all of TJ Rampit's commercial banking —including financing building construction and new equipment purchases, providing working capital financing for inventory and receivables, and longer term financing for new real estate purchases.

"We appreciate the relationship that we have with Ted and his father; we helped the Shorts grow TJ Rampit by helping them to anticipate their capital needs, which were varied at times, as their company expanded and sales grew," states Grabowski. "As a commercial lender I get a lot of satisfaction from helping quality companies like TJ Rampit grow and prosper."

Ted says his company also takes advantage of online banking services through Southern. "Their Internet banking product makes it easy to keep up with the rapidly changing pace of my business. They are just so personable and we really appreciate that. They are very easy to do business with."

"Their Internet banking product makes it easy to keep up with the rapidly changing pace of my business."
—Ted Short, Jr.

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Moving Forward Together

After 34 years with Fibre Converters, a company that has been closely aligned with the automotive industry, Jim Stuck, president and CEO, has been through a lot of swings in the market.

Fibre Converters was established in 1949, initially manufacturing interior poster board and laminating kraft paper to create grease-proof cartons for shipping. During its early years as a Michigan-based company, it

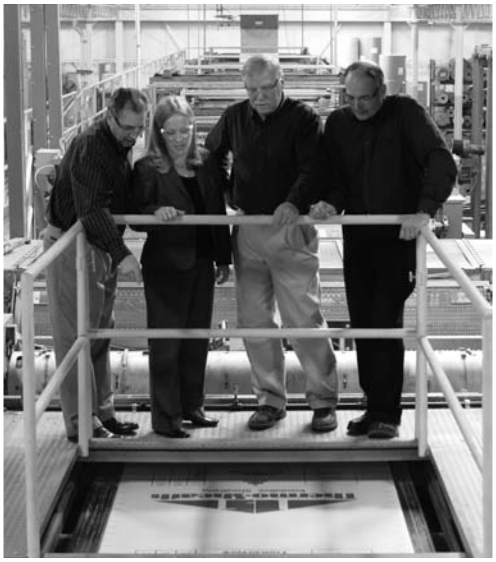
Fibre Converters team reviews plans. From left, David Posey, controller; Jim Stuck, president / chief executive officer; Mike Willis, director of quality; Steve Reed, vice president of operations; Dave Lushin, director of supply chain.

was heavily invested in manufacturing automotive interior components turning out door panels, package trays and sun visors.

As the technologies it utilized became more sophisticated, Fibre Converters began diversifying into new and different products and across different industries. Today it extrusion coats or laminates and die cuts custom laminated grades of recycled and virgin paper and paperboard. In addition to the automotive industry, Fibre Converters supplies products to the ready-to-assemble furniture, recreational vehicle, packaging, housing and defense industries.

The company moved to Constantine in 1993 to facilitate further growth in sales and the installation of new larger and advanced equipment. Fibre Converters had been doing business with Southern Michigan Bank & Trust as well as a large national bank for nearly 20 years—a relationship that dramatically changed during the past year.

"When the economy hit the skids in the fourth quarter of 2008, things got real interesting for a while," Jim notes, particularly when the company's longtime lead bank decided to exit the relationship. "We were 90 percent done with a major expansion project and they bolted," he recalls. "They really left us hanging. Although it didn't make it any easier, that happened to a lot of Michigan-based businesses when the large banks seemed to be exiting Michigan during the great recession. Southern was able to step in and provide the continuity of financial services that was crucial to us at that time."



(above left) Sarah Headley, vice president / commercial lender, is given a tour of facilities by Mike Willis, Steve Reed, and Jim Stuck. (above right) Jamie Tobalske, assistant vice president / e-Services officer, aids Cathy Piper and David Posey with their Internet banking.

Southern handles Fibre Converters' equipment financing, provides working capital financing for inventory and receivables, and traditional checking and cash management services.

Vice president and commercial lender Sarah Headley notes that the banks e-Services options have been very popular with the company. "Fibre Converters is a sophisticated customer with excellent financial reporting. The management group at Fibre Converters is open to new ideas and products the bank has to offer, particularly in the area of electronic banking. They believe that our products line up well with those offered by the big banks, and in some cases are even better."

Jim Stuck could not agree more. "With Southern, we had a seamless transition to their electronic banking services. They have the technology available that allows us to process and deposit all of our receivables right from our office. It's a very straightforward process and virtually instantaneous—you could be in the middle of nowhere and make it work."

"We love being back in the local arena for all of our banking services," Jim says. "When our lead bank decided that they were turning left and we were going right, we realized we were just a number. For us to be back with a bank that knows who we are as a business—and as individuals—is just great. Bigger is not necessarily better. Southern is large enough to meet our credit needs, and provide products and services at very competitive rates. We are extremely pleased with the way things worked out."

"Southern is large enough to meet our credit needs, and provide products and services at very competitive rates." *—Jim Stuck*

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Executive Officers of Southern Michigan Bancorp, Inc.

John H. Castle
Chairman & Chief Executive Officer

Kurt G. Miller
President

Danice L. Chartrand
Senior Vice President /
Chief Financial Officer

Southern Michigan Bancorp, Inc. Board of Directors

Marcia S. Albright
Cequent Performance Products, Inc.

Dean Calhoun
Coldwater Veneer, Inc.

John S. Carton
Retired Business Executive

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

H. Kenneth Cole
Hillsdale College

Gary H. Hart
Infinisource, Inc.

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

Gregory J. Hull
Farmer

Thomas E. Kolassa
HUB International, Inc.

Donald J. Labrecque
Labrecque Management

Brian P. McConnell
Burr Oak Tool, Inc.

Thomas D. Meyer
Meyer Ventures, LLC

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

Freeman E. Riddle
Spoor-Parlin, Inc.

Executive officers (from left to right) John H. Castle, chairman & chief executive officer; Danice L. Chartrand, senior vice president / chief financial officer; Kurt G. Miller, president.

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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

Officers of Southern Michigan Bank & Trust

COMMERICAL LOANS
David Clow
Senior Vice President /
Head of Commercial Lending

Deborah Davis
Vice President

Nick Grabowski
Vice President

Sarah Headley
Vice President

Robert Hungerford
Vice President

Doug Kiessling
Vice President

James Sobeske
Vice President

Tom Swoish
Vice President

Joan Trenary
Vice President

Jason Williams
Vice President

Marcia McClellan
Administration Officer

RESIDENTIAL & CONSUMER LOANS
Jamie Smoker
Senior Vice President /
Head of Residential & Consumer Lending

Rick Feller
Vice President /
Lending and Sr. Collection Adminstrator

Phyllis Wingate
Vice President / Head of Retail Loan Operations

Tina Mack
Assistant Vice President /
Loan Operations

Jeremiah Ervans
Assistant Vice President /
Retail Loan Officer

Tim Fox
Assistant Vice President /
Retail Loan Officer

DeAnne Hawley
Assistant Vice President /
Retail Loan Officer

Shari Kline
Assistant Vice President /
Retail Loan Officer

Diane Krimmel
Assistant Vice President /
Retail Loan Officer

Lori Lemmon
Assistant Vice President /
Retail Loan Officer

Tammy Malatok
Assistant Vice President /
Retail Loan Officer

Gregory Mallar
Assistant Vice President /
Retail Loan Officer

Desiree Kauffman
Retail Loan Officer

Judie Ratering
Retail Loan Officer

Connie Swain-Caudill
Assistant Vice President /
Senior Collections Manager

LOAN REVIEW
Trisha Pawloski
Assistant Vice President /
Loan Review Officer

TRUST DEPARTMENT
Mary Guthrie
Senior Vice President /
Senior Trust Officer

R. 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

RETAIL BANKING SERVICES

Eric Anglin
First Vice President /
Retail Banking Services /
Chief Deposit Officer

COLDWATER MAIN & EAST CHICAGO BRANCHES
Abby Austin
Branch Manager

BATTLE CREEK BRANCH
Claudia Murch
Assistant Vice President /
Branch Manager

MARSHALL BRANCH
Annette Campau
Assistant Vice President /
Community Banking Officer

HILLSDALE BRANCH
Lori Neill
Assistant Vice President /
Regional Branch Manager

CAMDEN BRANCH
Martha Zilch
Teller Supervisor*

UNION CITY BRANCH
Ken Brooks
Vice President /
Regional Branch Manager

TEKONSHA BRANCH
Dawn Copas
Branch Manager

WESTERN REGION
Sally Cotton
First Vice President /
Regional Manager

MENDON BRANCH
Doreen Tobin
Assistant Vice President /
Regional Branch Manager

CENTREVILLE BRANCH
Paul Harker
Branch Manager

CASSOPOLIS
Janet Nosich
Branch Manager

CONSTANTINE BRANCH
Ashley Rice
Branch Manager*

THREE RIVERS MAIN BRANCH
Sharon Bachinski
Assistant Vice President /
Regional Branch Manager

THREE RIVERS WESTLAND BRANCH
Lynette Lorenz
Branch Manager

ACCOUNTING
Sara Herrmann
Vice President / Finance

INFORMATION SYSTEMS
Jeff Kiersey
Senior Vice President /
Chief Information Officer

Paul Mahle
Assistant Vice President /
Senior Data Processing Officer

Matt Siefken
Network and Systems Officer

OPERATIONS
Dave McKinley
First Vice President /
Head of Operations

Jamie Tobalske
Assistant Vice President /
e-Services Officer

Vikki Kline
Project / Research Officer

COMPLIANCE
Christine Hagaman
Vice President /
Compliance Officer

MARKETING
Patty Parker
Vice President

*Non Officer Position

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Shareholder Information

Annual Meeting

The annual meeting of Southern Michigan Bancorp, Inc. will be held on May 12, 2011 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

Southern Michigan Bancorp, Inc.

2010 Annual Report

Your Community. Your Bank.

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FORWARD-LOOKING STATEMENTS

This Southern Michigan Bancorp, Inc. Annual 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. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "may", "should", "will", "is likely", or is "probably" to occur or "continue", has "begun" or "is scheduled" or "on track" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "intends", "predicts", "projects", or "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "near term", "going forward", "starting" and variations of such words and similar expressions. 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 liquidity levels, 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 other real estate owned, 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), and management's assumptions concerning pension and other postretirement benefit plans involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to successfully implement new programs and initiatives, increase efficiencies, respond to declines in collateral values and credit quality, maintain our current level of deposits and other sources of funding, 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.

Risk factors include, but are not limited to, the risk factors described in "Item 1A – Risk Factors" of Southern Michigan Bancorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2010. 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 provides 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 ("the Bank") for the periods indicated. This discussion should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements.

Overview

Southern is a Michigan corporation and a bank holding company registered under the Bank Holding Company Act of 1956. Southern wholly owns the Bank and Southern Michigan Bancorp Capital Trust I, a Delaware statutory trust. The Bank wholly owns FNB Financial Services, Inc., a Michigan corporation.

Our business, which we conduct primarily through the Bank, is concentrated in a single industry segment - commercial banking. We offer a variety of deposit, payment, credit and other financial services to all types of customers. These services include time, savings, and demand deposits, safe deposit services, and automated teller machine services. Loans, including both commercial and consumer, are extended primarily on a secured basis to corporations, partnerships and individuals. Commercial lending covers such categories as business, industry, agricultural, construction, inventory and real estate. Consumer lending covers direct and indirect loans to purchasers of residential real property and consumer goods. We offer trust and investment services, which include investment management, trustee services, IRA rollovers and retirement plans, institutional and personal custody, estate settlement, wealth management, estate planning assistance, wealth transfer planning assistance, charitable gift planning assistance, and cash management custody. We operate 17 banking offices located in Athens, Battle Creek, Camden, Cassopolis, Centreville, Coldwater, Constantine, Hillsdale, Marshall, Mendon, Tekonsha, Three Rivers, and Union City, Michigan.

On December 1, 2007, we completed the acquisition of FNB Financial Corporation ("FNB") and its subsidiary bank, FNB Financial. On April 24, 2009, FNB Financial was consolidated with and into the Bank.

At December 31, 2010, on a consolidated basis, we had assets of $493.9 million, deposits of $409.9 million, a net loan portfolio of $303.8 million, trust assets under management totaling $215.0 million, and shareholders' equity of $47.8 million.

Results of Operations

Southern's net income for 2010 was $3,098,000 compared to $1,936,000 in 2009, an increase of $1,162,000, or 60.02%. Provision for loan losses of $1,375,000 was expensed in 2010, down from $2,725,000 in 2009. Non-interest income increased 0.49% to $7,207,000 in 2010. Non-interest expense decreased 3.75%, or $712,000, to $18,258,000 in 2010.

	Percent Change from Prior Year			Percent Change from Prior Year	
	2010	**2009**		**2010**	**2009**
Net interest income	-1.77%	-6.78%	Assets	6.81%	-2.65%
Provision for loan losses	-49.54%	-46.36%	Securities available for sale	4.00%	-13.34%
Non-interest income	0.49%	12.71%	Gross loans	-7.07%	-0.67%
Non-interest expense	-3.75%	0.00%	Allowance for loan losses	-6.27%	-14.48%
Net income	60.02%	138.13%	Deposits	7.61%	-3.33%
			Other borrowings	-6.95%	-13.29%
			Shareholders' equity	4.61%	2.97%

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 6.56% in 2010, 4.29% in 2009 and 1.77% in 2008. The return on average assets was 0.65% in 2010, 0.41% in 2009 and 0.17% in 2008.

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 2010, Southern's net interest margin (FTE) was 3.95% compared to 4.14% for 2009 and 4.36% for 2008. Beginning 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 0.25%. For both 2009 and 2010, 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 0.44%, from 5.45% in 2009 to 5.01% in 2010, while deposit yields were down 0.27%, from 1.49% in 2009 to 1.22% in 2010.

In 2010, the lower interest margin was a result of reduced rates for all interest earning asset types and reduced loan and investment volumes partially offset by reduced rates for deposits. The net effect was a decrease of $402,000 in net interest income (FTE) compared to 2009.

In 2009, the lower interest margin was a result of lower rates being in effect for the entire year and reduced balances in loans and investment securities. The net effect was a decrease of $1,256,000 in net interest income (FTE) compared to 2008.

Despite the lower net interest margin in 2008, net interest income (FTE) increased during the year by $3,055,000. The increase resulted primarily from the acquisition of FNB. The 2008 increase in net interest income was a result of a $2,606,000 improvement in interest income and a $449,000 reduction of interest expense. The 2008 increase in interest income was the result of a $104.1 million of additional average earning assets, primarily from the acquisition of FNB, which was enough to overcome the rate decrease. Despite adding $103.6 million of average interest bearing liabilities, primarily from the acquisition of 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 2010, 2009 and 2008.

Table 1. Average Balances and Tax Equivalent Interest Rates

	2010			2009			2008		
(Dollars in Thousands)	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS									
Interest earning assets:									
Loans(1)(2)(3)	$ 322,349	$ 19,251	5.97%	$ 333,397	$ 19,966	5.99%	$ 334,873	$ 22,665	6.77%
Taxable investment securities(4)	33,765	604	1.79	38,329	1,134	2.96	44,341	2,100	4.74
Tax-exempt investment securities(1)	21,023	1,165	5.54	23,044	1,338	5.81	24,272	1,429	5.89
Federal funds sold and other(5)	45,459	155	0.34	18,487	69	0.37	17,624	358	2.03
Total interest earning assets	422,596	21,175	5.01	413,257	22,507	5.45	421,110	26,552	6.31
Non-interest earning assets:									
Cash and due from banks	11,489			11,059			13,795		
Other assets(6)	49,828			49,505			49,797		
Less allowance for loan losses	(5,757)			(6,548)			(5,339)		
Total assets	$ 478,156			$ 467,273			$ 479,363		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Demand deposits	$ 148,968	$ 518	0.35%	$ 142,931	$ 612	0.43%	$ 159,576	$ 2,072	1.30%
Savings deposits	47,937	70	0.15	51,450	108	0.21	54,480	375	0.69
Time deposits	136,369	3,189	2.34	135,781	3,952	2.91	129,358	4,546	3.51
Securities sold under agreements to repurchase and overnight borrowings	16,714	50	0.30	14,899	41	0.28	10,423	156	1.50
Other borrowings	12,131	486	4.01	12,284	490	3.99	13,138	721	5.49
Subordinated debentures	5,155	157	3.05	5,155	197	3.82	5,155	319	6.19
Total interest bearing liabilities	367,274	4,470	1.22	362,500	5,400	1.49	372,130	8,189	2.20
Non-interest bearing liabilities:									
Demand deposits	58,298			55,934			55,557		
Other	4,197			2,852			4,343		
Common stock subject to repurchase obligation	1,172			836			1,379		
Shareholders' equity	47,215			45,151			45,954		
Total liabilities and shareholders' equity	$ 478,156			$ 467,273			$ 479,363		
Net interest income		$ 16,705			$ 17,107			$ 18,363	
Interest rate spread			3.79%			3.96%			4.11%
Net margin on interest earning assets			3.95%			4.14%			4.36%

(1) Includes tax equivalent adjustment of interest (assuming a 34% tax rate) for securities and loans of $396,000 and $64,000, respectively for 2010; $455,000 and $114,000, respectively for 2009; and $486,000 and $137,000, respectively for 2008.
(2) Average balance includes average nonaccrual loan balances of $7,139,000 in 2010; $8,135,000 in 2009; and $7,946,000 in 2008.
(3) Interest income includes loan fees of $494,000 in 2010; $365,000 in 2009; and $602,000 in 2008.
(4) Average balance includes average unrealized gain of $618,000 in 2010; $976,000 in 2009; and $684,000 in 2008 on available for sale securities.
(5) Includes average federal reserve deposit account balances of $41,006,000 in 2010 and $15,771,000 in 2009.
(6) Includes $15,612,000 in 2010, $15,967,000 in 2009 and $16,333,000 in 2008 relating to goodwill and other intangible assets.

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)

	2010 Compared to 2009 Increase (Decrease) Due To			2009 Compared to 2008 Increase (Decrease) Due To		
Interest income on:	Rate	Volume	Net	Rate	Volume	Net
Loans	$ (55)	$ (660)	$ (715)	$ (2,600)	$ (99)	$ (2,699)
Taxable investment securities	(407)	(123)	(530)	(710)	(256)	(966)
Tax-exempt investment securities	(59)	(114)	(173)	(19)	(72)	(91)
Federal funds sold and other	(6)	92	86	(306)	17	(289)
Total interest earning assets	$ (527)	$ (805)	$ (1,332)	$ (3,635)	$ (410)	$ (4,045)
Interest expense on:						
Demand deposits	$ (119)	$ 25	$ (94)	$ (1,263)	$ (197)	$ (1,460)
Savings deposits	(31)	(7)	(38)	(247)	(20)	(267)
Time deposits	(780)	17	(763)	(811)	217	(594)
Securities sold under agreements to repurchase and overnight borrowings	4	5	9	(163)	48	(115)
Other borrowings	2	(6)	(4)	(187)	(44)	(231)
Subordinated debentures	(40)	-	(40)	(122)	-	(122)
Total interest bearing liabilities	$ (964)	$ 34	$ (930)	$ (2,793)	$ 4	$ (2,789)
Net interest income	$ 437	$ (839)	$ (402)	$ (842)	$ (414)	$ (1,256)

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 $1,375,000 in 2010, compared to $2,725,000 in 2009 and $5,080,000 in 2008. The reduced provision in 2010 resulted primarily from a 53.2% reduction in net charge-offs. In 2010, net charge-offs totaled $1,756,000 compared to $3,754,000 recorded in 2009.

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 significantly impacted loss levels in 2009 and 2008.

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 Financial 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 2008 provision for loan losses of $2,350,000.

Non-Interest Income

Non-interest income of $7,207,000 was relatively flat in 2010 compared to 2009, but increased $809,000, or 12.7%, in 2009 compared to 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.

Service charges on deposit accounts decreased $334,000, or 12.2%, in 2010 compared to 2009, but were flat at $2,746,000 in 2009 compared to 2008. Reduced non-sufficient fund activity was the primary cause of the decrease in 2010.

Trust fees of $997,000 were relatively flat in 2010 compared to 2009, and down 9.4%, or $103,000, in 2009 compared to the 2008. The 2009 decline in income reflected a decline in market value of assets managed despite an increase in new accounts.

Net securities gains of $207,000, $682,000 and $15,000 were recognized in 2010, 2009 and 2008, respectively. During 2009, Southern sold $26.4 million of securities which significantly reduced the level of mortgage-backed securities it held.

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 $57,470,000 in 2010 compared to $41,586,000 in 2009 and $17,455,000 in 2008. Net gains on loan sales increased $545,000 in 2010 compared to 2009, as a result of lower interest rates and an increase in mortgage lending staff. During 2010, Southern restructured its retail mortgage department to increase local market share. In 2009, net gains on loan sales increased $420,000 compared to 2008, as rates moved lower causing an increase in refinancing. Net gains on loan sales decreased $54,000 in 2008, as residential mortgage refinancing activity declined due to increasing rates.

Income and fees from automated teller machines (ATMs) increased $194,000, or 27.6%, in 2010 compared to 2009. During the fourth quarter of 2009, the Company converted all of its ATMs to a new processor and network resulting in increased fees.

In 2010 and 2008, Southern recorded $156,000 and $390,000 respectively, as a gain from life insurance proceeds. In 2009, Southern did not record any gain from life insurance proceeds.

Non-Interest Expense

Non-interest expense decreased $712,000, or 3.8%, in 2010 compared to 2009 and was flat at $18,970,000 in 2009 compared to 2008.

Salaries and employee benefits expense increased $273,000, or 2.8%, in 2010 compared to 2009 and decreased $780,000, or 7.4%, comparing 2009 to 2008. Southern was able to reduce staff in 2009 through attrition and also reduced contributions to the 401(k) plan. At both December 31, 2010 and 2009, Southern had 196 full-time equivalent positions compared to 202 at December 31, 2008.

Equipment expense decreased $21,000 in 2010 compared to 2009 and $317,000 in 2009 compared to 2008. Depreciation expense decreased $59,000 in 2010 compared to 2009 and $174,000 in 2009 compared to 2008, as certain assets became fully depreciated.

Professional and outside services decreased $413,000 in 2010 over 2009 and $221,000 in 2009 over 2008. Both the 2010 and 2009 decreases resulted from Southern being able to reduce fees paid for outside consulting relating to system conversions.

ATM expense decreased $188,000 in 2010 compared to 2009 after increasing $224,000 in 2009 compared to 2008. The 2009 increase was a result of conversion costs incurred relating to converting our ATM processing systems to a common system.

FDIC assessments decreased $215,000, or 25.1%, in 2010 compared to 2009. FDIC assessments in the second quarter of 2009 included a one-time special assessment. 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.

Other real estate (ORE) expense of $195,000 and loss on other real estate of $215,000 in 2010 both represented a decrease compared to 2009. Other real estate (ORE) expense of $319,000 and loss on other real estate of $318,000 in 2009 and $201,000 and $213,000, respectively in 2008, both represented an increase compared to the prior year period. The 2008 increase was due partially to the acquisition of FNB, but also, as with the 2009 increase, due to the depressed real estate market which resulted in a significant increase in the number of properties held by Southern. Property values in Southern's market area at December 31, 2010 remained depressed, but appeared to have stabilized. At December 31, 2010, Southern reported ORE of $1,247,000, compared to $1,187,000 at December 31, 2009, with 48% of total ORE at December 31, 2010 related to one commercial property.

Income Taxes

Income tax provision (credit) was $721,000 in 2010, $79,000 in 2009, and $(760,000) in 2008. 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 $289,000 in 2010, $351,000 in 2009, and $363,000 in 2008. 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. Additional income tax information is reported in Note L to the consolidated financial statements.

Financial Condition

Total assets at December 31, 2010 totaled $493,880,000, an increase of $31,471,000, or 6.8%, from December 31, 2009. Cash and cash equivalents increased $54,019,000 and investments increased $2,280,000 compared to December 31, 2009, due to a $23,555,000 reduction in gross loans and an increase of $28,996,000 in deposits.

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2010 increased $54,019,000, or 217.7%, over balances at December 31, 2009. At December 31, 2010, Southern had balances of $65,031,000 with the Federal Reserve, compared to $11,961,000 at December 31, 2009. During 2008, the Federal Reserve began paying banks interest on balances maintained at the Federal Reserve. At December 31, 2010 and 2009, the interest rate paid by the Federal Reserve exceeded the overnight federal funds rate paid by Southern's primary correspondent bank. Higher balances were held in cash and cash equivalents rather than being invested in the securities portfolio as few attractive investment alternatives were available.

Securities Available for Sale

The securities available for sale portfolio increased by $2,280,000, or 4.0%, from December 31, 2009 to December 31, 2010. The portfolio is monitored and securities or federal funds are purchased as deemed prudent by the Asset Liability Management Committee (ALCO).

The securities available for sale portfolio had net unrealized gains of $141,000 at December 31, 2010 and $635,000 at December 31, 2009. 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 southwest Michigan. Gross loans decreased $23,555,000, or 7.1%, and $2,231,000, or 0.7%, in 2010 and 2009, respectively. The decreases resulted from net charge offs and payments received on loans exceeding new loan volume. During 2010, customer demand for new loans was weak. Customers appeared to be waiting for economic conditions to improve before expanding or starting new ventures.

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 $60,778,000 and $59,823,000 at December 31, 2010 and 2009, 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	
	2010	**2009**	**2008**
Nonaccrual loans:		(Dollars in thousands)	
Commercial and commercial real estate	$ 3,755	$ 5,576	$ 5,512
Real estate mortgage	1,451	1,933	3,178
Consumer	87	76	25
	5,293	7,585	8,715
Loans contractually past due 90 days or more and still on accrual:			
Commercial and commercial real estate	1	14	353
Real estate mortgage	-	-	75
Consumer	-	-	9
	1	14	437
Total nonperforming loans	5,294	7,599	9,152
Other real estate	1,247	1,187	1,119
Total nonperforming assets	$ 6,541	$ 8,786	$ 10,271
Nonperforming loans to year-end loans	1.71%	2.28%	2.73%
Nonperforming assets to total assets	1.32%	1.90%	2.16%

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, 2009 to December 31 2010 was primarily a reflection of loans being transferred to foreclosed assets or charged-off. At December 31, 2010, 2009 and 2008, Southern had loans of $10,766,000, $11,135,000 and $15,257,000, respectively, which were considered impaired.

Holdings of other real estate of $1,247,000 at December 31, 2010 increased $60,000 from the end of 2009. However, one commercial property was added in 2010 which accounted for 47.6% of the December 31, 2010 balance. During 2010 and 2009, loans of $1,545,000 and $3,197,000, respectively, were transferred to foreclosed assets. Elevated balances in other real estate continued to reflect the elevated 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 collectability 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, 2010, specific reserves totaled $1,171,000 compared to $1,550,000 at December 31, 2009, a decrease of 24.5%.

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 $5,694,000, or 1.84% of loans, at December 31, 2010 compared to $6,075,000, or 1.82%, of loans at December 31, 2009.

The allowance for loan losses at December 31, 2010 consisted of $3,238,000 from the historical loss experience component and specifically allocated reserves, leaving $2,456,000 from the other factors. This compares to $2,916,000 from the historical loss experience component and specifically allocated reserves and $3,159,000 from the other factors at December 31, 2009.

At December 31, 2010, 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 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 increased 7.6%, or $28,996,000, in 2010 compared to 2009 and decreased 3.3%, or $13,138,000, in 2009 compared to 2008. The increase in 2010 was across all deposit types. The majority of deposits are derived from core client sources, relating to long term relationships with local individual, business and public clients. The 2009 decrease included the elimination of one non-core deposit relationship, totaling $14.2 million, during the first quarter of 2009. A small amount of brokered deposits, $6.4 million at December 31, 2010, 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 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 is not considered the primary beneficiary of this trust, therefore the trust is not consolidated in Southern's financial statements, but rather the subordinated debentures are shown as a liability. Southern may redeem the subordinated debentures subject to the receipt by Southern of the proper approval of the Federal Reserve, if such approval is required under applicable capital guidelines or policies of the Federal Reserve. The subordinated debentures may be redeemed on January 7, April 7, July 7 and October 7 of each year either in whole or in integrals 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 but not 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 20 consecutive quarterly periods. Southern's investment in the common stock of the trust is $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, 2010 was 3.04%.

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" below.

Shareholders' equity increased $2,109,000, or 4.6%, from December 31, 2009 to December 31, 2010. It increased $1,318,000 from December 31, 2008 to December 31, 2009. The increases for both 2010 and 2009 were primarily attributable to 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 capital ratios listed in Note V to the consolidated financial statements. The capital ratios include the common stock subject to repurchase obligation in Southern's employee stock ownership plan. As discussed in Note V, the Bank exceeded the minimum requirements to be categorized as "well capitalized" at December 31, 2010 under applicable regulatory guidelines.

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 ALCO, whose members are comprised of senior management.

Southern maintains correspondent accounts with regional and national banks for various purposes. Historically, cash sufficient to meet the operating needs of its branches is maintained at its lowest practical levels. However, in 2010 Southern maintained increased levels of cash as loan volumes decreased, securities were called or matured and investment opportunities were limited. From time to time, Southern is a participant in the federal funds market. Federal funds are generally borrowed or sold for one-day periods. During 2010 and 2009, federal funds were sold with an average balance of $1,485,000 and $2,716,000, respectively. During 2010 and 2009, Southern also averaged $41,006,000 and $15,771,000, respectively, 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. Over the last two years, correspondent banks have significantly curtailed these lines of credit that were previously available to Southern. As of December 31, 2010, Southern had a $3 million line of credit with a correspondent bank. As a result of the decrease in federal funds lines of credit availability, collateral was pledged at the Federal Reserve Bank “Discount Window.” At December 31, 2010, $3 million of securities were pledged that could be used for future borrowings. In addition, Southern has $7.8 million of securities which are available to be pledged for future borrowings. Southern also has the ability to borrow $30.3 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 the Bank, 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 December 31, 2010, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay Southern without prior regulatory approval was $4.0 million.

Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and 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, 2010, Southern had commitments of $60,778,000 for lines of credit, $1,720,000 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 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 1-4% up and down ramped and shock changes to interest rates on both a static and dynamic balance sheet over a 24 month period. With the current Federal Reserve target rate at 0% - .25%, no further decrease in rates was modeled at December 31, 2010. 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 results are shown in the table below:

Ramp Change/Dynamic	**% Change**	**Ramp Change/Static**	**% Change**
+400	6.68%	+400	6.26%
+300	3.44%	+300	3.08%
+200	0.80%	+200	0.49%
+100	0.08%	+100	-0.24%
-100	NA	-100	NA
-200	NA	-200	NA
-300	NA	-300	NA
-400	NA	-400	NA
Shock Change/Dynamic	**% Change**	**Shock Change/Static**	**% Change**
+400	19.90%	+400	18.77%
+300	12.96%	+300	12.08%
+200	5.57%	+200	4.92%
+100	0.76%	+100	0.28%
-100	NA	-100	NA
-200	NA	-200	NA
-300	NA	-300	NA
-400	NA	-400	NA

The market value of equity analysis estimates the change in the market value of equity using interest rate change scenarios from +4% to –4% in 1% increments. As with the income simulation analysis, no further rate reductions were assumed as of December 31, 2010. The following table illustrates the percent change in equity based on changes in market interest rates:

	change in market value of equity
4% increase in market rates	12.83%
3% increase in market rates	9.92%
2% increase in market rates	6.76%
1% increase in market rates	3.46%
No change	0.00%
1% decrease in market rates	NA%
2% decrease in market rates	NA%
3% decrease in market rates	NA%
4% decrease in market rates	NA%

The results of the simulations at December 31, 2010 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

Southern uses 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, Southern 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, 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 the notes to the 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. Southern has elected to perform its annual goodwill impairment test as of November 30 each year. Such test was performed by an independent third-party.

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 2010 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 is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Rule 15-d-15(f) of the Exchange Act. Southern's internal control system is designed to provide reasonable assurance to Southern's management and Board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles, and includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of Southern; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of Southern are being made only in accordance with authorizations of management and directors of Southern; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Southern's assets that could have a material effect on the financial statements.

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, with the participation of the Chief Executive Officer and Chief Financial Officer, assessed the effectiveness of internal control over financial reporting as of December 31, 2010. In making this assessment, management 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 this assessment, management believes that as of December 31, 2010, Southern's internal control over financial reporting was effective based on those criteria.

There were no changes in Southern's internal control over financial reporting that occurred during the year ended December 31, 2010 that have materially affected, or that are reasonably likely to materially affect, Southern's internal control over financial reporting.

J H Castle

John H. Castle
Chairman and
Chief Executive Officer

Danice Chartrand

Danice L. Chartrand
Chief Financial Officer

February 11, 2011

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, 2010 and 2009, 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, 2010. 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, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America.

Clifton Gunderson LLP

Toledo, Ohio
March 28, 2011

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31, 2010	December 31, 2009
ASSETS		
Cash	$ 3,860	$ 3,862
Due from banks	74,973	20,952
Cash and cash equivalents	78,833	24,814
Federal funds sold	275	2,540
Securities available for sale	59,228	56,948
Loans held for sale	2,637	605
Loans, net of allowance for loan losses of $5,694 - 2010 ($6,075 - 2009)	303,830	327,004
Premises and equipment, net	12,599	12,914
Accrued interest receivable	2,107	2,054
Net cash surrender value of life insurance	9,965	9,881
Goodwill	13,422	13,422
Other intangible assets, net	2,005	2,355
Other assets	8,979	9,872
Total Assets	$ 493,880	$ 462,409
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	$ 59,942	$ 55,250
Interest bearing	349,959	325,655
Total deposits	409,901	380,905
Securities sold under agreements to repurchase and overnight borrowings	15,027	14,799
Accrued expenses and other liabilities	4,476	4,039
Other borrowings	10,079	10,832
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in Employee Stock Ownership Plan, 107,627 shares outstanding in 2010 (101,999 shares in 2009)	1,399	945
Total Liabilities	446,037	416,675
Shareholders' equity		
Preferred stock, 100,000 shares authorized; none issued or outstanding	-	-
Common stock, $2.50 par value:		
Authorized – 4,000,000 shares		
Issued – 2,340,717 shares in 2010 (2,323,410, shares in 2009)		
Outstanding (other than ESOP shares) –2,233,090 shares in 2010 (2,221,411 shares in 2009)	5,583	5,553
Additional paid-in capital	18,033	18,363
Retained earnings	24,692	22,062
Accumulated other comprehensive income, net	(168)	193
Unearned Employee Stock Ownership Plan shares	(297)	(437)
Total Shareholders' Equity	47,843	45,734
Total Liabilities and Shareholders' Equity	$ 493,880	$ 462,409

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, 2010	2009	2008
Interest income:			
Loans, including fees	$ 19,187	$ 19,852	$ 22,528
Securities:			
Taxable	604	1,134	2,100
Tax-exempt	769	883	943
Other	155	69	358
Total interest income	20,715	21,938	25,929
Interest expense:			
Deposits	3,777	4,671	6,992
Other	693	729	1,197
Total interest expense	4,470	5,400	8,189
Net Interest Income	16,245	16,538	17,740
Provision for loan losses	1,375	2,725	5,080
Net Interest Income after Provision for Loan Losses	14,870	13,813	12,660
Non-interest income:			
Service charges on deposit accounts	2,412	2,746	2,744
Trust fees	997	987	1,090
Net securities gains	207	682	15
Net gains on loan sales	1,301	756	336
Earnings on life insurance assets	349	358	363
Income from automated teller machines	897	703	624
Brokerage income	228	246	249
Gain on life insurance proceeds	156	-	390
Other	660	694	552
Total non-interest income	7,207	7,172	6,363
Non-interest expense:			
Salaries and employee benefits	10,075	9,802	10,582
Occupancy, net	1,353	1,351	1,383
Equipment	896	917	1,234
Printing, postage and supplies	592	615	659
Telecommunication	386	372	379
Professional and outside services	941	1,354	1,575
Software maintenance	410	415	396
Amortization of other intangibles	350	362	374
Automated teller machines	333	521	297
FDIC deposit assessments	640	855	179
Other real estate	195	319	201
Loss on sale of other real estate	215	318	213
Other	1,872	1,769	1,498
Total non-interest expense	18,258	18,970	18,970
Income before income taxes	3,819	2,015	53
Income tax provision (credit)	721	79	(760)
Net Income	$ 3,098	$ 1,936	$ 813
Basic Earnings Per Common Share	$ 1.34	$ 0.84	$ 0.36
Diluted Earnings Per Common Share	$ 1.34	$ 0.84	$ 0.36

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, 2010, 2009 and 2008

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2008	$ 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
Comprehensive income:						
Net income for 2010			3,098			3,098
Net change for the year in other comprehensive income items				(361)		(361)
Total comprehensive income						2,737
Cash dividends declared - $.20 per share			(468)			(468)
Issuance of restricted stock (18,325 shares of common stock at $10.10 per share)	46	(46)				-
Vesting of restricted stock		79				79
Restricted stock forfeiture (1,018 shares)	(2)	2				-
Change in common stock subject to repurchase	(14)	(440)				(454)
Reduction of ESOP obligation					140	140
Stock option expense		75				75
Balance at December 31, 2010	$ 5,583	$ 18,033	$ 24,692	$ (168)	$ (297)	$ 47,843

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,		
	2010	**2009**	**2008**
Operating Activities			
Net income	$ 3,098	$ 1,936	$ 813
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	1,375	2,725	5,080
Depreciation	995	1,054	1,228
Deferred income taxes	175	506	(1,043)
Amortization of other intangible assets	350	362	374
Net amortization of investment securities	586	389	214
Stock option and restricted stock grant compensation expense	154	132	141
Net securities gains	(207)	(682)	(15)
Loans originated for sale	(57,470)	(41,586)	(17,455)
Proceeds on loans sold	56,739	41,858	17,936
Net gains on loan sales	(1,301)	(756)	(336)
Net loss on other real estate sales	215	318	213
Gain on life insurance proceeds	(156)	-	(390)
Net loss on disposal of premises and equipment	29	9	46
Net change in obligation under ESOP	140	154	121
Net change in:			
Accrued interest receivable	(53)	560	773
Cash surrender value	(349)	(358)	(363)
Other assets	826	(1,762)	124
Accrued expenses and other liabilities	383	145	(1,075)
Net cash from operating activities	5,529	5,004	6,386
Investing Activities			
Activity in available for sale securities:			
Proceeds on securities sold	7,445	26,366	-
Proceeds from maturities and calls	48,172	37,683	75,750
Purchases	(58,770)	(55,348)	(63,427)
Net change in federal funds sold	2,265	780	3,129
Proceeds from life insurance	421	-	1,241
Loan originations and payments, net	20,254	(4,720)	(4,093)
Proceeds on other real estate sales	1,239	2,456	1,513
Proceeds from sale of equipment	91	-	2
Proceeds from sale of FHLB stock	169	-	-
Additions to premises and equipment	(800)	(691)	(1,227)
Net cash from investing activities	20,486	6,526	12,888
Financing Activities			
Net change in deposits	28,996	(13,138)	(5,126)
Net change in securities sold under agreements to repurchase and overnight borrowings	228	909	4,114
Proceeds from other borrowings	5,000	8,000	600
Repayments of other borrowings	(5,753)	(9,663)	(2,873)
Purchase of ESOP shares	-	-	(609)
Cash dividends paid	(467)	(813)	(1,849)
Repurchase of common stock	-	-	(12)
Net cash from financing activities	28,004	(14,705)	(5,755)
Net change in cash and cash equivalents	54,019	(3,175)	13,519
Beginning cash and cash equivalents	24,814	27,989	14,470
Ending cash and cash equivalents	$ 78,833	$ 24,814	$ 27,989

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

SOUTHERN MICHIGAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. (the Company) is a Michigan corporation and registered bank holding company. The Company's business is concentrated in a single operating segment: commercial banking. The Company's wholly-owned subsidiary bank, Southern Michigan Bank & Trust (the Bank), offers individuals, businesses, institutions and government agencies a full range of commercial banking services primarily in the southwest Michigan communities in which the Bank is located and in areas immediately surrounding these communities. The Bank makes 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 the Company and the Bank after elimination of significant inter-company balances and transactions. The Bank owns FNB Financial Services, which conducts a brokerage business. 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) the fact that the Company has the intention and the ability to hold the security to maturity.

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. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired.

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 is recognized in the period identified. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, a second step to the impairment test is required.

The Company's most recent annual impairment analysis as of November 30, 2010, indicated that the Step 2 analysis was not necessary.

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 past acquisitions. They are initially measured at fair value and then amortized on an accelerated method over their estimated useful lives, which is 10 years.

Other Real Estate: Other real estate was $1,247,000 and $1,187,000 at December 31, 2010 and 2009 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 as non-interest expense.

Stock Compensation: The Company has adopted the requirements of "share-based payment transactions", using the modified prospective transition method. Under this method, the Company recognizes compensation cost for equity-based compensation for all new or modified grants.

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

Advertising Costs: Advertising costs are expensed as incurred.

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. Any interest and penalties resulting from the filing of the income tax returns is included in the provision for income taxes.

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.

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

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.

Concentrations of Credit Risk: The Company grants commercial, real estate and installment loans to customers mainly in southwest 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, 2010 and such 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, 2010 and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 3% of the loan portfolio at December 31, 2010 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: commercial banking.

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, 2010 and 2009.

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 outstanding as of December 31, 2010 that will have a material future adverse effect on the consolidated financial statements.

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

Subsequent Events: Management evaluated subsequent events through the date the financial statements were issued. Events or transactions occurring after December 31, 2010, but prior to when the financial statements were issued, that provided additional evidence about conditions that existed at December 31, 2010, have been recognized in the financial statements for the year ended December 31, 2010. Events or transactions that provided evidence about conditions that did not exist at December 31, 2010, but arose before the financial statements were issued, have not been recognized in the financial statements for the year ended December 31, 2010.

Reclassifications: Certain items in the 2009 and 2008 consolidated financial statements have been reclassified to conform to the current year presentation.

Adoption of New Accounting Standards: In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2010-06, *Fair Value Measurements and Disclosures,* (ASU 2010-06), which provides amendments to ASC 820-10 and is intended to improve disclosure requirements related fair value measurements. ASU 2010-06 clarifies that a reporting entity should provide fair value measurement disclosures for each class of assets and liabilities measured at fair value. A class is often a subset of assets or liabilities within a line item in the statement of financial assets. Reporting entities should also provide disclosures about the valuation techniques and inputs used to measure fair value for fair value measurements falling within Level 2 or 3. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Information on fair value measurements is included in Note U to the consolidated financial statements.

ASC 860-10 addresses accounting for transfers of financial assets. Among other requirements, the ASC 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 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. Among other things, ASC 860-10 applies to any transfer of financial assets, which for the Company primarily relates to loan participations sold. The adoption of ASC 860-10 effective January 1, 2010 did not have any impact on the Company's consolidated financial statements.

In July 2010, the FASB issued Accounting Standards Update 2010-20, *Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20) which increases disclosures made about the credit quality of loans and the allowance for credit losses. The disclosures provide additional information about the nature of credit risk inherent in the Company's loans, how credit risk is analyzed and assessed, and the reasons for the change in the allowance for loan losses. The expanded disclosure requirements of ASU 2010-20 are disclosed in Note E of the Company's December 31, 2010 consolidated financial statements, except for activity occurring during the period, which will be required to be reported in 2011. The additional disclosure requirements relating to troubled debt restructurings were deferred by ASU 2011-01, issued in January 2011.

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, 2010, 2009 and 2008 is presented below:

	2010	2009	2008
Basic Earnings Per Common Share			
Net income (in thousands)	$ 3,098	$ 1,936	$ 813
Weighted average common shares outstanding	2,339,490	2,322,642	2,310,303
Less: Unallocated ESOP shares	(27,851)	(31,090)	(29,538)
Weighted average common shares outstanding for basic earnings per common share	2,311,639	2,291,552	2,280,765
Basic earnings per common share	$ 1.34	$ 0.84	$ 0.36
Diluted Earnings Per Common Share			
Net income (in thousands)	$ 3,098	$ 1,936	$ 813
Weighted average common shares outstanding for basic earnings per common share	2,311,639	2,291,552	2,280,765
Add: Dilutive effects of assumed exercises of stock options	3,636	349	279
Average shares and dilutive potential of common shares outstanding	2,315,275	2,291,901	2,281,044
Diluted earnings per common share	$ 1.34	$ 0.84	$ 0.36

Stock options for 196,394, 214,822 and 207,348 shares of common stock were not considered in computing diluted earnings per share for 2010, 2009 and 2008, respectively, because they were anti-dilutive.

NOTE C - SECURITIES

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

Available for Sale, December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 24,117	$ 26	$ (37)	$ 24,106
U.S. government sponsored entities and agencies	6,685	3	(10)	6,678
States and political subdivisions	25,225	372	(227)	25,370
Asset-backed securities	2,487	-	(11)	2,476
Mortgage-backed securities	573	25	-	598
Total	$ 59,087	$ 426	$ (285)	$ 59,228

NOTE C – SECURITIES (CONTINUED)

Available for Sale, December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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

Securities with unrealized losses at year end 2010 and 2009 that have not been recognized in income are as follows (in thousands):

2010	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**
Federal agencies	$ 13,335	$ (37)	$ -	$ -	$ 13,335	$ (37)
U.S. government sponsored entities and agencies	2,997	(10)	-	-	2,997	(10)
States and political subdivisions	5,257	(218)	883	(9)	6,140	(227)
Asset-backed securities	2,487	(11)	-	-	2,487	(11)
Total temporarily impaired	$ 24,076	$ (276)	$ 883	$ (9)	$ 24,959	$ (285)

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**
Federal agencies	$ 11,142	$ (14)	$ -	$ -	$ 11,142	$ (14)
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)

Unrealized losses have not been recognized into income as management believes the issuers are of sound credit quality, management has no intent to sell the securities, the Company has the ability to hold to maturity 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):

	2010	2009	2008
Proceeds	$ 7,445	$ 26,366	$ -
Gross gains	206	678	-

The tax benefit (provision) related to these net realized gains and losses was $(70,000), $(231,000) and $0 for 2010, 2009 and 2008, respectively.

Gains on calls of securities were $1,000, $4,000 and $15,000 for 2010, 2009 and 2008, respectively.

NOTE C – SECURITIES (CONTINUED)

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Contractual maturities of debt securities at year-end 2010 were as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 6,628	$ 6,651
Due from one to five years	34,567	34,676
Due from five to ten years	13,276	13,307
Due after ten years	4,043	3,996
Mortgage-backed securities	573	598
Total	$ 59,087	$ 59,228

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 $28,344,000 and $29,857,000, respectively, were pledged as collateral for repurchase accounts and for other purposes at year-end 2010 and 2009.

At year-end 2010 and 2009, the market value of securities issued by the State of Michigan and all its political subdivisions totaled $19,903,000 and $15,466,000, 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 of Indianapolis stock totaled $1,877,000 and $2,046,000 at December 31, 2010 and 2009, respectively, and are included in other assets because such investments are considered restricted. Such investments are recorded at cost and evaluated for impairment.

NOTE D – LOANS

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

	2010	2009
Commercial	$ 58,763	$ 61,855
Real estate - commercial	136,371	148,806
Real estate - construction	11,135	10,522
Consumer	10,153	11,889
Real estate mortgage	93,102	100,007
	309,524	333,079
Less allowance for loan losses	(5,694)	(6,075)
Loans, net	$ 303,830	$ 327,004

At December 31, 2010 and 2009, 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.

	2010	2009
Balance at January 1	$ 16,578	$ 10,278
New loans, including renewals	7,805	12,672
Repayments	(10,192)	(6,354)
Other changes, net	(92)	(18)
Balance at December 31	$ 14,099	$ 16,578

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $151,125,000 and $127,917,000 at December 31, 2010 and 2009, respectively.

NOTE D – LOANS (CONTINUED)

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

	2010	2009	2008
Balance at January 1	$ 753	$ 708	$ 749
Additions	371	269	162
Amortized to expense	(256)	(224)	(203)
Balance at December 31	$ 868	$ 753	$ 708

No valuation allowance for capitalized mortgage servicing rights was considered necessary at December 31, 2010, 2009 or 2008 because the fair value of such rights approximated or exceeded the carrying value.

NOTE E – ALLOWANCE FOR LOAN LOSSES

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

	2010	2009	2008
Balance at January 1	$ 6,075	$ 7,104	$ 5,156
Provision for loan losses	1,375	2,725	5,080
Loans charged off	(2,031)	(3,926)	(3,343)
Recoveries	275	172	211
Net charge-offs	(1,756)	(3,754)	(3,132)
Balance at December 31	$ 5,694	$ 6,075	$ 7,104

In evaluating the allowance for loan losses, loans are analyzed based on the department originating the loan which in some instances may be different than how the loans are categorized for regulatory reporting purposes. The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2010 (in thousands):

Ending allowance balance attributable to loans:	**Individually Evaluated for Impairment**	**Collectively Evaluated for Impairment**	**Total**
Commercial, including commercial real estate	$ 867	$ 3,372	$ 4,239
Consumer	-	87	87
Real estate mortgage – first lien	300	911	1,211
Real estate mortgage – junior lien	4	153	157
Total ending allowance balance	$ 1,171	$ 4,523	$ 5,694

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

Loans:	**Loans Individually Evaluated for Impairment**	**Loans Collectively Evaluated for Impairment**	**Total**
Commercial, including commercial real estate	$ 7,676	$ 208,725	$ 216,401
Consumer	87	9,762	9,849
Real estate mortgage – first lien	2,881	66,556	69,437
Real estate mortgage – junior lien	122	13,715	13, 837
Total ending loans balance	$ 10,766	$ 298,758	$ 309,524

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

	2010	**2009**
Year end loans with allowance for loan losses allocated	$ 4,891	$ 5,439
Year end loans with no allowance for loan losses allocated	5,875	5,696
Total impaired loans	$ 10,766	$ 11,135
Amount of allowance allocated to these loans	$ 1,171	$ 1,550

	2010	**2009**	**2008**
Average balance of impaired loans during the year	$ 11,719	$ 11,754	$ 17,100
Cash basis interest income recognized during the year	$ 345	$ 409	$ 866
Interest income recognized during the year	$ 396	$ 367	$ 881

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2010 (in thousands):

	Unpaid Principal Balance	**Allowance for Loan Losses Allocated**
With no related allowance recorded:		
Commercial	$ 608	$ -
Real estate - commercial	2,685	-
Real estate – construction	-	-
Consumer	87	-
Real estate mortgage	2,495	-
With an allowance recorded:		
Commercial	588	99
Real estate - commercial	1,823	413
Real estate – construction	583	173
Consumer	-	-
Real estate mortgage	1,897	486
Total	$ 10,766	$ 1,171

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

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

	2010	2009
Loans past due over 90 days still on accrual	$ 1	$ 14
Nonaccrual loans	5,293	7,585

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 following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2010 (in thousands):

	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial	216	1
Real estate - commercial	2,295	-
Real estate – construction	583	-
Consumer	87	-
Real estate mortgage	2,112	-
Total	$ 5,293	$ 1

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of December 31, 2010 by class of loans (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due & Non Accrual	Total Past Due &Non Accrual	Loans Not Past Due or Non Accrual	Total
Commercial	$ 277	$ 20	$ 217	$ 514	$ 58,249	$ 58,763
Real estate - commercial	184	-	2,295	2,479	133,892	136,371
Real estate – construction	-	-	583	583	10,552	11,135
Consumer	62	-	87	149	10,004	10,153
Real estate mortgage	737	28	2,112	2,877	90,225	93,102
Total	$ 1,260	$ 48	$ 5,294	$ 6,602	$ 302,922	$ 309,524

Troubled Debt Restructurings:

The Company has allocated $379,000 and $215,000 of specific reserves to customers whose loan terms have been modified as of December 31, 2010 and 2009, respectively. The Company has committed to lend no additional amounts to these customers.

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis includes all loans from the commercial loan department. This analysis is performed at least annually. The Company uses the following definitions for risk ratings:

> **Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.
>
> **Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
>
> **Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

As of December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (in thousands):

	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial	$ 44,819	$ 12,821	$ 1,123	$ -	$ -	$ 58,763
Real estate - commercial	110,384	19,054	6,311	370	252	136,371
Real estate – construction	2,371	1,047	4,630	-	3,087	11,135
Real estate – mortgage	7,096	2,892	2,700	-	80,414	93,102
Consumer	-	-	-	-	10,153	10,153
Total	$ 164,670	$ 35,814	$ 14,764	$ 370	$ 93,906	$ 309,524

NOTE F – PREMISES AND EQUIPMENT, NET

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

	2010	2009
Land	$ 2,366	$ 2,373
Buildings and improvements	16,854	15,087
Furniture and equipment	9,991	7,701
	29,211	25,161
Less accumulated depreciation	(16,612)	(12,247)
Totals	$ 12,599	$ 12,914

Depreciation and amortization expense charged to operations was $995,000, $1,054,000 and $1,228,000 in 2010, 2009 and 2008, respectively.

Rent expense under operating leases amounted to $42,000, $57,000 and $68,000 in 2010, 2009 and 2008, respectively.

Lease commitments under noncancelable operating equipment leases at December 31, 2010 were as follows (in thousands):

2011	$ 46
2012	39
2013	35
2014	7
2015	7
Thereafter	8
Total	$ 142

NOTE G – INTANGIBLE ASSETS

Acquired core deposit intangible assets as of December 31 were (in thousands):

	2010	2009
Gross carrying amount	$ 3,122	$ 3,122
Accumulated amortization	(1,117)	(767)
Unamortized balance	$ 2,005	$ 2,355

Amortization of core deposit intangible assets for the years ended December 31, 2010, 2009 and 2008 was $350,000, $362,000 and $374,000, respectively.

Estimated amortization of core deposit intangible assets for each of the five years subsequent to December 31, 2010 is as follows (in thousands):

2011	$ 339
2012	325
2013	296
2014	284
2015	272

NOTE H – DEPOSITS

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

	2010	2009
Non-interest bearing checking	$ 59,942	$ 55,250
Interest bearing checking	100,388	86,606
Savings	48,579	46,346
Money market accounts	62,845	57,776
Time deposits	138,147	134,927
Totals	$ 409,901	$ 380,905

NOTE H – DEPOSITS (CONTINUED)

The carrying amount of time deposits over $100,000 was $54,046,000 and $49,896,000 at December 31, 2010 and 2009, respectively. Interest expense on time deposits over $100,000 was $979,000, $1,336,000 and $1,435,000 for the years ended December 31, 2010, 2009 and 2008, respectively.

At year-end 2010, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2011	$	60,130
2012		36,597
2013		15,894
2014		16,412
2015		9,101
Thereafter		13
Total	$	138,147

Related party deposits were $11,412,000 and $14,271,000 at December 31, 2010 and 2009, respectively.

NOTE I – OTHER BORROWINGS

Other borrowings at December 31, 2010 and 2009 included $7,234,000 and $7,343,000, respectively, in advances from the Federal Home Loan Bank (FHLB) of Indianapolis. Advances outstanding at December 31, 2010 require payments through December 31, 2013 with fixed interest rates ranging from 2.12% to 4.57%, with a weighted average rate of 2.33%. Principal is due at maturity for $7,000,000 of the advances. The remaining $234,000 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, 2010 and 2009 was approximately $79,641,000 and $93,148,000, respectively.

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 the Bank. At December 31, 2010 and 2009, $2,501,000 and $3,000,000, respectively, was outstanding under the loan.

Other borrowings also include a loan from a local community bank with a balance at December 31, 2010 and 2009 of $344,000 and $489,000, respectively. The loan matures on February 28, 2013 and is unsecured.

At year-end 2010, scheduled principal reductions on other borrowings were as follows for the years ending December 31 (in thousands):

	FHLB	GLBB	Other	Total
2011	$ 1,117	$ 620	$ 150	$ 1,887
2012	5,078	598	154	5,830
2013	1,039	626	40	1,705
2014	-	657	-	657
Total other borrowings	$ 7,234	$ 2,501	$ 344	$ 10,079

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):

	2010	2009
At December 31:		
Outstanding balance	$ 15,027	$ 14,799
Average interest rate	0.30%	0.26%
Daily average for the year:		
Outstanding balance	$ 16,714	$ 14,789
Average interest rate	0.30%	0.28%
Maximum outstanding at any month end	$ 18,847	$ 14,799

At December 31, 2010, the Bank had a line of credit arrangement available to purchase federal funds totaling $3,000,000, with no outstanding borrowings.

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, subject to the receipt by the Company of the proper approval of the Federal Reserve, if such approval is required under applicable capital guidelines or policies of the Federal Reserve. The subordinated debentures may be redeemed on January 7, April 7, July 7 and October 7 of each year either in whole or in integrals 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, but not 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 20 consecutive quarters.

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, 2010 was 3.04%. The Company's investment in the common stock of the trust is $155,000 and is included in other assets.

NOTE L – INCOME TAXES

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

	2010	2009	2008
Current	$ 546	$ (427)	$ 283
Deferred	175	506	(1,043)
Totals	$ 721	$ 79	$ (760)

The deferred income tax provision (credit) consists of the tax effect of temporary differences, including a credit of $207,000 in 2010 and $23,000 in 2009 resulting from the utilization of a net operating loss carryforwards.

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

	2010	2009	2008
Income tax at statutory rate	$ 1,298	$ 685	$ 18
Tax-exempt interest income, net	(289)	(351)	(363)
Earnings on life insurance assets, including gain from proceeds in 2010 and 2008	(172)	(122)	(256)
Low income housing partnership tax credit	(127)	(127)	(127)
Write-off capital loss carryforward	60	-	-
Change in valuation allowance	(54)	-	-
Other items, net	5	(6)	(32)
Totals	$ 721	$ 79	$ (760)

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

	2010	2009
Deferred tax assets:		
Allowance for loan losses	$ 1,150	$ 1,342
Deferred compensation and supplemental retirement liability	765	731
Net operating loss carryforward	-	207
Intangible asset amortization	12	24
Pension liability – SFAS 158	135	117
Capital loss carryforward	-	60
Nonaccrual loan interest	245	272
Tax credit carryforwards	796	483
Stock based compensation	146	110
Other	127	201
	3,376	3,547
Valuation allowance	-	(54)
Total deferred tax assets, net of valuation allowance	3,376	3,493
Deferred tax liabilities:		
Mortgage servicing rights	(295)	(256)
Goodwill	(191)	(170)
Purchase accounting adjustments	(761)	(887)
Net unrealized gain on available for sale securities	(48)	(216)
Other	(308)	(202)
Total deferred tax liabilities	(1,603)	(1,731)
Net deferred tax assets, included in other assets	$ 1,773	$ 1,762

At December 31, 2010, the Company has available alternative minimum tax credit carryforwards of $541,000, which may be utilized in the future to the extent computed regular tax exceeds the alternative minimum tax. The Company also has low income housing credits of $255,000 at December 31, 2010, which will begin to expire in 2029 if not utilized.

NOTE L – INCOME TAXES (CONTINUED)

The Company and its subsidiaries file U.S. federal and certain state tax returns. In general, tax returns are no longer subject to tax examinations by tax authorities for years before 2007.

The Company had no uncertain tax positions as of December 31, 2010 and 2009.

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 is as follows (in thousands):

	2010	2009
Change in benefit obligation:		
Beginning benefit obligation	$ (2,272)	$ (2,418)
Service cost	-	(29)
Interest cost	(130)	(145)
Settlement adjustment	-	125
Actuarial loss	(35)	(44)
Benefits paid	223	239
Ending benefit obligation	(2,214)	(2,272)
Change in plan assets, at fair value:		
Beginning plan assets	1,937	2,147
Actual return	56	47
Employer contributions	-	10
Benefits paid	(223)	(239)
Plan expenses paid	(26)	(28)
Ending plan assets	1,744	1,937
Net amount recognized in other liabilities – funded status	$ (470)	$ (335)

The accumulated benefit obligation for the defined benefit pension plan was $2,214,000 and $2,272,000 at December 31, 2010 and 2009, respectively.

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

	2010	2009	2008
Components of net periodic benefit cost:			
Service cost	$ 27	$ 29	$ 32
Interest cost	130	145	142
Expected return on plan assets	(114)	(147)	(151)
Recognized net actuarial loss	3	39	2
Settlement adjustment	35	42	-
Net periodic benefit cost	$ 81	$ 108	$ 25

At December 31, 2010 and 2009 net actuarial losses of $396,000 and $343,000, respectively, have 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 2011 is $13,000.

NOTE M – BENEFIT PLANS (CONTINUED)

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

	2010	2009	2008
Discount rate on benefit obligation	5.5%	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	N/A	4.0%

Asset Category	Target Allocation 2011	Percentage of Plan Assets at Year-end 2010	Percentage of Plan Assets at Year-end 2009	Weighted Average Expected Long-Term Rate of Return - 2010
Equity securities	0%	0%	0%	0%
Debt securities	1%	0%	1%	0%
Cash and time certificates	99%	100%	99%	.20%
	100%	100%	100%	.20%

The pension plan assets are managed by the Bank's Trust Department. A written investment policy which we believe 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, 2010 is primarily fixed income investments with a target of 90% time certificates and 10% 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 in all material respects.

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, 2010 amounted to $1,744,000 consisting of cash and time certificates with fair value measured using quoted prices in active markets (Level 1). There were no plan assets measured at fair value using significant unobservable inputs (Level 3) for the years ended or as of December 31, 2010 or 2009.

The Company does not expect to contribute to its pension plan in 2011.

At year-end 2010, estimated future benefit payments from the plan were as follows for the years ending December 31 (in thousands):

2011	$ 36
2012	55
2013	231
2014	139
2015	36
2016 – 2020	1,353

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 the Bank and administrative costs of the plan are borne by the plan participants. Expense charged to operations for contributions to the plan totaled $299,000, $388,000 and $610,000 in 2010, 2009 and 2008, respectively.

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

	2010	2009
Allocated shares	107,627	101,999
Unallocated shares	24,021	29,649
Total ESOP shares	131,648	131,648

The fair value of the allocated shares held by the ESOP is $1,399,000 and $945,000 at December 31, 2010 and 2009, 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, 2010 and 2009 was $297,000 and $416,000, respectively. In 2005, the ESOP obtained a loan for $204,000 to purchase 7,568 shares. The balance of the loan was $21,000 at December 31, 2009 and was repaid in 2010.

Deferred Compensation Plan: Directors and certain officers of the Bank may defer a portion of their director fees or compensation in a non-qualified deferred compensation plan. An account is established for each participant in the plan and credited with the participant's annual deferred compensation plus interest based on the stated rate determined annually. Upon retirement, participants receive the balance in their account over 15 years. Participants also continue to earn interest during retirement based on their remaining account balance. Participants are immediately vested in their account balances. The plan is intended to be funded by certain bank-owned life insurance contracts. The interest rate paid on deferred compensation balances as of December 31, 2010 ranged from 5.94% to 12.98%. There were no new participants in the plan during 2010. Deferred compensation expense was $245,000, $237,000 and $246,000 in 2010, 2009 and 2008, respectively. The liability for deferred compensation benefits was $2,024,000 and $1,913,000 at December 31, 2010 and 2009, respectively, and is included in accrued expenses and other liabilities in the accompanying consolidated balance sheets.

NOTE M – BENEFIT PLANS (CONTINUED)

Supplemental Retirement Plan: The Bank also maintains a supplemental retirement plan to provide annual payments to certain current and former executives subsequent to their retirement. Benefits under the plan were frozen effective December 31, 2008. Expense associated with this plan totaled $28,000, $12,000 and $77,000 in 2010, 2009 and 2008, respectively. Liabilities associated with this plan totaled $226,000 and $232,000 at December 31, 2010 and 2009, respectively.

NOTE N – STOCK OPTIONS

The Company has stock based compensation plans as described below. Total compensation cost charged against income for those plans was $154,000, $132,000 and $141,000 in 2010, 2009 and 2008, respectively.

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, 2010, 105,199 shares were available for issuance 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 totaled 115,500. Options were 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 were granted and a vesting period as determined by the Board of Directors. The plan terminated on March 20, 2010.

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.

	2010	2009	2008
Risk-free interest rate	0.96%	3.58%	2.94%
Expected option life	8 years	8 years	8 years
Expected stock price volatility	23.64%	22.39%	14.48%
Dividend yield	3.29%	3.58%	3.51%
Weighted-average fair value of options granted during year	$1.53	$0.97	$1.96

NOTE N – STOCK OPTIONS (CONTINUED)

A summary of the activity in the plans for 2010 follows:

Stock Options

	Shares Subject to Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	225,270	$ 21.83		
Granted	8,075	10.10		
Exercised	-	-		
Forfeited	(14,368)	23.37		
Outstanding at end of year	218,977	$ 21.29	5.8 years	$ 98,000
Exercisable at year-end	133,702	$ 22.10	4.7 years	$ -

	2010	2009	2008
Intrinsic value of options exercised	-	-	-
Cash received from option exercise	-	-	-
Tax benefit realized from option exercises	-	-	-

As of December 31, 2010, there was $77,000 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 1.1 years.

Restricted Stock – Restricted shares may be issued under the 2005 plan 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, 2010, 2009 and 2008 was $39,000, $29,000 and $13,000, respectively. As of December 31, 2010, there was $250,000 of total unrecognized compensation cost related to unvested shares granted under the plan. The cost is expected to be recognized over a weighted average period of 3.6 years.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2010	17,062	$ 11.26
Granted	18,325	10.10
Vested	(3,776)	12.29
Forfeited	(1,018)	10.64
Nonvested at December 31, 2010	30,593	$ 10.46

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, 2010 and 2009, the Company had no 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, 2010 and 2009, commitments under outstanding standby letters of credit were $1,720,000 and $1,457,000, respectively.

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

	2010	2009
Fixed rate	$ 4,333	$ 2,765
Variable rate	56,445	57,058
Totals	$ 60,778	$ 59,823

The fixed rate commitments have stated interest rates ranging from 3.25% 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 (loss) amounted to $(168,000) at December 31, 2010 and $193,000 at December 31, 2009 and is summarized as follows (in thousands):

	2010	2009
Unrealized gain on available-for-sale securities, net of income taxes of $48 in 2010 and $216 in 2009	$ 93	$ 419
Pension liability, net of income taxes of $135 in 2010 and $117 in 2009	(261)	(226)
Total	$ (168)	$ 193

The changes in the components of accumulated comprehensive income (loss), and related tax effects for the years ended December 31, 2010, 2009 and 2008 are as follows (in thousands):

	2010	2009	2008
Unrealized gain (loss) on available for sale securities	$ (287)	$ 320	$ 741
Reclassification adjustments for net realized gains included in net income	(207)	(682)	(15)
Accrued pension liability	(53)	29	(281)
	(547)	(333)	445
Tax effect	186	113	(154)
Other comprehensive income (loss), net of tax	$ (361)	$ (220)	$ 291

NOTE Q – RESTRICTIONS ON TRANSFERS FROM SUBSIDIARIES

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 December 31, 2010, using the most restrictive of these conditions, the aggregate cash dividends that the Bank could pay the Company without prior regulatory approval was approximately $4.0 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, 2010	December 31, 2009
Assets		
Cash and cash equivalents	$ 683	$ 616
Investment in subsidiary bank	54,963	53,301
Investment in non banking subsidiary	189	190
Premises and equipment, net	876	908
Other assets	711	528
Total Assets	$ 57,422	$ 55,543
Liabilities and Shareholders' Equity		
Dividends payable	$ 117	$ 116
Other liabilities	63	104
Other borrowings	2,845	3,489
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in ESOP	1,399	945
Shareholders' equity	47,843	45,734
Total Liabilities and Shareholders' Equity	$ 57,422	$ 55,543

Statements of Income	Year ended December 31, 2010	2009	2008
Dividends from subsidiary banks	$ 1,358	$ 1,113	$ 4,088
Interest income	25	34	33
Interest expense	(300)	(351)	(693)
Other income	137	137	148
Other expenses	(290)	(269)	(320)
	930	664	3,256
Federal income tax credit	(146)	(153)	(283)
	1,076	817	3,539
Equity in net income, less dividends received, of:			
Subsidiary banks	2,023	1,121	(2,725)
Non-banking subsidiary	(1)	(2)	(1)
Net Income	$ 3,098	$ 1,936	$ 813

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

Statements of Cash Flows	Year ended December 31,		
	2010	**2009**	**2008**
Operating Activities			
Net income	$ 3,098	$ 1,936	$ 813
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received, of:			
Subsidiary banks	(2,023)	(1,121)	2,725
Non-banking subsidiary	1	2	1
Stock option and restricted stock grant compensation expense	154	132	141
Depreciation	32	32	32
Net change in obligation under ESOP	140	154	121
Other, net	(224)	211	(9)
Net cash from operating activities	1.178	1,346	3,824
Investing Activities			
Retirement of bank stock	-	3,000	-
Additions to premises and equipment	-	-	(4)
Net cash from investing activities	-	3,000	(4)
Financing Activities			
Proceeds from other borrowings	-	3,000	600
Repayments of other borrowings	(644)	(6,557)	(1,687)
Cash dividends paid	(467)	(813)	(1,849)
Purchase of ESOP shares	-	-	(609)
Repurchase of common stock	-	-	(12)
Net cash from financing activities	(1,111)	(4,370)	(3,557)
Net change in cash and cash equivalents	67	(24)	263
Beginning cash and cash equivalents	616	640	377
Ending cash and cash equivalents	$ 683	$ 616	$ 640

NOTE S – SUPPLEMENTAL CASH FLOW DISCLOSURES

The following supplemental cash flow disclosures are provided for the years ended December 31, 2010, 2009 and 2008 (in thousands):

	2010	2009	2008
Cash paid during the year for:			
Interest	$ 4,527	$ 5,692	$ 8,280
Income taxes	492	-	480
Non-cash operating activities:			
Change in deferred income taxes on net unrealized gain on available for sale securities	(168)	123	(249)
Change in deferred income taxes on pension liability	(18)	(10)	95
Change in pension liability	53	29	(281)
Non-cash investing activities:			
Change in unrealized gain on available for sale securities	(494)	(362)	726
Transfers from loans to foreclosed assets	1,545	3,197	1,987

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, 2010 and 2009, 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, 2010 and 2009 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):

	2010		2009	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial assets:				
Cash and cash equivalents	$ 78,833	$ 78,833	$ 24,814	$ 24,814
Federal funds sold	275	275	2,540	2,540
Securities available for sale	59,228	59,228	56,948	56,948
Loans held for sale	2,637	2,637	605	605
Loans, net of allowance for loan losses	303,830	307,946	327,004	329,961
Accrued interest receivable	2,107	2,107	2,054	2,054
Financial liabilities:				
Deposits	$ (409,901)	$ (406,143)	$ (380,905)	$ (382,166)
Securities sold under agreements to repurchase and overnight borrowings	(15,027)	(15,027)	(14,799)	(14,799)
Other borrowings	(10,079)	(9,835)	(10,832)	(10,983)
Subordinated debentures	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	(171)	(171)	(228)	(228)

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 also has 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.

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.

NOTE U – FAIR VALUE MEASUREMENTS (CONTINUED)

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.

The following table summarizes financial and nonfinancial assets (there were no financial or nonfinancial liabilities) measured at fair value as of December 31, 2010, 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:				
Federal agencies	$ 24,106	$ -	$ -	$ 24,106
U.S. government sponsored entities and agencies	6,678	-	-	6,678
States and political subdivisions	-	22,378	2,992	25,370
Asset-backed securities	2,476	-	-	2,476
Mortgage-backed securities	-	548	-	548
Total available for sale	$ 33,260	$ 22,976	$ 2,992	$ 59,228
Nonrecurring:				
Impaired loans	$ -	$ -	$ 9,595	$ 9,595
Other real estate owned	$ -	$ -	$ 1,247	$ 1,247

Impaired loans are reported net of a $1,171,000 allowance for loan losses.

NOTE U – FAIR VALUE MEASUREMENTS (CONTINUED)

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 $1,247,000, which is made up of the balance of $1,356,000, net of a valuation allowance of $109,000 at December 31, 2010. Write-downs of other real estate owned amounted to $109,000 for the year ending December 31, 2010 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, 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 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, 2010 and 2009 (in thousands):

	2010	2009
Balance at January 1, 2010	$ 3,099	$ 3,002
Net maturities and calls	(938)	(316)
Unrealized net gains (losses) included in other comprehensive income	2	(2)
Net transfers into level 3	829	415
Balance at December 31, 2010	$ 2,992	$ 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 adequately capitalized or worse, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

NOTE 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
2010						
Total capital (to risk weighted assets)						
Consolidated	$43,577	13.7%	$25,459	8.0%	N/A	N/A
Bank	44,284	14.0	25,365	8.0	$31,707	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	39,578	12.4	12,729	4.0	N/A	N/A
Bank	40,299	12.7	12,683	4.0	19,024	6.0
Tier 1 capital (to average assets)						
Consolidated	39,578	8.2	19,263	4.0	N/A	N/A
Bank	40,299	8.4	19,235	4.0	24,044	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
2009						
Total capital (to risk weighted assets)						
Consolidated	$40,733	11.9%	$27,367	8.0%	N/A	N/A
Bank	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
Bank	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
Bank	37,982	8.4	18,078	4.0	22,598	5.0

Recent Regulatory Developments: On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which brings significant financial reform. Among other things, the law:

- Creates a Financial Services Oversight Council to identify emerging systemic risks and improve interagency cooperation;
- Creates a Consumer Financial Protection Agency authorized to promulgate and enforce consumer protection regulations relating to financial products, which would affect both banks and non-bank finance companies;
- Establishes strengthened capital standards for banks and bank holding companies, and disallows trust preferred securities from being included in Tier 1 capital determination for certain financial institutions;
- Enhances regulation of financial markets, including derivatives and securitization markets;
- Contains a series of provisions covering mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards and prepayments;
- Grants the Board of Governors of the Federal Reserve System the power to regulate debit card interchange fees;
- Prohibits certain trading activities by banks;
- Permanently increases the maximum standards FDIC deposit insurance amount to $250,000; and
- Creates an Office of National Insurance with the U.S. Department of Treasury.

NOTE V – REGULATORY MATTERS (CONTINUED)

While the provisions of the Act receiving the most public attention have generally been those more likely to affect larger institutions, the Act also contains many provisions which will affect smaller institutions such as the Company in substantial and unpredictable ways. Consequently, compliance with the Act's provisions may curtail the Company's revenue opportunities, increase its operating costs, require it to hold higher levels of regulatory capital and/or liquidity or otherwise adversely affect the Company's business or financial results in the future. The Company's management is actively reviewing the provisions of the Act and assessing its probable impact on the Company's business, financial condition, and result of operations. However, because many aspects of the Act are subject to future rulemaking, it is difficult to precisely anticipate its overall financial impact on the Company and Bank at this time.

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
2010						
First Quarter	$ 5,209	$ 4,040	$ 200	$ 702	$ .30	$ .30
Second Quarter	5,122	4,013	150	803	.35	.35
Third Quarter	5,249	4,149	425	870	.38	.38
Fourth Quarter	5,135	4,043	600	723	.31	.31
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

SELECTED FINANCIAL DATA

(in thousands, except per share data)

	Year Ended December 31				
	2010	2009	2008	2007	2006
Total interest income	$ 20,715	$ 21,938	$ 25,929	$ 23,544	$ 21,454
Net interest income	16,245	16,538	17,740	14,906	14,495
Provision for loan losses	1,375	2,725	5,080	745	500
Net income	3,098	1,936	813	4,133	4,009
Per share data:					
Basic earnings per share	1.34	.84	.36	2.29	2.27
Diluted earnings per share	1.34	.84	.36	2.28	2.26
Cash dividends	.20	.20	.80	.80	.78
Balance sheet data:					
Gross loans	309,524	333,079	335,310	335,978	252,825
Deposits	409,901	380,905	399,043	399,169	282,509
Other borrowings	10,079	10,832	12,492	14,753	6,973
Common stock subject to repurchase	1,399	945	728	2,029	2,148
Equity	47,843	45,734	44,416	44,219	28,482
Total assets	493,880	462,409	474,996	480,178	329,891
Return on average assets	.65%	.41%	.17%	1.18%	1.25%
Return on average equity (1)	6.56	4.29	1.77	12.72	14.54
Dividend payout ratio (2)	15.11	24.13	227.33	36.90	34.44
Average equity to average assets (1)	9.87	9.66	9.59	9.27	8.56

(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.

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. As of March 14, 2011, there were 2,340,339 shares of Southern common stock issued and outstanding held by 417 holders of record.

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			2010		
	Bid Price		Cash Dividends Declared	Bid Price		Cash Dividends Declared
Quarter Ended	High Bid	Low Bid		High Bid	Low Bid	
March 31	$ 8.10	$ 5.10	$ .05	$ 11.00	$ 9.60	$ .05
June 30	14.00	5.50	.05	12.25	10.50	.05
September 30	9.00	6.80	.05	12.40	11.30	.05
December 31	10.05	8.30	.05	13.50	11.75	.05

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.