2011 Annual report

SOUTHERN MICHIGAN BANCORP, INC.

Southern Michigan BANCORP, INC.

Continuous Banking Since 1872

Financial Summary

For the Year	2011	2010
Net interest income	$ 15,927,000	$ 16,245,000
Provision for loan losses	1,050,000	1,375,000
Non-interest income	6,796,000	7,207,000
Non-interest expense	17,312,000	18,258,000
Net income	3,402,000	3,098,000
Per Share		
Basic earnings	$1.46	$1.34
Diluted earnings	1.46	1.34
Cash dividends declared	0.22	0.20
At Year End		
Assets	$ 509,220,000	$ 493,880,000
Gross loans	332,804,000	309,524,000
Allowance for loan loss	5,412,000	5,694,000
Deposits	420,511,000	409,901,000
Other borrowings	7,751,000	10,079,000
Shareholders' equity	51,865,000	47,843,000
Ratios		
Return on average assets	0.68%	0.65%
Return on average equity	6.80%	6.56%
Total risk-based capital ratio	13.67%	13.69%
ALLL as percentage of loans	1.63%	1.84%

Southern Michigan Bancorp, Inc. is a bank holding company. The Company's wholly-owned subsidiary, Southern Michigan Bank & Trust, 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.

To Our Shareholders

“Much of Southern’s new business activity is attributable to our focus on personalized service as well as the attractiveness of Southern as a strong and stable community banking franchise.”
—John H. Castle, Chairman and Chief Executive Officer

I am pleased to announce that Southern Michigan Bancorp, Inc. reported net income for 2011 of $3.4 million, or $1.46 per share. This represents a 9.8 percent increase over net income of $3.1 million, or $1.34 per share, for 2010. Our net income for the year was bolstered by strong fourth quarter earnings in which Southern earned just over $1 million, an increase of 39 percent over the $723,000 earned for the fourth quarter of 2010.

Southern’s financial performance for 2011 was significantly impacted by continued improvements in the quality of our loan portfolio, successful implementation of strategies to reduce operating expenses, and loan growth of $23.3 million, principally in the fourth quarter of 2011, from year-end 2010 levels. Growth in the loan portfolio resulted in favorable improvement in our net interest margin with fourth quarter 2011 net interest income increasing by $123,000, or 3 percent, compared to 2010.

Key loan portfolio metrics reflected substantial improvements compared with 2010 results. Our loan portfolio at year-end 2011 totaled $332.8 million, and represented an increase of 7.5 percent over $309.5 million in loan totals at year end 2010. Provision for loan loss expense for 2011, which totaled $1.05 million, was reduced by more than 23 percent from provision for loan loss expense of $1.375 million for 2010. Net loan charge-offs for 2011 were at the lowest level in four years totaling $1.332 million, or .40 percent of loans, down from $1.756 million, or .55 percent of loans for 2010.

Total non-interest expense for 2011 decreased $946 thousand to $17.3 million, or 5.2 percent, as compared to 2010. This was accomplished by consolidating two offices, streamlining back-office operations and deploying new technologies to enhance customer service.

Total assets as of December 31, 2011 were $509.2 million, a record high level in Southern’s history, compared with $493.9 million as of December 31, 2010. Our annualized return on average assets for 2011 and 2010 was 0.68 percent and 0.65 percent, respectively. The annualized return on average equity was 6.80 percent for 2011 compared to 6.56 percent for 2010.

Southern’s financial results for 2011 reflect steady improvement across most operating areas of the bank. We are now approaching levels of performance attained prior to the onset of the economic downturn that began about four years ago. As a result we were able to increase the fourth quarter 2011 dividend to $.07 per share, or $.28 annualized, an increase of $.02 per share over our October 2011 cash dividend payment. As our financial performance improves and greater certainty emerges within regulatory and economic environments, we will continue to evaluate alternative dividend payment options and strategies.

Signs of economic improvement are slowly beginning to emerge locally and regionally. Our pipeline for new loans is at the highest level in several years. Much of Southern’s new business activity is attributable to our focus on personalized service as well as the attractiveness of Southern as a strong and stable community banking franchise. We have been successful in growing the loan portfolio while maintaining our conservative discipline that has always been an important part of our credit culture.

All banks, including Southern, are operating in an unprecedented environment of historically low interest rates that, according to the Federal Reserve, are likely to remain in effect for some time. As a result our net interest margins, the difference between what we pay for deposits and what we charge for loans, are expected to continue to be narrow. In addition, the full effect of new bank regulations, including the Dodd-Frank Act, has yet to be reflected in our operating cost structure. Although we are satisfied with our accomplishments attained during 2011 and over the past four years, we remain cautious due to the many uncertainties likely to have a profound impact on community banks in Michigan and throughout the United States. Future earnings growth will come from selective retention of new clients and from identifying strategies to lower operating expenses without sacrificing our traditionally high standards of customer service.

During 2012 and beyond, we expect to further adapt emerging technologies to our core banking services. Our customers' use of mobile and internet banking, ATMs, debit cards, remote deposit capture and other technologically-based services and delivery channels is growing at double digit rates. At the same time, routine banking transactions completed in our branches are flat or declining despite increases in overall customer relationships. Over the next several years, our branch network will take on a greater role involving consultative selling and managing more complex banking transactions.

Uncertainties associated with a slow economic recovery, persistently high unemployment, changes in tax policies, rising health care costs and costly new regulations will provide imposing challenges to many community banks. Southern remains in an enviable position to take advantage of growth and other expansion opportunities that may be presented to us in the future.

In closing, our successes achieved last year were the product of effective planning by our Board of Directors and strategic execution by our management group and staff. Many opportunities and challenges lie ahead for 2012. We remain focused on Southern's core mission to create value for our shareholders.

Thank you for your continued support of Southern.

Sincerely,

J H Castle

John H. Castle
Chairman and Chief Executive Officer

Jim Sobeske, Vice President (left), meets with Dave Haylett, President of Haylett Auto & RV Supercenter, in the Haylett showroom at company headquarters in Coldwater, Michigan.

Client Profile:

HAYLETT AUTO & RV SUPERCENTER

"...They are a first class team. When you become a customer of Southern Michigan Bank & Trust, you gain a business partner with a vast amount of knowledge and experience."

—Dave Haylett, President, Haylett Auto & RV Supercenter

Relationships are important to Dave Haylett. "There's a confidence and security in working with people you know," says Dave. Relationships are what got Dave into the car business in the first place. As a child, he mowed lawn for retired Dodge dealer Leonard Pierce in Coldwater and spent hours listening to his "war stories" about the business. As a teenager, Dave worked at Dick Johnson's local Chevrolet dealership washing Bell Telephone trucks on Saturdays. "I loved the atmosphere. I didn't know it at the time, but I was certainly being groomed for my lifetime passion."

After spending many successful years as General Sales Manager of Battle Creek Ford, he ventured out on his own in 1989. Three of the people who worked for Dave in Battle Creek work for him today, 22 years later, at Haylett Auto & RV Supercenter. "I'm so proud of the fact we've maintained great relationships with our employees, with our vendors, and with our customers. I've been in this business long enough to have had the pleasure of seeing generations come back as customers – first a husband and wife, then their children, and now grandchildren. I think that says a lot about the way we do business."

In the early 1990s, Dave identified the growing potential of the recreational vehicle (RV) market and added a full service RV dealership to his business. "Starting a dealership in this area turned out to be a major plus for us," Dave recalls. "I was able to get access to the top lines of reputable RV manufacturers because they were not being effectively represented in this region. I wouldn't have had this opportunity in a metropolitan area." This strategic move, coupled with the Haylett reputation and service culture, have propelled Haylett Auto & RV Supercenter to be recognized as a "Jayco Gold Dealer" (the top 8% of dealers in the country); Haylett Auto & RV Supercenter is ranked 6th in the state of Michigan in travel trailer sales. Dave is a longstanding board member of the Michigan Association of Recreational Vehicles & Campgrounds (MARVAC). His business has dealings worldwide, from Coldwater, Michigan to Canada and to Europe.

"The landscape of this business is constantly changing; if you don't move with it, you could be gone," Dave observes. The Haylett business has evolved into a company offering brokerage, RV, trailer and vehicle sales, parts and accessories, and service. When Dave saw another opportunity to increase his business, he turned to Southern Michigan Bank & Trust. "I've known the team at Southern for years, so I decided to rely on the relationships I've had with those individuals to see if they would be willing to work with me." Not only was Southern Michigan Bank & Trust willing and able to work with Dave, they were also knowledgeable of his operations and had a presence in the area in which he was looking to expand.

"It sounds cliché, but Southern Michigan Bank & Trust truly is big enough to serve you, yet small enough to know you. They are a first class team. When you become a customer of Southern Michigan Bank & Trust, you gain a business partner with a vast amount of knowledge and experience. We deal with so many aspects running our various operations, and Southern Michigan Bank & Trust can handle them all - from cash management and electronic banking to ACH and financing." With the help of vice president of commercial lending, Jim Sobeske, and Electronic Services Officer Jamie Tobalske, the phenomenal undertaking of transitioning from one financial institution to another went smoothly. "I'm so excited about the next chapter of this business, and I'm looking forward to a long relationship with Southern Michigan Bank & Trust."

"We are well aware that Dave has many banking options available and honored that he chose Southern Michigan Bank & Trust as his bank. We are proud to be associated with him and his team," Sobeske added. "We share with Dave the high value placed on relationships and what it takes to earn and maintain that level of trust."

Bill Russell, President/CEO and Steven Andrews, Vice President of Finance, both of Three Rivers Health, meet with John Castle, CEO and Robert Hungerford, Vice President in the hospital's front entrance (pictured left to right).

Client Profile:
THREE RIVERS HEALTH

"... They are large enough to support our needs, and they were able to develop an extremely complex financing solution."
—Bill Russell, President/CEO, Three Rivers Health

"The difference between providing health care services in the city versus rural communities is simple. In the city they take care of patients. In rural communities we take care of family and friends," states Three Rivers Health President/CEO Bill Russell.

Three Rivers Health employees, medical staff and volunteers are dedicated to providing high quality health care services to communities in Southwestern Michigan. Its vision is to improve the health of these residents by offering, in connection with an impressive network of providers, excellence and value in healthcare services, primarily through educating and promoting wellness and preventative services. With 300 employees, it is one of the largest employers in St. Joseph County.

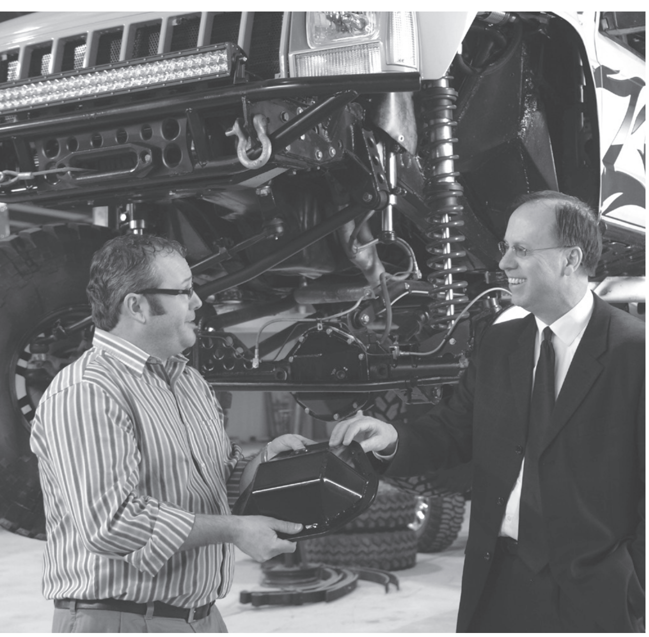
The Three Rivers Health Authority Board (TRHAB) understood that the financial losses experienced in 2008 and 2009 could not continue, and major changes needed to be made in order for this important community health care provider to remain viable. TRHAB retained a new CEO, Bill Russell, in July of 2009 and together they made some painful, but essential changes. Steven Andrews, vice president of finance, confirmed that as a direct result of their actions, the hospital's operating results improved dramatically from losing $3.1 million in 2008 to generating a net profit of $504,000 in 2011.

The TRHAB also identified the need to explore financing alternatives, not only to lower its borrowing costs, but also to obtain new funding to invest in strategic initiatives that would ensure that future health care demands would be met. It was ultimately decided that for the hospital to remain a viable operation, it needed to change its organizational structure and become a nonprofit, tax-exempt corporation. Southern Michigan Bank & Trust supported the idea of making this change while remaining a community owned entity, offering counsel to hospital officials regarding financial and organizational options. The new organizational structure was then placed on a ballot proposal, and in November 2011, an unprecedented 85% of voters said, "yes" to the proposed change.

Robert Hungerford, vice president and commercial lender at Southern states, "Having been a part of this community the past 25 years, I have seen firsthand how our local hospital has responded to the needs of the community, and we were pleased to be able to help the hospital with attractive financing alternatives."

Bill Russell is excited about the future of Three Rivers Health and partnering with Southern: "I was impressed with Southern Michigan Bank & Trust as a regional bank. They are large enough to support our needs, and they were able to develop an extremely complex financing solution. Banking with them will allow us to reduce operating overhead, begin generating cash from operations, reinvest more in our facility in order to strengthen our balance sheet, and sustain and advance our mission while creating a better opportunity to survive in an ever-changing, unpredictable health care environment."

In describing the hospital's confidence in Southern Michigan Bank & Trust, Bill Russell said, "Many years ago I was given the sage advice to find good people to work with and then get out of their way to let them do what they're good at doing. Southern Michigan Bank & Trust is just that – good people who are good at what they do. They are our partner in this venture, and I'm happy to let them do what they're good at doing so we can continue to take care of the health of our friends and family."



John Castle, CEO; Kurt Miller, President; and Tom Swoish Vice-President; meet with Steve Olmstead (second from right), President of Sport Truck USA in the company's distribution center. In photo on upper left, Tom Swoish speaks with Glen Hard COO, (on left), and Mark Meldrum, CFO of Sport Truck USA. In photo on lower left, Hard describes to Swoish BDS Suspsension parts during tour of facility.

Client Profile:
SPORT TRUCK USA

“Southern has always been there for us; they are competitive, have quick response times, and they know and understand our business.”
—Mark Meldrum, CFO, Sport Truck USA

“We’re different and we want our customers to know it right off the bat. The standard warranty in our industry is two paragraphs long, complex and designed to get the company out of backing their product. We don’t operate that way; we never have,” says Steve Olmstead, President of Sport Truck USA. Our warranty reads, “If you are the original purchaser of any BDS product and it breaks, we will give you a new part. Period.”

Standing apart from the crowd and having a simple “do what’s right” attitude has served the company well as it has transformed into a major player in the suspension and off-road products market. After observing an industry that was unwilling to stand behind their products and put the best interests of the customer at the forefront of their business, the company developed its own line of suspension products under the name BDS Suspension. Seeking out distributors and shop owners with the same philosophy of top-notch customer service has also helped to enable national and international growth. Dealing with local vendors and suppliers has always been a priority for BDS. “Ninety-nine percent of our parts are made in the US. A majority are made within 150 miles of Coldwater,” states Olmstead. “When a part is ordered it ships the same day, and if a product is in our catalog or on the website, it is in stock.”

Sport Truck USA d/b/a Truckmaster Distributing is a full service, globally recognized distributor of aftermarket vehicle accessories offering over 100,000 warehoused parts to the United States and Canada. Its emphasis is suspension products and it is regarded as an industry expert in this specialized area. It is also the exclusive distributor to subsidiaries BDS Suspension, Zone Offroad Products and 4x4 Posi-Lok. Under the guidance of a skilled management team, this company has evolved into a major player with annual sales more than doubling over the past three years. Sport Truck is also unique in that it is completely employee-owned and continues to be based in Coldwater, Michigan, all while maintaining its position as an industry leader.

“Our companies share the same culture of being customer service driven,” states Kurt Miller, President of Southern Michigan Bank & Trust. “We are proud of our longstanding relationship with Sport Truck USA and the ability to support its banking needs as this company continues to grow.” Sport Truck makes good use of a wide range of Southern’s cash management and electronic services; from direct deposit of payroll and Health Savings Accounts, to wire transfers, account reconciliations and electronic statements. In October 2011, Tom Swoish, vice president and commercial loan officer, closed on a specialized loan arrangement to Sport Truck’s Employee Stock Ownership Program to purchase the remaining shares of outstanding stock and become 100% employee-owned. Olmstead states, “We were in a unique situation. We weren’t borrowing money to buy more parts or build a warehouse. We were borrowing to finance the purchase of company stock.”

Although Sport Truck USA has been a long-time customer of Southern Michigan Bank & Trust, there were other financial institutions “courting” the business. “Southern has always been there for us; they are competitive, have quick response times, and they know and understand our business,” said CFO Mark Meldrum. Olmstead added, “They’ve always allowed us to pursue our company goals without worrying about adequate funding. We believe in staying local whenever it’s possible. A relationship with someone in your own backyard has a tendency to last through the many ups and downs of the business cycle.”

Southern Michigan Bancorp, Inc.
Board of Directors

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 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

Officers of Southern Michigan Bank & Trust

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

COMMERCIAL 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

RESIDENTIAL & CONSUMER LOANS

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

Rick Feller
Vice President /
Lending and Sr. Collections
Administrator

Phyllis Wingate
Vice President /
Head of Retail 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

Cassidy Munn
Assistant Vice President /
Retail Loan Officer

Desiree Kauffman
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
Assistant Vice President /
Branch Manager

BATTLE CREEK & MARSHALL BRANCHES

Claudia Murch
Assistant Vice President /
Regional Branch Manager

HILLSDALE AND CAMDEN BRANCHES

Lori Neill
Assistant Vice President /
Regional Branch Manager

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

THREE RIVERS MAIN BRANCH

Sharon Bachinski
Assistant Vice President /
Regional Branch Manager

THREE RIVERS WESTLAND BRANCH

Lynette Lorenz
Assistant Vice President /
Branch Manager

ACCOUNTING

Sara Herrmann
Vice President /
Finance

OPERATIONS / INFORMATION SYSTEMS

Dave McKinley
First Vice President /
Head of Operations

Paul Mahle
Assistant Vice President /
Senior Data Processing Officer

Becky Omo
Assistant Vice President /
Operations Representative

Angie Smith
Assistant Vice President /
Operations Manager

Jamie Tobalske
Assistant Vice President /
e-Services Officer

Jeff Kiersey
Systems Solutions Officer

Vikki Kline
Project /
Research Officer

COMPLIANCE

Christine Hagaman
Vice President /
Compliance Officer

MARKETING

Patty Parker
Vice President

Shareholder Information

Annual Meeting
The annual meeting of Southern Michigan Bancorp, Inc. will be held on May 10, 2012 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

Royal Securities Company
Grand Rapids, Michigan
(616) 459-2844 or
(888) 804-8891

Continuous Banking Since 1872

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Your Community. Your Bank.

2011 Annual report

SOUTHERN MICHIGAN BANCORP, INC.

Southern Michigan
BANCORP, INC.

Contents

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 "probable" 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 trends in our credit quality metrics, future capital levels, future charge-off levels, real estate valuation, future levels of non-performing assets and costs associated with administration and disposition of non-performing assets, the rate of asset dispositions, dividends, future growth and funding sources, future liquidity levels, future profitability levels, future FDIC assessment levels, future effects of new or changed accounting standards, 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 and mortgage servicing rights), 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, 2011. 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 and its subsidiaries 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 Michigan Bancorp, Inc. (Southern) is a Michigan corporation and a bank holding company registered under the Bank Holding Company Act of 1956. Southern wholly owns Southern Michigan Bank & Trust (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 15 banking offices located in Battle Creek, Camden, 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, 2011, on a consolidated basis, we had assets of $509.2 million, deposits of $420.5 million, a net loan portfolio of $327.4 million, trust assets under management totaling $213.6 million, and shareholders' equity of $51.9 million.

Results of Operations

Southern's net income for 2011 was $3,402,000 compared to $3,098,000 in 2010, an increase of $304,000, or 9.81%. Provision for loan losses of $1,050,000 was expensed in 2011, down from $1,375,000 in 2010. Non-interest income decreased 5.70%, or $411,000, to $6,796,000 in 2011. Non-interest expense decreased 5.18%, or $946,000, to $17,312,000 in 2011. Following is a summary of percentage changes from prior year for various financial statement elements:

	Percent Change from Prior Year	
	2011	2010
Net interest income	-1.96%	-1.77%
Provision for loan losses	-23.64%	-49.54%
Non-interest income	-5.70%	0.49%
Non-interest expense	-5.18%	-3.75%
Net income	9.81%	60.02%

	Percent Change from Prior Year	
	2011	2010
Total assets	3.11%	6.81%
Securities available for sale	52.54%	4.00%
Gross loans	7.52%	-7.07%
Allowance for loan losses	-4.95%	-6.27%
Deposits	2.59%	7.61%
Other borrowings	-23.10%	-6.95%
Shareholders' equity	8.41%	4.61%

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 6.80% in 2011, 6.56% in 2010 and 4.29% in 2009. The return on average assets was 0.68% in 2011, 0.65% in 2010 and 0.41% in 2009.

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 2011, Southern's net interest margin (FTE) was 3.67% compared to 3.95% for 2010 and 4.14% for 2009. Southern's interest rate spread and margin both further decreased as yields on earning assets decreased 0.51%, from 5.01% in 2010 to 4.50% in 2011, while Southern's cost of funds for deposits and other borrowings decreased 0.24%, from 1.22% in 2010 to 0.98% in 2011.

In 2011, the lower interest margin was a result of reduced rates for all interest earning asset types, partially offset by reduced rates for deposits. The net effect was a decrease of $287,000 in net interest income (FTE) compared to 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.

The following table presents a summary of net interest income (FTE) for 2011, 2010 and 2009.

Table 1. Average Balances and Tax Equivalent Interest Rates

	2011			2010			2009		
(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)	$ 311,117	$ 17,973	5.78%	$ 322,349	$ 19,251	5.97%	$ 333,397	$ 19,966	5.99%
Taxable investment securities(4)	56,260	631	1.12	33,765	604	1.79	38,329	1,134	2.96
Tax-exempt investment securities(1)	27,323	1,393	5.10	21,023	1,165	5.54	23,044	1,338	5.81
Federal funds sold and other(5)	53,103	172	0.32	45,459	155	0.34	18,487	69	0.37
Total interest earning assets	447,803	20,169	4.50	422,596	21,175	5.01	413,257	22,507	5.45
Non-interest earning assets:									
Cash and due from banks	11,226			11,489			11,059		
Other assets(6)	49,024			49,828			49,505		
Less allowance for loan losses	(5,434)			(5,757)			(6,548)		
Total assets	$ 502,619			$ 478,156			$ 467,273		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Demand deposits	$ 173,888	$ 519	0.30%	$ 148,968	$ 518	0.35%	$ 142,931	$ 612	0.43%
Savings deposits	50,789	44	0.09	47,937	70	0.15	51,450	108	0.21
Time deposits	127,675	2,578	2.02	136,369	3,189	2.34	135,781	3,952	2.91
Securities sold under agreements to repurchase and overnight borrowings	16,171	52	0.32	16,714	50	0.30	14,899	41	0.28
Other borrowings	8,916	402	4.51	12,131	486	4.01	12,284	490	3.99
Subordinated debentures	5,155	156	3.03	5,155	157	3.05	5,155	197	3.82
Total interest bearing liabilities	382,594	3,751	0.98	367,274	4,470	1.22	362,500	5,400	1.49
Non-interest bearing liabilities:									
Demand deposits	64,760			58,298			55,934		
Other	3,866			4,197			2,852		
Common stock subject to repurchase obligation	1,347			1,172			836		
Shareholders' equity	50,052			47,215			45,151		
Total liabilities and shareholders' equity	$ 502,619			$ 478,156			$ 467,273		
Net interest income		$ 16,418			$ 16,705			$ 17,107	
Interest rate spread			3.52%			3.79%			3.96%
Net margin on interest earning assets			3.67%			3.95%			4.14%

(1) Includes tax equivalent adjustment of interest (assuming a 34% tax rate) for securities and loans of $473,000 and $17,000, respectively for 2011; $396,000 and $64,000, respectively for 2010; and $455,000 and $114,000, respectively for 2009.
(2) Average balance includes average nonaccrual loan balances of $6,063,000 in 2011; $7,139,000 in 2010; and $8,135,000 in 2009.
(3) Interest income includes loan fees of $509,000 in 2011; $494,000 in 2010; and $365,000 in 2009.
(4) Average balance includes average unrealized gain of $737,000 in 2011; $618,000 in 2010; and $976,000 in 2009 on available for sale securities.
(5) Includes average federal reserve deposit account balances of $50,658,000 in 2011, $41,006,000 in 2010 and $15,771,000 in 2009.
(6) Includes $15,267,000 in 2011, $15,612,000 in 2010 and $15,967,000 in 2009 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)

	2011 Compared to 2010 Increase (Decrease) Due To			**2010 Compared to 2009 Increase (Decrease) Due To**		
Interest income on:	**Rate**	**Volume**	**Net**	**Rate**	**Volume**	**Net**
Loans	$ (619)	$ (659)	$ (1,278)	$ (55)	$ (660)	$ (715)
Taxable investment securities	(279)	306	27	(407)	(123)	(530)
Tax-exempt investment securities	(99)	327	228	(59)	(114)	(173)
Federal funds sold and other	(8)	25	17	(6)	92	86
Total interest earning assets	$ (1,005)	$ (1)	$ (1,006)	$ (527)	$ (805)	$ (1,332)
Interest expense on:						
Demand deposits	$ (79)	$ 80	$ 1	$ (119)	$ 25	$ (94)
Savings deposits	(30)	4	(26)	(31)	(7)	(38)
Time deposits	(417)	(194)	(611)	(780)	17	(763)
Securities sold under agreements to repurchase and overnight borrowings	4	(2)	2	4	5	9
Other borrowings	56	(140)	(84)	2	(6)	(4)
Subordinated debentures	(1)	-	(1)	(40)	-	(40)
Total interest bearing liabilities	$ (467)	$ (252)	$ (719)	$ (964)	$ 34	$ (930)
Net interest income	$ (538)	$ 251	$ (287)	$ 437	$ (839)	$ (402)

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 $1,050,000 in 2011, compared to $1,375,000 in 2010, and $2,725,000 in 2009. The lower provisions in 2011 and 2010 resulted primarily from a continued trend of lower net loan charge-offs. In 2011, net charge-offs totaled $1,332,000 compared to $1,756,000 in 2010 and $3,754,000 in 2009.

Non-Interest Income

Non-interest income of $6,796,000 decreased $411,000, or 5.7%, in 2011 compared to 2010 and was relatively flat in 2010 at $7,207,000 compared to $7,172,000 in 2009. The 2011 decrease was primarily a result of a decline in service charges on deposit accounts which decreased $380,000, or 15.8%, in 2011 compared to 2010, and were down $334,000, or 12.2%, in 2010 compared to 2009. The Company made changes to its overdraft protection program in July of 2010 and in June of 2011 to comply with regulatory guidance that became effective in August of 2010 and July of 2011, respectively. These changes resulted in a lower volume on non-sufficient funds items which reduced income. Southern also recorded $156,000 gain from life insurance proceeds in 2010 which did not recur in 2011.

Trust fees of $1,120,000 in 2011 increased $123,000, or 12.3%, compared to 2010 and were relatively flat in 2010 at $997,000 compared to $987,000 in 2009. Changes to the trust department fee structure and new account relationships were the primary causes for the increase in 2011.

Net securities gains of $29,000, $207,000 and $682,000 were recognized in 2011, 2010 and 2009, respectively. In 2011, an unanticipated call of securities triggered the gain. 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 $41,562,000 in 2011 compared to $57,470,000 in 2010 and $41,586,000 in 2009. Net gains on loan sales decreased $66,000 in 2011 compared to 2010. 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.

Income and fees from automated teller machines (ATMs) and debit cards increased $118,000, or 13.2%, in 2011 compared to 2010 and $194,000, or 27.6%, in 2010 compared to 2009. Increases were primarily due to increased volumes of approved transactions.

Income from loan servicing increased $105,000, or 32.7%, in 2011 compared to 2010 and was flat at $321,000 in 2010 compared to 2009. Increased balances in loans sold in the secondary market in 2011 and 2010 resulted in higher loan servicing income.

Non-Interest Expense

Non-interest expense decreased $946,000, or 5.2%, in 2011 compared to 2010 and $712,000, or 3.8%, in 2010 compared to 2009.

Salaries and employee benefits expense decreased $161,000, or 1.6%, in 2011 compared to 2010 and increased $273,000, or 2.8%, in 2010 compared to 2009. At December 31, 2011, Southern had 171 full-time equivalent positions, compared to 196 at both December 31, 2010 and 2009. The reduction in salaries and benefits expense in 2011, as well as full-time equivalent positions, was a result of the closure of two branches in 2011 and one branch in December 2010, as well as a concentrated effort to right-size staffing levels bank wide.

Occupancy expense decreased $159,000, or 11.8%, in 2011 compared to 2010 and was flat at $1,353,000 in 2010 compared to $1,351,000 in 2009. The decrease in 2011 occupancy costs was primarily attributable to the aforementioned branch closures.

Equipment expense decreased $139,000, or 15.5%, in 2011 compared to 2010 and $21,000, or 2.3%, in 2010 compared to 2009. Depreciation expense decreased $106,000 in 2011 compared to 2010 and $59,000 in 2010 compared to 2009, as certain assets became fully depreciated.

Printing, postage and supplies expense decreased $96,000, or 16.2%, in 2011 compared to 2010 and $23,000, or 3.7%, in 2010 compared to 2009. The 2011 reduction was primarily a result of outsourcing the statement rendering and mailing processes to a third party vendor during 2011.

Professional and outside services decreased $32,000, or 3.4%, in 2011 compared to 2010 and $413,000, or 30.5%, in 2010 compared to 2009. The 2010 decrease primarily resulted from Southern being able to reduce fees paid for outside consulting relating to system conversions.

FDIC deposit assessments decreased $163,000, or 25.5%, in 2011 compared to 2010 and $215,000, or 25.1%, in 2010 compared to 2009. The reduction in 2011 was due to a formula change used to calculate the FDIC assessments. The new formula was effective April 1, 2011. FDIC assessments in the second quarter of 2009 included a one-time special assessment.

Other real estate owned (OREO) expense of $147,000 and loss on sale or writedown of OREO of $118,000 in 2011 both represented decreases as compared to 2010. OREO expense of $195,000 and loss on sale or writedown of OREO of $215,000 in 2010 and $319,000 and $318,000, respectively, in 2009, also represented a decrease compared to the prior year period. There were fewer OREO properties held and sold throughout 2011 than in 2010. At December 31, 2011, Southern reported OREO of $1,530,000, compared to $1,247,000 at December 31, 2010, with 34% of total OREO at December 31, 2011 related to one commercial property.

Income Taxes

Income tax provision was $959,000 in 2011, $721,000 in 2010 and $79,000 in 2009. 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 $311,000 in 2011, $289,000 in 2010 and $351,000 in 2009. Additional income tax information is reported in Note L to the consolidated financial statements.

Financial Condition

Total assets at December 31, 2011 totaled $509,220,000, an increase of $15,340,000, or 3.1%, from total assets of $493,880,000 at December 31, 2010. Cash and cash equivalents decreased $36,648,000 and available for sale securities increased $31,116,000 compared to December 31, 2010. Gross loans increased $23,280,000 and deposits increased $10,610,000 compared to December 31, 2010.

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2011 decreased $36,648,000, or 46.5%, compared to balances at December 31, 2010. At December 31, 2011, Southern had balances of $29,625,000 with the Federal Reserve, compared to $65,031,000 at December 31, 2010. During 2008, the Federal Reserve began paying banks interest on balances maintained at the Federal Reserve. At December 31, 2011 and 2010, the interest rate paid by the Federal Reserve exceeded the overnight federal funds rate paid by Southern's primary correspondent bank. Balances were moved from cash and cash equivalents into the loan and securities portfolios to improve margin. Loan demand increased during the last half of 2011.

Securities Available for Sale

The securities available for sale portfolio increased $31,116,000, or 52.5%, from December 31, 2010 to December 31, 2011. 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 $1,368,000 at December 31, 2011 and $141,000 at December 31, 2010. 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.

At December 31, 2011, Southern had no investment in securities of issuers outside of the United States.

Loans

Substantially all loans are granted to customers located in Southern's service area, which is primarily southwest Michigan. Gross loans increased $23,280,000, or 7.5%, in 2011. The increase in 2011 was a result of increased loan demand, primarily in the fourth quarter. Gross loans decreased $23,555,000, or 7.1%, in 2010. The decrease in 2010 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 commercial 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 $77,147,000 and $60,778,000 at December 31, 2011 and 2010, 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, loans modified under troubled debt restructurings, 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.

In the course of working with borrowers, Southern may choose to restructure the contractual terms of certain loans. Southern attempts to work-out an alternative payment schedule with the borrower in order to optimize collectability of the loan. Any loans that are modified are reviewed by Southern to identify if a troubled debt restructuring ("TDR") has occurred, which is when, for economic or legal reasons related to a borrower's financial difficulties, Southern grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with its current financial status and the restructuring of the loan may include the transfer of assets from the borrower to satisfy the debt, a modification of loan terms, or a combination of the two.

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

	December 31		
	2011	2010	2009
	(Dollars in thousands)		
Nonaccrual loans:			
Commercial and commercial real estate	$ 3,626	$ 3,755	$ 5,576
Real estate mortgage	2,048	1,451	1,933
Consumer	29	87	76
	5,703	5,293	7,585
Loans contractually past due 90 days or more and still on accrual:			
Commercial and commercial real estate	6	1	14
Real estate mortgage	-	-	-
Consumer	-	-	-
	6	1	14
Accruing loans modified under troubled debt restructurings:			
Commercial and commercial real estate	1,933	1,745	-
Real estate mortgage	1,607	1,552	702
Consumer	-	-	-
	3,540	3,297	702
Total nonperforming loans	9,249	8,591	8,301
Other real estate owned	1,530	1,247	1,187
Total nonperforming assets	$ 10,779	$ 9,838	$ 9,488
Nonperforming loans to year-end loans	2.78%	2.78%	2.49%
Nonperforming assets to total assets	2.12%	1.99%	2.05%

The balance of nonaccrual restructured loans, which is included in nonaccrual loans, was $694,000 at December 31, 2011, $1,375,000 at December 31, 2010 and $1,493,000 at December 31, 2009.

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated for in the allowance for loan losses where appropriate. Nonperforming loans increased from December 31, 2010 to December 31, 2011 as a result of an increase in both nonaccrual loans and troubled debt restructurings. Nonaccrual loans decreased from December 31, 2009 to December 31, 2010, but non-performing loans increased due to an increase in loans modified under troubled debt restructurings. At December 31, 2011, 2010 and 2009, Southern had loans of $9,881,000, $10,766,000 and $11,135,000, respectively, which were considered impaired.

Other real estate owned of $1,530,000 at December 31, 2011, increased $283,000 from December 31, 2010. However, one commercial property was added in 2010 which accounted for 34.1% of the December 31, 2011 balance. During 2011 and 2010, loans of $892,000 and $1,545,000, 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 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.

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 materially 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, 2011, specific reserves totaled $984,000 compared to $1,171,000 at December 31, 2010, a decrease of 16.0%.

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 $5,412,000, or 1.63% of loans, at December 31, 2011 compared to $5,694,000, or 1.84% of loans, at December 31, 2010.

The allowance for loan losses at December 31, 2011 consisted of $3,129,000 from the historical loss experience component and specifically allocated reserves, leaving $2,283,000 from the other factors. This compares to $3,238,000 from the historical loss experience component and specifically allocated reserves and $2,456,000 from the other factors at December 31, 2010.

At December 31, 2011, 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.

Deposits

Deposits have traditionally represented Southern's principal source of funds. Total deposits increased 2.6%, or $10,610,000, in 2011 compared to 2010 and 7.6%, or $28,996,000, in 2010 compared to 2009. In 2011, deposits increased in all categories, except time deposits. 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. A small amount of brokered deposits, $5,429,000 at December 31, 2011, are maintained, but are not used to support growth. Attracting and keeping traditional deposit relationships will continue to be a focus of Southern.

Southern closed three branches during late 2010 and early 2011. Two of the locations are supported by other branch facilities in near proximity. One location, Cassopolis, was located outside of Southern's primary market area. Deposit reductions from this location since December 31, 2010 totaled $5,919,000. In addition, Southern made the strategic decision based on current liquidity levels to reduce certificate of deposit rates and specials. As a result, certificate of deposit balances from non-core customers have declined in 2011.

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 three month London Interbank Offered Rate (LIBOR) plus 2.75%. The rate at December 31, 2011 was 3.15%.

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 $4,022,000, or 8.4%, from December 31, 2010 to December 31, 2011. It increased $2,109,000, or 4.6%, from December 31, 2009 to December 31, 2010. The increases for both 2011 and 2010 were primarily attributable to net income offset by dividends to shareholders. The 2011 increase also included $739,000 of accumulated other comprehensive income, primarily related to unrealized gains on available for sale securities, net of related income taxes.

The Federal Reserve Board uses capital adequacy guidelines in its examination and regulation of bank holding companies. If capital falls below minimum guidelines, a bank holding company may, among other items, be denied approval to acquire or establish additional banks or non-bank businesses.

The FDIC Improvement Act of 1991 established a system of prompt corrective action to resolve the problems of undercapitalized banks. Under this system, federal banking regulators have established five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, in which all institutions are placed. The FDIC has also specified by regulation the relevant capital levels for each of the categories.

The FDIC is required to take specified mandatory supervisory actions and is authorized to take other discretionary actions with respect to banks in the three undercapitalized categories. The severity of the action depends upon the capital category in which the bank is placed. Subject to a narrow exception, the FDIC must generally appoint a receiver or conservator for a bank that is critically undercapitalized. A bank in any of the under-capitalized categories is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. An undercapitalized bank is also generally prohibited from paying any dividends, increasing its average total assets, making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval.

Failure to meet capital guidelines could subject a bank to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting brokered deposits, and other restrictions on its business. In addition, such a bank would generally not receive regulatory approval of any application that requires the consideration of capital adequacy, such as a branch or merger application, unless the bank could demonstrate a reasonable plan to meet the capital requirement within a reasonable period of time.

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, 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, nor common stock subject to repurchase obligation in Southern's employee stock ownership plan.

As of December 31, 2011, the capital ratios of the Bank exceeded the minimum thresholds to be categorized as "well-capitalized" under applicable regulations. Note V of our consolidated financial statements provides additional information regarding our capital ratios, and is here incorporated by reference.

Liquidity

Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Southern maintains certain levels of liquid assets (the most liquid of which are cash and cash equivalents, federal funds sold and investment securities) in order to meet these demands. Maturing loans and investment securities are the principal sources of asset liquidity. Liquidity is monitored and closely managed by the 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, the Company continues to maintain high levels of liquidity, with investment securities, federal funds and cash and cash equivalents held to improve the liquidity of the balance sheet during this period of economic uncertainty. The Company expects to maintain higher than normal levels of liquidity until economic conditions improve and more attractive investment opportunities emerge.

From time to time, Southern is a participant in the federal funds market. Federal funds are generally borrowed or sold for one-day periods. The average balance of federal funds sold was $269,000 in 2011 and $1,485,000 in 2010. During 2011 and 2010, Southern averaged $50,658,000 and $41,006,000, 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. As of December 31, 2011, Southern had available a $3 million line of credit with a correspondent bank. As a result of the decrease in federal funds lines of credit availability, collateral has been pledged at the Federal Reserve Bank "Discount Window." At December 31, 2011, $3 million of securities were pledged that could be used for future borrowings. In addition, Southern has $31.9 million of securities which are available to be pledged for future borrowings. Southern also has the ability to borrow $35.9 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, 2011, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay Southern without prior regulatory approval was $6.7 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, 2011, Southern had commitments of $77,147,000 for lines of credit, $1,690,000 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, 2011. 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	9.97%	+400	9.69%
+300	6.83%	+300	6.59%
+200	3.79%	+200	3.66%
+100	1.32%	+100	1.26%
-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	23.55%	+400	22.18%
+300	17.15%	+300	15.88%
+200	9.93%	+200	9.03%
+100	3.12%	+100	2.89%
-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, 2011. 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	16.80%
3% increase in market rates	12.96%
2% increase in market rates	8.86%
1% increase in market rates	4.59%
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, 2011 are within the guidelines set and approved by Southern's Board of Directors, with the exception of the +300 Shock Change/Dynamic and +300 Shock Change/Static. The guideline limit for these simulations is 15% and both were slightly outside of this limit at December 31, 2011. Management continues to monitor this and report the results to the Board of Directors on a quarterly basis.

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 2011 consolidated financial statements have been audited by the independent accounting firm of CliftonLarsonAllen 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. CliftonLarsonAllen 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, 2011. 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, 2011, 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, 2011 that have materially affected, or that are reasonably likely to materially affect, Southern's internal control over financial reporting.

JH Castle

Danice L Chartrand

John H. Castle
Chairman and
Chief Executive Officer

Danice L. Chartrand
Chief Financial Officer

February 10, 2012

CliftonLarsonAllen

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, 2011 and 2010, 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, 2011. 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, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

CliftonLarsonAllen LLP

Toledo, Ohio
March 30, 2012

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

	December 31, 2011	December 31, 2010
ASSETS		
Cash	$ 3,531	$ 3,860
Due from banks	38,654	74,973
Cash and cash equivalents	42,185	78,833
Federal funds sold	287	275
Securities available for sale	90,344	59,228
Loans held for sale	1,088	2,637
Loans, net of allowance for loan losses of $5,412 - 2011 ($5,694 - 2010)	327,392	303,830
Premises and equipment, net	12,546	12,599
Accrued interest receivable	2,148	2,107
Net cash surrender value of life insurance	10,312	9,965
Goodwill	13,422	13,422
Other intangible assets, net	1,666	2,005
Other assets	7,830	8,979
Total Assets	$ 509,220	$ 493,880
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	$ 61,930	$ 59,942
Interest bearing	358,581	349,959
Total deposits	420,511	409,901
Securities sold under agreements to repurchase and overnight borrowings	18,074	15,027
Accrued expenses and other liabilities	4,568	4,476
Other borrowings	7,751	10,079
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in Employee Stock Ownership Plan, 115,170 shares outstanding in 2011 (107,627 shares in 2010)	1,296	1,399
Total Liabilities	457,355	446,037
Shareholders' equity		
Preferred stock, 100,000 shares authorized; none issued or outstanding	-	-
Common stock, $2.50 par value:		
Authorized – 4,000,000 shares		
Issued – 2,358,599 shares in 2011 (2,340,717 shares in 2010)		
Outstanding (other than ESOP shares) –2,243,429 shares in 2011 (2,233,090 shares in 2010)	5,609	5,583
Additional paid-in capital	18,278	18,033
Retained earnings	27,576	24,692
Accumulated other comprehensive income (loss), net	571	(168)
Unearned Employee Stock Ownership Plan shares	(169)	(297)
Total Shareholders' Equity	51,865	47,843
Total Liabilities and Shareholders' Equity	$ 509,220	$ 493,880

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,		
	2011	**2010**	**2009**
Interest income:			
Loans, including fees	$ 17,955	$ 19,187	$ 19,852
Securities:			
Taxable	631	604	1,134
Tax-exempt	920	769	883
Other	172	155	69
Total interest income	19,678	20,715	21,938
Interest expense:			
Deposits	3,141	3,777	4,671
Other	610	693	729
Total interest expense	3,751	4,470	5,400
Net Interest Income	15,927	16,245	16,538
Provision for loan losses	1,050	1,375	2,725
Net Interest Income after Provision for Loan Losses	14,877	14,870	13,813
Non-interest income:			
Service charges on deposit accounts	2,032	2,412	2,746
Trust fees	1,120	997	987
Net securities gains	29	207	682
Net gains on loan sales	1,235	1,301	756
Earnings on life insurance assets	347	349	358
ATM and debit card fee income	1,015	897	703
Brokerage income	217	228	246
Gain on life insurance proceeds	-	156	-
Income from loan servicing	426	321	326
Other	375	339	368
Total non-interest income	6,796	7,207	7,172
Non-interest expense:			
Salaries and employee benefits	9,914	10,075	9,802
Occupancy, net	1,194	1,353	1,351
Equipment	757	896	917
Printing, postage and supplies	496	592	615
Telecommunication	376	386	372
Professional and outside services	909	941	1,354
Software maintenance	435	410	415
Amortization of other intangibles	339	350	362
ATM expenses	371	333	521
FDIC deposit assessments	477	640	855
Other real estate owned expenses	147	195	319
Loss on sale or write down of other real estate owned	118	215	318
Other	1,779	1,872	1,769
Total non-interest expense	17,312	18,258	18,970
Income before income taxes	4,361	3,819	2,015
Income tax provision	959	721	79
Net Income	$ 3,402	$ 3,098	$ 1,936
Basic Earnings Per Common Share	$ 1.46	$ 1.34	$ 0.84
Diluted Earnings Per Common Share	$ 1.46	$ 1.34	$ 0.84

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, 2011, 2010 and 2009

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2009	$ 5,528	$ 18,473	$ 20,593	$ 413	$ (591)	$ 44,416
Comprehensive income:						
Net income for 2009			1,936			1,936
Net change 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 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
Comprehensive income:						
Net income for 2011			3,402			3,402
Net change in other comprehensive income items				739		739
Total comprehensive income						4,141
Cash dividends declared - $.22 per share			(518)			(518)
Issuance of restricted stock (18,525 shares of common stock at $12.70 per share)	46	(46)				-
Vesting of restricted stock		105				105
Restricted stock forfeiture (643 shares)	(2)	2				-
Change in common stock subject to repurchase	(18)	121				103
Reduction of ESOP obligation					128	128
Stock option expense		63				63
Balance at December 31, 2011	$ 5,609	$ 18,278	$ 27,576	$ 571	$ (169)	$ 51,865

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, 2011	2010	2009
Operating Activities			
Net income	$ 3,402	$ 3,098	$ 1,936
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	1,050	1,375	2,725
Depreciation of premises and equipment	869	995	1,054
Deferred income taxes	150	175	506
Amortization of other intangible assets	339	350	362
Net amortization of investment securities	393	586	389
Stock option and restricted stock grant compensation expense	168	154	132
Net gains on security calls and sales	(29)	(207)	(682)
Loans originated for sale	(41,562)	(57,470)	(41,586)
Proceeds on loans sold	44,346	56,739	41,858
Net gains on loan sales	(1,235)	(1,301)	(756)
Net loss from sale or write down of other real estate owned	118	215	318
Gain on life insurance proceeds	-	(156)	-
Net loss on disposal of premises and equipment	7	29	9
Net change in obligation under ESOP	128	140	154
Net change in:			
Accrued interest receivable	(41)	(53)	560
Cash surrender value	(347)	(349)	(358)
Other assets	628	826	(1,762)
Accrued expenses and other liabilities	44	383	145
Net cash from operating activities	8,428	5,529	5,004
Investing Activities			
Activity in available for sale securities:			
Proceeds on securities sold	-	7,445	26,366
Proceeds from maturities and calls	39,052	48,172	37,683
Purchases	(69,305)	(58,770)	(55,348)
Net change in federal funds sold	(12)	2,265	780
Proceeds from life insurance	-	421	-
Loan originations and payments, net	(25,504)	20,254	(4,720)
Proceeds from sale of other real estate owned and repossessed assets	481	1,239	2,456
Proceeds from sale of equipment	58	91	-
Proceeds from sale of FHLB stock	176	169	-
Additions to premises and equipment	(881)	(800)	(691)
Net cash from investing activities	(55,935)	20,486	6,526
Financing Activities			
Net change in deposits	10,610	28,996	(13,138)
Net change in securities sold under agreements to repurchase and overnight borrowings	3,047	228	909
Proceeds from other borrowings	-	5,000	8,000
Repayments of other borrowings	(2,328)	(5,753)	(9,663)
Cash dividends paid	(470)	(467)	(813)
Net cash from financing activities	10,859	28,004	(14,705)
Net change in cash and cash equivalents	(36,648)	54,019	(3,175)
Beginning cash and cash equivalents	78,833	24,814	27,989
Ending cash and cash equivalents	$ 42,185	$ 78,833	$ 24,814

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

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. (the Company) is a 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.

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

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

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs net of recoveries. Estimating the risk of loss and the amount of loss on any loan is necessarily subjective. 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 determined to be 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, in the judgment of management, 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)

Transfers of Financial Assets (continued): The transfer of a participating interest in a financial asset must have all of the following characteristics: (1) from the date of transfer, it must represent a proportionate ownership interest in the financial asset, (2) from the date of transfer, all cash flows received, except cash flows allocated as compensation for servicing or other services performed, must be divided proportionately among participating interest holders in the amount equal to their share ownership, (3) the rights of each participating interest holder must have the same priority, and (4) no party has the right to pledge or change the entire financial asset unless all participating interest holders agree to do so.

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, 2011, indicated that the Step 2 analysis was not required.

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 Owned: Other real estate owned was $1,530,000 and $1,247,000 at December 31, 2011 and 2010, respectively, and is included in other assets. Other real estate owned 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 estimated cost to sell at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and other real estate owned is carried at the lower of carrying amount or fair value less estimated cost to sell. 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.

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

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. Benefits from tax positions taken or expected to be taken in a tax return are not recognized if the likelihood that the tax position would be sustained upon examination by a taxing authority is considered to be 50% or less. 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.

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 71% of the loan portfolio at December 31, 2011 (67% 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 27% of the loan portfolio at December 31, 2011 (30% at December 31, 2010) and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 2% of the loan portfolio at December 31, 2011 (3% 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.

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

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, 2011 and 2010.

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, 2011 that will have a material future adverse effect on the consolidated financial statements.

Subsequent Events: Management evaluated subsequent events through the date the financial statements were issued. Events or transactions occurring after December 31, 2011, but prior to when the financial statements were issued, that provided additional evidence about conditions that existed at December 31, 2011, have been recognized in the financial statements for the year ended December 31, 2011. Events or transactions that provided evidence about conditions that did not exist at December 31, 2011, but arose before the financial statements were issued, have not been recognized in the financial statements for the year ended December 31, 2011.

Reclassifications: Certain items in the 2010 and 2009 consolidated financial statements have been reclassified to conform to the current year presentation.

Adoption of New Accounting Standards: In July 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (ASU) No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* 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 were disclosed in the Company's December 31, 2010 consolidated financial statements. Other required disclosures about activity that occurs during an interim reporting period were effective for periods beginning on or after December 15, 2010, and are disclosed for the year ended December 31, 2011 in Note E.

In December 2010, the FASB issued ASU No. 2010-29 *Business Combinations (Topic 805) - Disclosure of Supplementary Pro Forma Information for Business Combinations.* If a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 also expands the supplementary pro forma disclosures. ASU 2010-29 is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. ASU 2010-29 will only affect the Company if there are future business combinations.

In December 2010, the FASB issued ASU No. 2010-28 *Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 is effective for fiscal years and interim periods within those years, beginning after December 15, 2010. ASU 2010-28 did not have an impact on the Company's financial condition, results of operations, or disclosures for the period ended December 31, 2011 because the most recent Step 1 goodwill impairment test performed as of November 30, 2011 did not result in a negative carrying amount.

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

In April 2011, FASB issued ASU No. 2011-02 *Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring.* ASU 2011-02 clarifies whether loan modifications constitute troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 was effective July 1, 2011, retrospectively to January 1, 2011, and did not have any impact on the Company's financial condition or results of operations.

In April 2011, FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreement,* amending ASC topic 860 to improve accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity by removing, from the assessment of effective control, the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. Consequently, the amendments in ASU 2011-03 also eliminate the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The other criteria applicable to the assessment of effective control are not changed by the amendments in ASU 2011-03. This guidance is effective for the first interim or annual period beginning on or after December 15, 2011, and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of this standard is not expected to have an impact on the Company's consolidated financial statements.

In May 2011, FASB issued ASU No. 2011-04 *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in ASU 2011-04 generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. ASU 2011-04 results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRSs. The amendments in ASU 2011-04 are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011 and early application is not permitted. The Company will adopt the methodologies prescribed by ASU 2011-04 by the date required, and does not anticipate the ASU will have a material effect on its financial position or results of operations.

In June 2011, FASB issued ASU No. 2011-05 *Amendments to Topic 220, Comprehensive Income.* Under the amendments in ASU 2011-05, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Either option requires the entity to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income.

The amendments in ASU 2011-05 should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted and the amendments do not require any transition disclosures. The Company did not early adopt ASU 2011-05.

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

In September 2011, FASB issued ASU 2011-08, *Intangibles – Goodwill and Other (Topic 350) Testing Goodwill for Impairment*. The amendments in ASU 2011-08 gives the entity the option of first assessing qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after the assessment, the entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. The amendments in ASU 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, however the Company did not early adopt ASU 2011-08.

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, 2011, 2010 and 2009 is presented below:

	2011	2010	2009
Basic Earnings Per Common Share			
Net income (in thousands)	$ 3,402	$ 3,098	$ 1,936
Weighted average common shares outstanding	2,350,180	2,339,490	2,322,642
Less: Unallocated ESOP shares	(20,733)	(27,851)	(31,090)
Weighted average common shares outstanding for basic earnings per common share	2,329,447	2,311,639	2,291,552
Basic earnings per common share	$ 1.46	$ 1.34	$ 0.84
Diluted Earnings Per Common Share			
Net income (in thousands)	$ 3,402	$ 3,098	$ 1,936
Weighted average common shares outstanding for basic earnings per common share	2,329,447	2,311,639	2,291,552
Add: Dilutive effects of assumed exercises of stock options	4,378	3,636	349
Average shares and dilutive potential of common shares outstanding	2,333,825	2,315,275	2,291,901
Diluted earnings per common share	$ 1.46	$ 1.34	$ 0.84

Stock options for 199,961, 196,394 and 214,822 shares of common stock were not considered in computing diluted earnings per share for 2011, 2010 and 2009, respectively, because they were anti-dilutive.

NOTE C - SECURITIES

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

Available for Sale, December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 28,303	$ 132	$ -	$ 28,435
U.S. government sponsored entities and agencies	22,855	101	-	22,956
States and political subdivisions	32,324	1,124	(3)	33,445
Asset-backed securities	2,487	-	(11)	2,476
Mortgage-backed securities	3,007	25	-	3,032
Total	$ 88,976	$ 1,382	$ (14)	$ 90,344

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

Securities with unrealized losses at December 31, 2011 and 2010 that have not been recognized in income are as follows (in thousands):

2011	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
States and political subdivisions	$ 1,005	$ (3)	$ -	$ -	$ 1,005	$ (3)
Mortgage-backed securities	-	-	2,487	(11)	2,487	(11)
Total temporarily impaired	$ 1,005	$ (3)	$ 2,487	$ (11)	$ 3,492	$ (14)

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)

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.

NOTE C – SECURITIES (CONTINUED)

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

	2011	2010	2009
Proceeds	$ -	$ 7,445	$ 26,366
Gross gains	-	206	678

The tax provision related to gross realized gains was $70,000 and $231,000 for 2010 and 2009, respectively.

Gains on calls of securities were $29,000, $1,000 and $4,000 for 2011, 2010 and 2009, respectively.

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Contractual maturities of debt securities at year-end 2011 were as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 16,504	$ 16,599
Due from one to five years	49,879	50,449
Due from five to ten years	13,278	13,742
Due after ten years	3,821	4,046
Mortgage-backed securities	5,494	5,508
Total	$ 88,976	$ 90,344

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 $32,089,000 and $28,344,000, respectively, were pledged as collateral for repurchase accounts and for other purposes at year-end 2011 and 2010.

At December 31, 2011 and 2010, the fair value of securities issued by the State of Michigan and all its political subdivisions totaled $26,314,000 and $19,903,000, 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 $1,701,000 and $1,877,000 at December 31, 2011 and 2010, respectively, and are included in other assets because such investments are considered restricted. Such investments are recorded at cost and evaluated for impairment.

At December 31, 2011, the Company had no investment in securities of issuers outside of the United States.

NOTE D – LOANS

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

	2011	2010
Commercial	$ 70,056	$ 58,763
Real estate - commercial	150,829	136,371
Real estate - construction	12,479	11,135
Consumer	8,167	10,153
Real estate mortgage	91,273	93,102
	332,804	309,524
Less allowance for loan losses	(5,412)	(5,694)
Loans, net	$ 327,392	$ 303,830

NOTE D – LOANS (CONTINUED)

Credit Risk Elements:

Construction loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption, vacancy and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. Construction loans often involve the disbursement of funds with repayment substantially dependent on the success of the ultimate project. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, general economic conditions and the availability of long-term financing. The Bank typically requires guarantees on these loans. The Bank's construction loans are secured primarily by properties located in its primary market area.

The Bank originates 1 – 4 family real estate and consumer loans utilizing credit reports to supplement the underwriting process. The Bank's manual underwriting standards for 1 – 4 family loans are generally in accordance with FHLMC and loan policy manual underwriting guidelines. Properties securing 1 – 4 family real estate loans are appraised by fee appraisers, which are independent of the loan origination function and have been approved by management. The loan-to-value ratios normally do not exceed 80% without credit enhancements such as mortgage insurance. The Bank will lend up to 100% of the lesser of the appraised value or purchase price for conventional 1 – 4 family real estate loans, provided private mortgage insurance is obtained. The underwriting standards for consumer loans include a determination of the applicant's payment history on other debts and an assessment of their ability to meet existing obligations and payments on the proposed loan. To monitor and manage loan risk, policies and procedures are developed and modified, as needed by management. This activity, coupled with smaller loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, market conditions are reviewed by management on a regular basis. The Bank's 1 – 4 family real estate loans are secured primarily by properties located in its primary market area.

Commercial and agricultural real estate loans are subject to underwriting standards and processes similar to commercial and agricultural operating loans, in addition to those unique to real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial and agricultural real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Loan to value is generally 75% of the lower of the cost or value of the assets. Appraisals on properties securing these loans are generally performed by fee appraisers approved by the Commercial Loan Committee. Because payments on commercial and agricultural real estate loans are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. Management monitors and evaluates commercial and agricultural real estate loans based on collateral and risk rating criteria. The Bank typically requires guarantees on these loans. The Bank's commercial and agricultural real estate loans are secured primarily by properties located in its primary market area.

Commercial and agricultural operating loans are underwritten based on the Bank's examination of current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. This underwriting includes the evaluation of cash flows of the borrower, underlying collateral, if applicable, and the borrower's ability to manage its business activities. The cash flows of borrowers and the collateral securing these loans may fluctuate in value after the initial evaluation. A first priority lien on the general assets of the business normally secures these types of loans. Loan to value limits vary and are dependent upon the nature and type of the underlying collateral and the financial strength of the borrower. Crop and hail insurance is required for most agricultural borrowers. Loans are generally guaranteed by the principal(s). The Bank's commercial and agricultural operating lending is principally in its primary market area.

NOTE D – LOANS (CONTINUED)

The Bank has an internal credit analyst who reviews and validates credit risk on a periodic basis, as well as an internal loan review performed throughout the year. Results of the credit analyst are presented to management. Internal loan reviews are presented to management and the Audit Committee. The credit analysis and loan review processes complement and reinforce the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.

At December 31, 2011 and 2010, 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.

	2011	2010
Balance at January 1	$ 14,099	$ 16,578
New loans, including renewals	11,230	7,805
Repayments	(11,659)	(10,192)
Other changes, net	(128)	(92)
Balance at December 31	$ 13,542	$ 14,099

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $168,025,000 and $151,125,000 at December 31, 2011 and 2010, respectively.

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

	2011	2010	2009
Balance at January 1	$ 868	$ 753	$ 708
Additions	412	371	269
Amortized to expense	(311)	(256)	(224)
Balance at December 31	$ 969	$ 868	$ 753

No valuation allowance for capitalized mortgage servicing rights was considered necessary at December 31, 2011, 2010 or 2009 because the estimated fair value of such rights 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):

	2011	2010	2009
Balance at January 1	$ 5,694	$ 6,075	$ 7,104
Provision for loan losses	1,050	1,375	2,725
Loans charged off	(1,561)	(2,031)	(3,926)
Recoveries	229	275	172
Net charge-offs	(1,332)	(1,756)	(3,754)
Balance at December 31	$ 5,412	$ 5,694	$ 6,075

In evaluating the allowance for loan losses, loans are analyzed based on the department originating the loan (commercial, mortgage or consumer), which in some instances may be different than how the loans are categorized for regulatory reporting purposes. Consequently, loan groupings in Note D may vary from the disclosures in Note E. Required disclosures about activity in the allowance for loan losses for reporting periods subsequent to December 15, 2010 are provided below for the year ended December 31, 2011.

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The following is an analysis of the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of and for the year ended December 31, 2011 and as of December 31, 2010 (in thousands):

December 31, 2011	**2011**				
Allowance for Loan Losses:	**Commercial including Commercial Real Estate**	**Consumer**	**Real Estate Mortgage 1st Lien**	**Real Estate Mortgage Junior Lien**	**Total**
Balance at January 1	$4,239	$87	$1,211	$157	$5,694
Provision for loan losses	498	14	433	105	1,050
Loans charged off	(875)	(71)	(498)	(117)	(1,561)
Recoveries	177	38	9	5	229
Balance at December 31	$4,039	$68	$1,155	$150	$5,412
Ending balance individually evaluated for impairment	$744	-	$240	-	$984
Ending balance collectively evaluated for impairment	3,295	68	915	150	4,428
Total	$4,039	$68	$1,155	$150	$5,412
Total Loans:					
Ending balance individually evaluated for impairment	$6,440	$29	$3,326	$86	$9,881
Ending balance collectively evaluated for impairment	237,263	7,800	64,927	12,933	322,923
Ending balance	$243,703	$7,829	$68,253	$13,019	$332,804

Commercial loans also include demand deposit loan account charge-offs and recoveries amounting to $167,000 and $72,000, respectively, for the year ended December 31, 2011.

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2010 Allowance for Loan Losses:	2010 Commercial including Commercial Real Estate	Consumer	Real Estate Mortgage 1st Lien	Real Estate Mortgage Junior Lien	Total
Ending balance individually evaluated for impairment	$867	-	$300	$4	$1,171
Ending balance collectively evaluated for impairment	3,372	87	911	153	4,523
Total	$4,239	$87	$1,211	$157	$5,694
Total Loans:					
Ending balance individually evaluated for impairment	$7,676	$87	$2,881	$122	$10,766
Ending balance collectively evaluated for impairment	208,725	9,762	66,556	13,715	298,758
Ending balance	$216,401	$9,849	$69,437	$13,837	$309,524

The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2011 and December 31, 2010 (in thousands):

December 31, 2011	Unpaid Principal Balance	Allowance for Loan Losses Allocated
With no related allowance recorded:		
Commercial	$ 135	$ -
Real estate - commercial	2,649	-
Real estate - construction	232	-
Consumer	29	-
Real estate mortgage	2,485	-
With an allowance recorded:		
Commercial	744	26
Real estate - commercial	1,403	490
Real estate - construction	-	-
Consumer	-	-
Real estate mortgage	2,204	468
Total	$ 9,881	$ 984

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2010	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

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

	2011	2010	2009
Average balance of impaired loans during the year	$ 10,530	$ 11,719	$ 11,754
Cash basis interest income recognized during the year	$ 250	$ 345	$ 409
Interest income recognized during the year	$ 285	$ 396	$ 367

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of December 31, 2011 and December 31, 2010 by class of loans (in thousands):

December 31, 2011	Loans Past Due Accruing Interest						
	30-59 Days	60-89 Days	Over 90 Days	Total	Loans on Non-Accrual	Loans Not Past Due or Non-Accrual	Total
Commercial	$ 182	$ 120	$ 6	$ 308	$ 413	$ 69,335	$ 70,056
Real estate - commercial	538	144	-	682	2,982	147,165	150,829
Real estate - construction	-	-	-	-	231	12,248	12,479
Consumer	22	4	-	26	29	8,112	8,167
Real estate mortgage	1,476	780	-	2,256	2,048	86,969	91,273
Total	$ 2,218	$ 1,048	$ 6	$ 3,272	$ 5,703	$ 323,829	$ 332,804

NOTE E – ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2010 **Loans Past Due Accruing Interest**

	30-59 Days	60-89 Days	Over 90 Days	Total	Loans on Non-Accrual	Loans Not Past Due or Non-Accrual	Total
Commercial	$ 277	$ 20	$ 1	$ 298	$ 216	$ 58,249	$ 58,763
Real estate - commercial	184	-	-	184	2,295	133,892	136,371
Real estate - construction	-	-	-	-	583	10,552	11,135
Consumer	62	-	-	62	87	10,004	10,153
Real estate mortgage	737	28	-	765	2,112	90,225	93,102
Total	$ 1,260	$ 48	$ 1	$ 1,309	$ 5,293	$ 302,922	$ 309,524

Modifications:

The Company's loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (TDR), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

When the Company modifies a loan, management evaluates any possible concession based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole source of repayment for the loan is the liquidation of the collateral. In these cases, management uses the current fair value of the collateral, less selling costs. If management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs and deferred loan fees or costs), impairment is recognized through an allowance estimate or a charge-off to the allowance.

The following table summarizes the number and volume of TDRs the Company has recorded in its loan portfolio as of December 31, 2011 as well as the amount of specific reserves in the allowance for loan losses relating to TDRs (dollars in thousands):

December 31, 2011

	Number of Loans	Amount	Specific Reserves Allocated
Commercial	5	$ 733	$ 23
Real estate - commercial	5	1,619	13
Real estate - construction	-	-	-
Real estate - mortgage	21	1,882	181
Consumer	-	-	-
Total	31	$ 4,234	$ 217

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 Company'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 Company 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, 2011 and December 31, 2010, based on the most recent analysis performed, the risk category of loans by class of loans was as follows (in thousands):

December 31, 2011	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial	$ 59,492	$ 5,855	$ 4,709	$ -	$ -	$ 70,056
Real estate - commercial	128,405	14,681	7,437	-	306	150,829
Real estate - construction	5,547	2,542	520	-	3,870	12,479
Real estate - mortgage	7,399	3,177	2,743	-	77,954	91,273
Consumer	-	-	-	-	8,167	8,167
Total	$ 200,843	$ 26,255	$ 15,409	$ -	$ 90,297	$ 332,804

December 31, 2010	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):

	2011	2010
Land	$ 2,362	$ 2,366
Buildings and improvements	16,854	16,854
Furniture and equipment	10,255	9,991
	29,471	29,211
Less accumulated depreciation	(16,925)	(16,612)
Totals	$ 12,546	$ 12,599

Depreciation and amortization expense charged to operations was $869,000, $995,000 and $1,054,000 in 2011, 2010 and 2009, respectively.

Rent expense under operating leases amounted to $50,000, $42,000 and $57,000 in 2011, 2010 and 2009, respectively.

Lease commitments under noncancelable operating equipment leases at December 31, 2011 were as follows (in thousands):

2012	$ 43
2013	35
2014	7
2015	7
2016	7
Thereafter	8
Total	$ 107

NOTE G – INTANGIBLE ASSETS

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

	2011	2010
Gross carrying amount	$ 3,122	$ 3,122
Accumulated amortization	(1,456)	(1,117)
Unamortized balance	$ 1,666	$ 2,005

Amortization of core deposit intangible assets for the years ended December 31, 2011, 2010 and 2009 was $339,000, $350,000 and $362,000, respectively.

Estimated amortization of core deposit intangible assets for each of the five years subsequent to December 31, 2011 is as follows (in thousands):

2012	$ 325
2013	296
2014	284
2015	272
2016	260

NOTE H – DEPOSITS

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

	2011	2010
Non-interest bearing checking	$ 61,930	$ 59,942
Interest bearing checking	110,153	100,388
Savings	53,468	48,579
Money market accounts	74,996	62,845
Time deposits	119,964	138,147
Totals	$ 420,511	$ 409,901

NOTE H – DEPOSITS (CONTINUED)

The carrying amount of time deposits over $100,000 was $42,358,000 and $54,046,000 at December 31, 2011 and 2010, respectively. Interest expense on time deposits over $100,000 was $898,000, $979,000 and $1,336,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

At year-end 2011, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2012	$	63,355
2013		23,437
2014		19,670
2015		10,295
2016		3,207
Total	$	119,964

Related party deposits were $24,522,000 and $11,412,000 at December 31, 2011 and 2010, respectively.

NOTE I – OTHER BORROWINGS

Other borrowings at December 31, 2011 and 2010 included $6,117,000 and $7,234,000, respectively, in advances from the Federal Home Loan Bank (FHLB) of Indianapolis. Advances outstanding at December 31, 2011 require payments through December 31, 2013 with fixed interest rates ranging from 2.12% to 4.57%, with a weighted average rate of 2.52%. Principal is due at maturity for $6,000,000 of the advances. The remaining $117,000 FHLB advance at December 31, 2011 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, 2011 and 2010 was approximately $75,048,000 and $79,641,000, 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, 2011 and 2010, $1,439,000 and $2,501,000, respectively, was outstanding under the loan.

Other borrowings also include a loan from a local community bank with a balance at December 31, 2011 and 2010 of $195,000 and $344,000, respectively. The loan matures on February 28, 2013 and is unsecured.

At December 31, 2011, scheduled principal reductions on other borrowings were as follows for the years ending December 31 (in thousands):

	FHLB	GLBB	Other	Total
2012	$ 5,078	$ 458	$ 155	$ 5,691
2013	1,039	479	40	1,558
2014	-	502	-	502
Total other borrowings	$ 6,117	$ 1,439	$ 195	$ 7,751

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):

	2011	2010
At December 31:		
Outstanding balance	$ 18,074	$ 15,027
Average interest rate	0.24%	0.30%
Daily average for the year:		
Outstanding balance	$ 16,162	$ 16,714
Average interest rate	0.32%	0.30%
Maximum outstanding at any month end	$ 18,074	$ 18,847

At December 31, 2011, the Bank had a $3,000,000 line of credit arrangement available to purchase federal funds, 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 three month London Interbank Offered Rate (LIBOR) plus 2.75%. The rate at December 31, 2011 was 3.15%. Interest expense related to the subordinated debentures amounted to $156,000 in 2011, $157,000 in 2010, and $197,000 in 2009. 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):

	2011	2010	2009
Current	$ 809	$ 546	$ (427)
Deferred	150	175	506
Totals	$ 959	$ 721	$ 79

The deferred income tax provision 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 net operating loss carryforwards.

NOTE L – INCOME TAXES (CONTINUED)

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

	2011	2010	2009
Income tax at statutory rate	$ 1,483	$ 1,298	$ 685
Tax-exempt interest income, net	(311)	(289)	(351)
Earnings on life insurance assets, including gain from proceeds in 2010	(118)	(172)	(122)
Low income housing partnership tax credits	(127)	(127)	(127)
Write-off capital loss carryforward	-	60	-
Change in valuation allowance	-	(54)	-
Other items, net	32	5	(6)
Totals	$ 959	$ 721	$ 79

Deferred tax assets and liabilities consist of the following at December 31 (in thousands):

	2011	2010
Deferred tax assets:		
Allowance for loan losses	$ 1,134	$ 1,150
Deferred compensation and supplemental retirement liability	769	765
Intangible asset amortization	-	12
Pension liability	170	135
Nonaccrual loan interest	252	245
Tax credit carryforwards	655	796
Stock based compensation	175	146
Other	157	127
Total deferred tax assets	3,312	3,376
Deferred tax liabilities:		
Mortgage servicing rights	(329)	(295)
Goodwill	(211)	(191)
Purchase accounting adjustments	(646)	(761)
Net unrealized gain on available for sale securities	(465)	(48)
Depreciation	(296)	(51)
Other	(124)	(257)
Total deferred tax liabilities	(2,071)	(1,603)
Net deferred tax assets, included in other assets	$ 1,241	$ 1,773

At December 31, 2011, the Company has available alternative minimum tax credit carryforwards of $522,000, 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 credit carryforwards of $133,000 at December 31, 2011, which will begin to expire in 2029 if not utilized.

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 2008. The Internal Revenue Service recently completed an examination of the Company's 2009 federal tax return. The Company expects to pay approximately $284,000 of additional tax which will generate deferred tax assets of a similar amount, resulting in substantially no additional tax provision.

The Company believes that it had no uncertain tax positions as of December 31, 2011 and 2010.

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):

	2011	2010
Change in projected benefit obligation:		
Beginning benefit obligation	$ (2,214)	$ (2,272)
Interest cost	(124)	(130)
Actuarial loss	(166)	(35)
Benefits paid	408	223
Ending benefit obligation	(2,096)	(2,214)
Change in plan assets, at fair value:		
Beginning plan assets	1,744	1,937
Actual return	57	56
Employer contributions	82	-
Benefits paid	(408)	(223)
Plan expenses paid	(26)	(26)
Ending plan assets	1,449	1,744
Net amount recognized in other liabilities – funded status	$ (647)	$ (470)

The accumulated benefit obligation for the defined benefit pension plan was $2,096,000 and $2,214,000 at December 31, 2011 and 2010, respectively.

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

	2011	2010	2009
Components of net periodic benefit cost:			
Service cost, including plan expenses	$ 26	$ 26	$ 29
Interest cost	124	130	145
Expected return on plan assets	(105)	(114)	(147)
Recognized net actuarial loss	17	3	39
Settlement adjustment	92	36	42
Net periodic benefit cost	$ 154	$ 81	$ 108

At December 31, 2011 and 2010 net actuarial losses of $502,000 and $396,000, 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 2012 is $23,000.

NOTE M – BENEFIT PLANS (CONTINUED)

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

	2011	2010	2009
Discount rate on benefit obligation	5.0%	5.5%	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	N/A

Asset Category	Target Allocation 2012	Percentage of Plan Assets at Year-end 2011	Percentage of Plan Assets at Year-end 2010	Weighted Average Expected Long-Term Rate of Return - 2011
Equity securities	0%	0%	0%	0%
Debt securities	0%	0%	0%	0%
Cash and time certificates	100%	100%	100%	.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, 2011 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 being frozen, 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, 2011 amounted to $1,449,000 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) as of or for the years ended December 31, 2011 or 2010.

The Company expects to contribute $125,000 to its pension plan in 2012.

At December 31, 2011, estimated future benefit payments from the plan were as follows for the years ending December 31 (in thousands):

2012	$ 59
2013	172
2014	140
2015	36
2016	160
2017 – 2021	1,359

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 $253,000, $299,000 and $388,000 in 2011, 2010 and 2009, respectively.

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

	2011	2010
Allocated shares	115,170	107,627
Unallocated shares	15,402	24,021
Total ESOP shares	130,572	131,648

The fair value of the allocated shares held by the ESOP is $1,296,000 and $1,399,000 at December 31, 2011 and 2010, 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, 2011 and 2010 was $170,000 and $297,000, respectively. In 2005, the ESOP obtained a loan for $204,000 to purchase 7,568 shares. The loan 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, 2011 ranged from 5.38% to 12.98%. There were no new participants in the plan during 2011. Deferred compensation expense was $232,000, $245,000 and $237,000 in 2011, 2010 and 2009, respectively. The liability for deferred compensation benefits was $1,984,000 and $2,024,000 at December 31, 2011 and 2010, respectively, and is included in accrued expenses and other liabilities in the accompanying consolidated balance sheets.

NOTE M – BENEFIT PLANS (CONTINUED)

Supplemental Retirement Plans: The Bank also maintains a supplemental retirement plan (SERP) to provide annual payments to certain current and former executives subsequent to their retirement. Benefits under the SERP were frozen effective December 31, 2008. Expense associated with the SERP totaled $15,000, $28,000 and $12,000 in 2011, 2010 and 2009, respectively. Liabilities associated with the SERP totaled $207,000 and $226,000 at December 31, 2011 and 2010, respectively.

In December 2011, the Board of Directors approved the Defined Contribution Supplemental Executive Retirement Plan (2011 SERP), which is intended to provide select executive officers with a retirement benefit that is competitive with industry practices for bank executives when combined with the executive's other employer-funded retirement benefits. In contrast to the frozen SERP, the 2011 SERP is a defined contribution arrangement, which gives the Bank the discretion to make a specific annual nonqualified deferred compensation contribution to the account of participating executives. Whether an annual deferred compensation contribution will be made to the account balance of a participating executive, as well as the amount of the contribution, is at the discretion of the Bank's Board of Directors. The contribution that will be made by the Bank to the account of each executive is determined based on a percentage of base salary. Participants are generally entitled to receive payment of the benefit in their account in 120 equal monthly installments commencing at age 65. The Company's 2011 contribution, which was accrued at December 31, 2011, amounted to $70,000.

NOTE N – STOCK OPTIONS

The Company has stock based compensation plans as described below. Total compensation cost charged against income for those plans was $168,000, $154,000 and $132,000 in 2011, 2010 and 2009, 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, 2011, 99,007 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.

	2011	2010	2009
Risk-free interest rate	0.33%	0.96%	3.58%
Expected option life	8 years	8 years	8 years
Expected stock price volatility	23.40%	23.64%	22.39%
Dividend yield	2.99%	3.29%	3.58%
Weighted-average fair value of options granted during year	$1.86	$1.53	$0.97

NOTE N – STOCK OPTIONS (CONTINUED)

A summary of the activity in the plans for 2011 follows:

Stock Options

	Shares Subject to Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	218,977	$ 21.29		
Granted	8,075	12.70		
Exercised	-	-		
Forfeited	(6,026)	18.23		
Outstanding at end of year	221,026	$ 21.06	4.8 years	$ 60,000
Exercisable at year-end	141,276	$ 20.85	4.1 years	$ 52,000

	2011	2010	2009
Intrinsic value of options exercised	-	-	-
Cash received from option exercise	-	-	-
Tax benefit realized from option exercises	-	-	-

As of December 31, 2011, there was $29,000 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 .4 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, 2011, 2010 and 2009 was $91,000, $39,000 and $29,000, respectively. As of December 31, 2011, there was $376,000 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 3.5 years.

A summary of activity in the restricted stock plan for 2011 follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2011	30,593	$ 10.46
Granted	18,525	12.70
Vested	(7,166)	11.24
Forfeited	(643)	10.17
Nonvested at December 31, 2011	41,309	$ 11.33

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, 2011 and 2010, 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, 2011 and 2010, commitments under outstanding standby letters of credit were $1,690,000 and $1,720,000, respectively.

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

	2011	2010
Fixed rate	$ 3,475	$ 4,333
Variable rate	73,672	56,445
Totals	$ 77,147	$ 60,778

The fixed rate commitments have stated interest rates ranging from 4.50% to 14.00%. The terms of the above commitments range from 1 to 121 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 $571,000 at December 31, 2011 and $(168,000) at December 31, 2010 and is summarized as follows (in thousands):

	2011	2010
Unrealized gain on available-for-sale securities, net of income taxes of $465 in 2011 and $48 in 2010	$ 903	$ 93
Pension liability, net of income taxes of $170 in 2011 and $135 in 2010	(332)	(261)
Total	$ 571	$ (168)

The changes in the components of accumulated comprehensive income (loss), and related tax effects for the years ended December 31, 2011, 2010 and 2009 are as follows (in thousands):

	2011	2010	2009
Unrealized gain (loss) on available for sale securities	$ 1,256	$ (287)	$ 320
Reclassification adjustments for net realized gains included in net income	(29)	(207)	(682)
Accrued pension liability	(106)	(53)	29
	1,121	(547)	(333)
Tax effect	(382)	186	113
Other comprehensive income (loss), net of tax	$ 739	$ (361)	$ (220)

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, 2011, using the most restrictive of these conditions, the aggregate cash dividends that the Bank could pay the Company without prior regulatory approval was approximately $6.7 million.

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

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

Balance Sheets	**December 31, 2011**	**December 31, 2010**
Assets		
Cash and cash equivalents	$ 404	$ 683
Investment in subsidiary bank	57,947	54,963
Investment in non banking subsidiary	188	189
Premises and equipment, net	844	876
Other assets	778	711
Total Assets	$ 60,161	$ 57,422
Liabilities and Shareholders' Equity		
Dividends payable	$ 165	$ 117
Other liabilities	46	63
Other borrowings	1,634	2,845
Subordinated debentures	5,155	5,155
Common stock subject to repurchase obligation in ESOP	1,296	1,399
Shareholders' equity	51,865	47,843
Total Liabilities and Shareholders' Equity	$ 60,161	$ 57,422

Statements of Income	**Year ended December 31, 2011**	**2010**	**2009**
Dividends from subsidiary bank	$ 1,437	$ 1,358	$ 1,113
Interest income	16	25	34
Interest expense	(266)	(300)	(351)
Rental income from subsidiary bank	137	137	137
Other expenses	(310)	(290)	(269)
	1,014	930	664
Federal income tax credit	(144)	(146)	(153)
	1,158	1,076	817
Equity in net income, less dividends received, of:			
Subsidiary bank	2,245	2,023	1,121
Non-banking subsidiary	(1)	(1)	(2)
Net Income	$ 3,402	$ 3,098	$ 1,936

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

Statements of Cash Flows	Year ended December 31, 2011	2010	2009
Operating Activities			
Net income	$ 3,402	$ 3,098	$ 1,936
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received, of:			
Subsidiary bank	(2,245)	(2,023)	(1,121)
Non-banking subsidiary	1	1	2
Stock option and restricted stock grant compensation expense	168	154	132
Depreciation	32	32	32
Net change in obligation under ESOP	128	140	154
Other, net	(84)	(224)	211
Net cash from operating activities	1,402	1,178	1,346
Investing Activity			
Retirement of bank stock	-	-	3,000
Financing Activities			
Proceeds from other borrowings	-	-	3,000
Repayments of other borrowings	(1,211)	(644)	(6,557)
Cash dividends paid	(470)	(467)	(813)
Net cash from financing activities	(1,681)	(1,111)	(4,370)
Net change in cash and cash equivalents	(279)	67	(24)
Beginning cash and cash equivalents	683	616	640
Ending cash and cash equivalents	$ 404	$ 683	$ 616

NOTE S – SUPPLEMENTAL CASH FLOW DISCLOSURES

The following supplemental cash flow disclosures are provided for the years ended December 31, 2011, 2010 and 2009 (in thousands):

	2011	2010	2009
Cash paid during the year for:			
Interest	$ 3,791	$ 4,527	$ 5,692
Income taxes	590	492	-
Non-cash operating activities:			
Change in deferred income taxes on net unrealized gain on available for sale securities	417	(168)	123
Change in deferred income taxes on pension liability	(35)	(18)	(10)
Change in pension liability	106	53	29
Non-cash investing activities:			
Change in unrealized gain on available for sale securities	1,227	(494)	(362)
Transfers from loans to other real estate owned	892	1,545	3,197

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, 2011 and 2010, 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, 2011 and 2010 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):

	2011		2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 42,185	$ 42,185	$ 78,833	$ 78,833
Federal funds sold	287	287	275	275
Securities available for sale	90,344	90,344	59,228	59,228
Loans held for sale	1,088	1,088	2,637	2,637
Loans, net of allowance for loan losses	327,392	333,283	303,830	307,946
Accrued interest receivable	2,148	2,148	2,107	2,107
Financial liabilities:				
Deposits	$ (420,511)	$ (422,493)	$ (409,901)	$ (406,143)
Securities sold under agreements to repurchase and overnight borrowings	(18,074)	(18,074)	(15,027)	(15,027)
Other borrowings	(7,751)	(7,860)	(10,079)	(9,835)
Subordinated debentures	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	(131)	(131)	(171)	(171)

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

Fair value is defined 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.

Fair value must be determined using 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. A fair value hierarchy for valuation inputs has been established 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, 2011, 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	$ 28,435	$ -	$ -	$ 28,435
U.S. government sponsored entities and agencies	22,956	-	-	22,956
States and political subdivisions	-	31,213	2,232	33,445
Asset-backed securities	2,476	-	-	2,476
Mortgage-backed securities	-	3,032	-	3,032
Total available for sale	$ 53,867	$ 34,245	$ 2,232	$ 90,344
Nonrecurring:				
Impaired loans	$ -	$ -	$ 8,897	$ 8,897
Other real estate owned	$ -	$ -	$ 1,530	$ 1,530

Impaired loans are reported net of a $984,000 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 $1,530,000, which is made up of the balance of $1,599,000, net of a valuation allowance of $69,000 at December 31, 2011. Write-downs of other real estate owned amounted to $54,000 for the year ending December 31, 2011 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, 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	-	598	-	598
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.

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 ended December 31, 2010 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, 2011 and 2010 (in thousands):

	2011	2010
Balance at January 1	$ 2,992	$ 3,099
Net maturities and calls	(1,264)	(938)
Unrealized net gains included in other comprehensive income	153	2
Purchases	351	-
Net transfers into level 3	-	829
Balance at December 31	$ 2,232	$ 2,992

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.

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**
2011						
Total capital (to risk weighted assets)						
Consolidated	$47,309	13.7%	$27,684	8.0%	N/A	N/A
Bank	47,078	13.7	27,572	8.0	$34,465	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	42,970	12.4	13,842	4.0	N/A	N/A
Bank	42,756	12.4	13,786	4.0	20,679	6.0
Tier 1 capital (to average assets)						
Consolidated	42,970	8.6	19,917	4.0	N/A	N/A
Bank	42,756	8.6	19,963	4.0	24,953	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**
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

NOTE V – REGULATORY MATTERS (CONTINUED)

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.

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	Earnings Per Share Basic	Earnings Per Share Fully Diluted
2011						
First Quarter	$ 4,866	$ 3,863	$ 125	$ 748	$ .32	$ .32
Second Quarter	4,822	3,871	375	762	.33	.33
Third Quarter	4,944	4,027	375	887	.38	.38
Fourth Quarter	5,046	4,166	175	1,005	.43	.43
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

SELECTED FINANCIAL DATA

(in thousands, except per share data)

	Year Ended December 31				
	2011	2010	2009	2008	2007
Total interest income	$ 19,678	$ 20,715	$ 21,938	$ 25,929	23,544
Net interest income	15,927	16,245	16,538	17,740	14,906
Provision for loan losses	1,050	1,375	2,725	5,080	745
Net income	3,402	3,098	1,936	813	4,133
Per share data					
Basic earnings per share	1.46	1.34	.84	.36	2.29
Diluted earnings per share	1.46	1.34	.84	.36	2.28
Cash dividends	.22	.20	.20	.80	.80
Balance sheet data:					
Gross loans	332,804	309,524	333,079	335,310	335,978
Deposits	420,511	409,901	380,905	394,043	399,169
Other borrowings	7,751	10,079	10,832	12,492	14,753
Common stock subject to repurchase	1,296	1,399	945	728	2,029
Equity	51,865	47,843	45,734	44,416	44,219
Total assets	509,220	493,880	462,409	474,996	480,178
Return on average assets	.68%	.65%	.41%	.17%	1.18%
Return on average equity (1)	6.80	6.56	4.29	1.77	12.72
Dividend payout ratio (2)	15.23	15.11	24.13	227.33	36.90
Average equity to average assets (1)	9.96	9.87	9.66	9.59	9.27

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

COMMON STOCK MARKET PRICES AND DIVIDENDS

The Company's common stock is regularly quoted on the OTC Bulletin Board (OTCBB) under the symbol SOMC.OB. The bid prices described below are quotations reflecting inter-dealer prices, without retail markup, markdown or commissions, and may not necessarily represent actual transactions. As of March 9, 2012, there were 2,376,724 shares of Southern common stock issued and outstanding held by 410 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:

	2010			2011		
	Closing Price		Cash Dividends Declared	Closing Price		Cash Dividends Declared
Quarter Ended	High	Low		High	Low	
March 31	$ 11.00	$ 9.60	$ .05	$ 13.25	$ 12.00	$ .05
June 30	12.25	10.50	.05	12.85	11.90	.05
September 30	12.40	11.30	.05	12.69	11.80	.05
December 31	13.50	11.75	.05	12.55	11.05	.07

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.