2015 ANNUAL REPORT

Southern Michigan

BANCORP, INC.

FINANCIAL SUMMARY

FOR THE YEAR	2015	2014
Net interest income	$19,568,000	$18,707,000
Provision for loan losses	250,000	400,000
Non-interest income	7,313,000	6,606,000
Non-interest expense	18,875,000	18,310,000
Net income	5,806,000	4,792,000
PER SHARE		
Basic earnings	$2.42	$1.99
Diluted earnings	2.42	1.99
Cash dividends declared	0.63	0.58
AT YEAR END		
Assets	$582,771,000	$543,345,000
Gross loans	421,989,000	410,112,000
Allowance for loan loss	5,273,000	5,177,000
Deposits	477,485,000	444,270,000
Other borrowings	10,000,000	10,000,000
Shareholders' equity	67,769,000	63,160,000
RATIOS		
Return on average assets	1.02%	0.87%
Return on average equity	8.82%	7.79%
Total risk-based capital ratio	13.25%	13.61%
ALLL as percentage of loans	1.25%	1.26%

Southern Michigan Bancorp, Inc. (the Company) 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 southern Michigan communities in which they are located and in areas immediately surrounding these communities.

LETTER FROM THE CEO 2015

“Our Board of Directors and management team remain confident about the future of the bank. Like our clients, we are committed to being the best in our profession.”

Southern Michigan Bancorp, Inc. attained record earnings for the fourth consecutive year. Net income for 2015 totaled $5,806,000, an increase of 21.2 percent over 2014 results of $4,792,000. Earnings per share for 2015 were $2.42 compared with $1.99 in 2014. Other significant benchmarks included year-end total assets of $582.8 million and record-setting total loans of $422.0 million.

Southern’s financial performance for 2015 was influenced by a number of factors. Non-performing assets totaled $6.5 million at December 31, 2015, a decrease of $2.1 million or 24.3 percent, from $8.6 million at year end 2014. Net charge-offs for 2015 totaled $154,000, or .04 percent of total loans, compared to $461,000, or .11 percent of loans for 2014. Southern’s provision expense for loan losses totaled $250,000 for 2015, a decrease of $150,000, or 37.5 percent from $400,000 in 2014. The allowance for loan losses at December 31, 2015 was $5,273,000, or 1.25 percent of total loans. From a coverage perspective, the allowance remained at nearly 2.9 times the dollar amount of non-accrual loans at year end.

Our balance sheet exceeded $600 million several times last fall, and at December 31, 2015 was $582.8 million, an increase of $39.5 million over 2014 year end levels of $543.3 million. Deposits finished the year at $477.5 million, an increase of $33.2 million over December 31, 2014 levels of $444.3 million. Growth in the balance sheet led to corresponding increases of $24.3 million in the investment securities portfolio, and $11.9 million in loan totals as compared to year end 2014 levels. Net interest income was positively influenced as well and increased by $861,000 as compared to 2014 results.

The previously frozen defined benefit pension plan was terminated during the third quarter of 2015. Southern recorded $753,000 of pension expense to ensure the plan was fully funded to meet the benefit obligations of the plan. Going forward, we anticipate annual savings of approximately $125,000 in pension expense and $25,000 a year or more in actuarial and other costs necessary to maintain the plan. Pension termination costs were tempered by the receipt of $528,000 of tax free income from death benefits on bank owned life insurance policies.

Southern’s return on average assets and return on average equity for 2015 was 1.02 percent and 8.82 percent, respectively. Our return on tangible equity, which is total shareholders’ equity less goodwill and other intangibles, was 11.57 percent.

Supported by the bank’s consistent strength in credit quality and profitability, the board of directors approved an increase to the July, 2015 quarterly cash dividend from $0.15 per share to $0.16 per share. Southern’s total cash dividend for 2015 was $.62 per share as compared to $.56 paid in 2014. In addition, the market value of Southern’s stock performed well during the year. The market price on December 31, 2015 was $25.35 per share, an increase of $4.30 per share or 20.4 percent, from December 31, 2014 levels of $21.05 per share. The total return in the stock for 2015, considering both stock price appreciation and cash dividends, was 23.4 percent.

TO OUR SHAREHOLDERS

After months of planning and preparation, our new Portage Branch office opened on February 1, 2016. Growth of both small and medium-sized business relationships remains favorable, and we are pleased with the initial success that we have experienced in this market. Ongoing discussions with prospective borrowers from this region, and our commercial loan pipeline summary of approved commercial loans across all of the markets that we serve, suggests that we will continue to experience loan growth in 2016.

Southern was one of the first banks in Michigan to introduce Interactive Teller Machine technology or ITMs. ITMs offer similar features to Automated Teller Machines, however customers can interact directly with a customer service representative should they desire. While using the interactive portion of the ITM, the customer service representative can perform any routine teller transaction such as check cashing to the penny, accepting deposits, transferring money between accounts, and processing loan payments or loan advances. In addition, ITMs allow us to extend the traditional business day from 5:00 p.m. until 7:00 p.m. and transactions are still credited for that same day's business, offering customers greater flexibility and convenience. Southern continues to adapt to the ever changing electronic payments landscape as well, with the ability to support Apple Pay and Samsung Pay beginning in the fourth quarter of 2016. Our debit card customers will be able to link their debit card with a smart phone and make purchases by simply holding their phones over payment terminals at retailers who support contactless payments. This will also make online shopping with a smart phone seamless as debit card information will be securely contained in the smart phone.

As we have in previous years, we are proud to highlight client relationships important to the bank. Our 2015 Annual Report showcases three noteworthy customers that reflect the broad scope of commercial clients that Southern serves, each with their own unique needs. Sunil Patel owns and manages several hotels throughout the region including Comfort Inn & Suites, Best Western and Days Inn franchises. Dr. Michael Sussex owns and operates three vision centers as well as Tri-State Optical, a full service optical lab that produces eyeglass lenses for optometrists and HMOs throughout Michigan. Paul and Eric John own Ritz-Craft Corporation, a premier manufacturer of modular homes with facilities in Jonesville, Michigan as well as in Pennsylvania and North Carolina. All of these customers share a similar commitment to business excellence, exceeding customer expectations and helping to create stronger communities; exceptional attributes that we admire, and as a company strive to emulate.

Our Board of Directors and management team remain confident about the future of the bank. Like our clients, we are committed to being the best in our profession. Our size and strength, state of the art technology, and unparalleled leadership will facilitate our continued success as one of the premier financial services providers throughout Southern Michigan.

Sincerely,

John H. Castle
Chairman and Chief Executive Officer

CLIENT PROFILE 2015

(Top photo) John Castle, Chairman and CEO of Southern Michigan Bank & Trust, and Sunil Patel discuss the recent renovations at Sunil's Jackson property. (Bottom left) The Patels strive to give their guests a clean, relaxing environment in which to stay. (Bottom right, pictured left to right) John Castle, Sunil Patel, Sarah Headley, Vice President/Commercial Lending, and Tapan Patel tour the Jackson hotel.

SUNIL PATEL

Patel Family Embraces Hospitality

In 1983 Sunil Patel moved to the United States from his homeland of India. He, like his three sisters, pursued a career in the hospitality industry, each owning and successfully managing multiple hotel properties, establishing a reputation for providing a welcoming home away from home for their guests.

Sunil acquired his first hotel site in Hillsdale, Michigan in 1995, with additional properties to follow in Ohio and Michigan. It was after purchasing the partially constructed Hillsdale facility that Sunil met Southern Michigan Bank & Trust's Bob Stanley, and began working with Southern's commercial lenders; relationships that would last nearly twenty years and continue today with Sarah Headley, Vice President and Commercial Loan Officer. That, coupled with the exceptional day-to-day banking experiences he encountered at the Hillsdale branch, left a positive impression and earned his confidence. According to Sunil, it stood in stark contrast with his previous banking experiences with national financial institutions. "I learned early on that doing business with big banks wouldn't be a good fit for me," says Sunil.

"It's different at a community bank; when I have questions I can talk to someone and get the answers I need. I'm grateful to Southern for putting their trust in me to buy the properties and do what I love."

Sunil has not stopped looking for ways to refine his business. In keeping with his objective of giving travelers the best possible experience, he recently tackled the renovation of his Jackson location, providing a clean, fresh, and updated environment for every type of guest.

"I couldn't have built or renovated this hotel, or any of the others, without help from Southern Michigan Bank & Trust," Sunil declared.

In addition, Sunil is committed to improving his day-to-day operations by looking for ways to increase efficiency behind the scenes. Some of those solutions have come directly from Southern's suite of business eServices, such as adding direct deposit and PayCard options for employees, and taking advantage of online vendor payments; tools that have positively impacted the use of his operation's time, money and manpower.

It is because of these experiences, plus his overall satisfaction with personal banking at Southern, that Sunil is comfortable referring friends, family and other businesses to the bank, even opening a savings account for his own son, Tapan, when he was only five years old. Now, as a recent graduate of the University of Michigan, Tapan has chosen a career in the family business and become a shareholder of Southern Michigan Bancorp, Inc.

The Patels' story exemplifies the American dream of owning a business, being successful, and encouraging another generation to do the same. "The Patels have been long-time customers of Southern Michigan Bank & Trust. It's been a privilege to be a part of their family story, and to watch their business develop and grow," says Kurt Miller, President of Southern Michigan Bank & Trust.

CLIENT PROFILE 2015

(Top photo) Dr. Michael Sussex completes an eye exam in his Coldwater office. (Bottom left, pictured left to right) John Castle, Chairman and CEO of Southern Michigan Bank & Trust, Dr. Michael Sussex, and Jim Sobeske, Vice President/Commercial Lending, discuss technological advances in optometry. (Bottom right) Lisa Sussex, Property Manager for Sussex Properties, LLC, meets with Laurel Walkup, Assistant Vice President/eServices Officer of Southern Michigan Bank & Trust, regarding online banking solutions that will help Lisa manage their business with ease.

MICHAEL AND LISA SUSSEX

Bringing Success Into Focus

Dr. Michael Sussex is widely known as an exceptional optometrist serving the southern Michigan area for over 30 years; a healthcare professional who truly cares about his patients and his community.

Dr. Sussex credits his family doctor, Dr. Howard Wicklund, for stimulating his interest in the field of eye care. What began as a childhood curiosity became a successful profession, and ultimately a thriving business, offering comprehensive eye health services utilizing the latest technology. Today, Sussex Vision Centers are located in Coldwater, Sturgis, and Three Rivers.

"Many might be unaware that Michael is also a successful entrepreneur with a longstanding track record in a variety of businesses. I would rank him as one of the finest commercial real estate developers I have had the pleasure of working with," stated Jim Sobeske, Vice President and Commercial Loan Officer. By 1989, he formed Tri-State Optical, a wholesale laboratory producing eyewear for doctors throughout the state of Michigan, manufacturing safety glasses for industrial businesses, and serving as a provider for Health Maintenance Organizations. In addition, he acquired and began developing commercial properties; ventures that would eventually span four states.

Dr. Sussex says it was his father who set the example for him in real estate development. Growing up, young Michael spent his time after school and on weekends working with his dad to improve and ultimately resell a number of residential homes.

Today Dr. Sussex and his wife, Lisa, have built a substantial commercial real estate division, including prime retail strip centers in Michigan, Indiana, Illinois and Alabama.

According to Michael, "We were able to take advantage of a few time-sensitive commercial real estate and tenant acquisitions because of Southern Michigan Bank & Trust's ability to move quickly and work outside the box. We would not be as successful in our commercial real estate business without the help of Southern. We appreciate the support and expertise of Jim Sobeske, who has tailored loans to meet our specific needs and suggested other bank products and services with our personal and professional goals in mind."

Lisa, who serves as property manager, stated, "Prior to moving our accounts to Southern Michigan Bank & Trust, Laurel Walkup, Assistant Vice President and eServices Officer, took the time to understand the dynamics and processes of each of our businesses. She implemented electronic solutions that not only made things more efficient, but offered us the ability to manage virtually anywhere. I especially value the support and training that Laurel and her group provide."

John Castle, Chairman of the Board and Chief Executive Officer of Southern Michigan Bank & Trust adds, "We are honored to have Michael and Lisa as customers and shareholders of our bank and take enormous pride in their continued success."

Lisa concludes, "Southern Michigan Bank & Trust invested in us – they have faith in us, and that is something we will never forget."

"We would not be as successful…without the help of Southern Michigan Bank & Trust." - Dr. Michael Sussex

CLIENT PROFILE 2015

(Top photo, pictured left to right) Paul Lindsley, General Manager of Ritz-Craft in Jonesville; Rachel Doty, Vice President/Commercial Lending; Kurt Miller, President; Nick Grabowski, Executive Vice President/Head of Lending; Laurel Walkup, Assistant Vice President/eServices Officer; and John Castle, Chairman and CEO, tour Ritz-Craft's Jonesville facility. (Bottom left) Laurel Walkup works closely with Ritz-Craft employee, Kathy Shamplo, to demonstrate the latest technology advancements in banking. (Bottom right) One of Ritz-Craft's award winning home designs.

RITZ-CRAFT CUSTOM HOMES

Solid Values - Solid Foundation

Established in 1954 and headquartered in Mifflinburg, Pennsylvania, Ritz-Craft Custom Homes opened a manufacturing facility in Jonesville, Michigan in 2000. With this and another plant in North Carolina, Ritz-Craft is currently the largest family owned, off-site built home manufacturer in the United States.

“Locating a facility in Jonesville just made good sense,” said General Manager, Paul Lindsley. “The area embodied some of our core beliefs of family and work ethic; common themes among rural and farm-based areas. It was also within proximity to our supply and distribution chains.” The Jonesville facility employs close to one hundred people, including general and skilled laborers and office staff.

Ritz-Craft Custom Homes President & Chief Executive Officer, Paul John, along with his brother Eric John, Vice President, credit their employees for the company’s success and well-deserved recognition, including ten prestigious awards from the National Association of Home Builders in just the past two years. “We are a family-owned company; it is important to us that we remain accessible and maintain close relationships with our employees,” said Eric.

Paul and Eric already appreciated the importance of working with a community bank, so when a regional bank acquired the local provider they started with, they decided to find a new community bank. “We just moved away from a big bank in Pennsylvania, too,” Eric said. “They aren’t usually interested in helping us when things get tough.”

But Paul Lindsley had heard about SMB&T, knew its size, and felt confident that Southern could provide the relationship Ritz-Craft was looking for. As Eric said, “Southern Michigan Bank & Trust has stepped up to the plate. Financing a facility like this isn’t easy, but they’ve gone the extra mile and we have a genuine relationship.”

Ritz-Craft has taken advantage of many of the advanced technology features the bank offers, including Remote Deposit Capture, which allows checks to be deposited from their office rather than sending an employee to the bank several times each week. They have received eServices help from Laurel Walkup, worked with Vice President and Commercial Loan Officer Rachel Doty, and counted on bank support at every level.

According to Paul Lindsley, “There was a time, just a couple years ago, when banks stayed away from the home building industry. Southern never hesitated.” In fact, he has referred other local vendors to Southern. He said, “It feels good to give them a local name.”

In addition to the primary home-building component of Ritz-Craft, they have enjoyed rapid growth in other areas. In 2006 Ritz-Trans trucking company was established for the shipping of system-built homes. In 2008 Legacy Building Products became the direct distributor of raw materials to Ritz-Craft Corporation, and in 2011 they introduced Legacy Crafted Cabinets. Last year, they opened Rusty Rail Brewing Company, a craft brewery in Pennsylvania providing a full-service restaurant and event facility, with the expectation of statewide craft beer distribution within a year.

“Ritz-Craft consistently demonstrates their genuine spirit and lives their corporate values of providing a great work environment, tying success to strong relationships, and achieving quality in their products and services. Southern shares those principles,” said Kurt Miller, President of Southern Michigan Bank & Trust, “and we are proud to work with Paul and Eric John, Paul Lindsley, and the entire Ritz-Craft group.”

“We have a good future together with Southern Michigan Bank & Trust,” said Eric. “I feel confident about it.”

Executive Officers of Southern Michigan Bank & Trust and Southern Michigan Bancorp, Inc.

John H. Castle
Chairman & Chief Executive Officer

Kurt G. Miller
President / Chief Credit Officer

Nicholas M. Grabowski
Executive Vice President / Head of Lending

Danice L. Chartrand
Senior Vice President / Chief Financial Officer

Southern Michigan Bancorp, Inc. Board of Directors

Dean Calhoun
Coldwater Veneer, Inc.

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

Charles James Scott Clark
Clark Logic

H. Kenneth Cole
Retired Executive

Gary H. Hart
Infinisource, Inc.

Nolan E. (Rick) Hooker
Best American Car Washes

Gregory J. Hull
Farmer

Thomas E. Kolassa
Retired Executive

Donald J. Labrecque
Labrecque Management

Brian P. McConnell
Burr Oak Tool, Inc.

Kurt G. Miller
President / Chief Credit Officer of SMB, Inc. and SMB&T

Freeman E. Riddle
Retired Executive

Honorary Directors

John S. Carton
James T. Grohalski
Thomas D. Meyer
Jane L. Randall

OFFICERS AND BOARD OF DIRECTORS

Officers of Southern Michigan Bank & Trust

COMMERCIAL LOANS

Doug Kiessling
Regional Vice President / Commercial Loan Manager

Tom Swoish
Regional Vice President / Commercial Loan Manager

Deborah Davis
Vice President

Rachel Doty
Vice President

Sarah Headley
Vice President

Greg Miller
Vice President

James Sobeske
Vice President

Steve Todd
Vice President

Jay Williams
Vice President

Adam Losinski
Assistant Vice President

Corey Donner
Commercial Loan Officer

RETAIL LOANS

Rick Feller
Vice President / Retail Loan Officer / Sr. Collections Administrator

Phyllis Wingate
Vice President / Head of Retail Loan Operations

DeAnne Hawley
Assistant Vice President

Shari Kline
Assistant Vice President

Diane Krimmel
Assistant Vice President

Lori Lemmon
Assistant Vice President

Gregory Mallar
Assistant Vice President

Cassidy Munn
Assistant Vice President

Desiree Kauffman
Loan Operations Specialist

Connie Caudill
Assistant Vice President / Senior Collections Manager

Lynn Roper
Secondary Market / Loan Servicing Officer

ANGOLA, IN LENDING OFFICE

Kristie Prater
Assistant Vice President

RISK MANAGEMENT

Trisha Pawloski
Vice President / Risk Management Officer

TRUST DEPARTMENT

Mary Guthrie
Senior Vice President / Senior Trust Officer

R. David Rumsey
Vice President / Senior Investment 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

Tina Mack
Assistant Vice President / Branch Manager

BATTLE CREEK BRANCH

Lisa Walker
Assistant Vice President / Branch Manager

MARSHALL BRANCH

Kara Mead
Vice President / Commercial Loan Officer / Branch Manager

HILLSDALE & CAMDEN BRANCHES

Lori Neill
Assistant Vice President / Regional Branch Manager

UNION CITY BRANCH

Tim Fox
Assistant Vice President / Branch Manager / Retail Loan Officer

TEKONSHA BRANCH

Dawn Copas
Branch Manager

CENTREVILLE & CONSTANTINE BRANCHES

Tina Cronkhite
Assistant Vice President / Regional Branch Manager

MENDON BRANCH

Doreen Tobin
Assistant Vice President / Branch Manager

THREE RIVERS MAIN & THREE RIVERS WEST BRANCHES

Sharon Bachinski
Assistant Vice President / Branch Manager

PORTAGE BRANCH

Cammy Fleckenstein
Branch Manager

FINANCE

Kevin Vaughn
Vice President of Finance

OPERATIONS / INFORMATION SYSTEMS

Dave McKinley
First Vice President / Head of Operations

Angie Smith
Assistant Vice President / Operations Manager

Becky Omo
Assistant Vice President / Operations Representative

Vikki Kline
Project / Research Officer

Laurel Walkup
Assistant Vice President / e-Services Officer

SHAREHOLDER INFORMATION

Annual Meeting

The annual meeting of Southern Michigan Bancorp, Inc. will be held on May 5, 2016 at 4:00 p.m. at the Dearth Community Center on the Branch County Fairgrounds in Coldwater, Michigan.

Market Information

Inquiries regarding stock certificate administration, address changes, transfers, and other related services should be directed to:

American Stock Transfer and Trust Company, LLC

Website: www.amstock.com
Phone: (718) 921-8124
Toll free: (888) 509-4619
Email: info@amstock.com
Address: 6201 15th Avenue | Brooklyn, NY 11219

Market Makers

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

Raymond James Financial Associates
Chicago, Illinois
(312) 655-2961 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

2015 ANNUAL REPORT

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 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 may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement. We undertake no obligation to update or revise our forward-looking statements to reflect developments that occur or information obtained after the date of this report.

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

The following discussion provides a review of the consolidated financial condition and results of operations of Southern Michigan Bancorp, Inc. (Southern) and its 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 is a Michigan corporation and a single bank holding company registered under the Bank Holding Company Act of 1956. Southern wholly owns Southern Michigan Bank & Trust (the Bank), Southern Michigan Bancorp Capital Trust I (a Delaware statutory trust), and 27 Marshall Street LLC. The Bank wholly owns SMB 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, industrial, 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 14 banking offices located in Battle Creek, Camden, Centreville, Coldwater, Constantine, Hillsdale, Marshall, Mendon, Tekonsha, Three Rivers, and Union City, Michigan as well as a loan production office located in Angola, Indiana.

At December 31, 2015, on a consolidated basis, we had assets of $582.8 million, deposits of $477.5 million, a net loan portfolio of $416.7 million, trust assets under management totaling $244.6 million, and shareholders' equity of $67.8 million.

Results of Operations

Southern's net income for 2015 was $5,806,000, compared to $4,792,000 in 2014, an increase of $1,014,000, or 21.2%. Provision for loan losses of $250,000 was expensed in 2015, down from $400,000 in 2014. Non-interest income increased 10.7%, or $707,000, to $7,313,000 in 2015. Non-interest expense increased 3.1%, or $565,000, to $18,875,000 in 2015. Following is a summary of percentage changes from the prior year for various financial statement elements:

	Percent Change from Prior Year	
	2015	**2014**
Net interest income	4.60%	5.29%
Provision for loan losses	-37.50%	-46.67%
Non-interest income	10.70%	-8.72%
Non-interest expense	3.09%	1.56%
Net income	21.16%	6.51%

	Percent Change from Prior Year	
	2015	**2014**
Total assets	7.25%	0.72%
Securities available for sale	33.30%	-4.11%
Gross loans	2.90%	6.24%
Allowance for loan losses	1.85%	-1.16%
Deposits	7.48%	-1.36%
Shareholders' equity	7.30%	6.92%

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 8.82% in 2015, 7.79% in 2014, and 7.72% in 2013. The return on average assets was 1.02% in 2015, 0.87% in 2014, and 0.84% in 2013.

Net Interest Income

Interest income is the total amount earned on funds invested in loans, investment securities, interest bearing correspondent bank balances, 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 2015, Southern's net interest margin (FTE) was 3.92% compared to 3.91% for 2014. Southern's interest rate spread was the same in 2015 and 2014. The one basis point increase in the margin is primarily due to a slightly more favorable asset mix. Growth in interest income from earning assets was 4.34% in 2015 compared to 2014. This outpaced the increase in interest expense from interest bearing liabilities, which increased 2.14% in 2015 compared to 2014. The net effect was an increase of $872,000 in net interest income (FTE) compared to 2014.

For 2014, Southern's net interest margin (FTE) was 3.91% compared to 3.84% for 2013 and 3.80% for 2012. Southern's interest rate spread and margin both increased as cost of funds for deposits and other borrowings decreased 0.15%, from 0.53% in 2013 to 0.38% in 2014, partially offset by yields on interest-earning assets decreasing 0.06%, from 4.27% in 2013 to 4.21% in 2014. The net effect was an increase of $939,000 in net interest income (FTE) compared to 2013.

The following table presents a summary of net interest income (FTE) for 2015, 2014, and 2013.

Table 1. Average Balances and Tax Equivalent Interest Rates

(Dollars in Thousands)	2015 Average Balance	2015 Interest	2015 Yield/ Rate	2014 Average Balance	2014 Interest	2014 Yield/ Rate	2013 Average Balance	2013 Interest	2013 Yield/ Rate
ASSETS									
Interest earning assets:									
Loans(1)(2)(3)	$410,867	$ 19,618	4.77%	$ 389,321	$ 18,747	4.82%	$ 365,106	$ 18,397	5.04%
Taxable investment securities(4)	45,850	742	1.62	57,845	836	1.45	51,176	645	1.26
Tax-exempt investment securities(1)	38,390	1,319	3.44	28,795	1,202	4.17	31,242	1,327	4.25
Federal funds sold and other(5)	21,141	65	0.31	19,114	55	0.29	31,584	89	0.28
Total interest earning assets	516,248	21,744	4.21	495,075	20,840	4.21	479,108	20,458	4.27
Noninterest earning assets:									
Cash and due from banks	10,877			10,977			11,317		
Other assets(6)	49,192			49,566			47,832		
Less allowance for loan losses	(5,169)			(5,156)			(5,344)		
Total assets	$571,148			$ 550,462			$ 532,913		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Demand deposits	$211,736	$ 399	0.19%	$ 219,362	$ 460	0.21%	$ 205,597	$ 481	0.23%
Savings deposits	71,573	36	0.05	63,716	28	0.04	59,339	28	0.05
Time deposits	88,271	784	0.89	84,704	826	0.98	97,416	1,344	1.38
Securities sold under agreements to repurchase and overnight borrowings	14,442	29	0.20	14,716	28	0.19	17,408	37	0.21
Other borrowings	10,075	127	1.26	1,244	4	0.32	265	12	4.53
Subordinated debentures	5,155	154	2.99	5,155	151	2.93	5,155	152	2.95
Total interest bearing liabilities(7)	401,252	1,529	0.38	388,897	1,497	0.38	385,180	2,054	0.53
Noninterest bearing liabilities:									
Demand deposits	97,877			94,877			84,561		
Other	6,210			5,163			4,866		
Shareholders' equity	65,809			61,525			58,306		
Total liabilities and shareholders' equity	$571,148			$ 550,462			$ 532,913		
Net interest income		$ 20,215			$ 19,343			$ 18,404	
Interest rate spread			3.83%			3.83%			3.74%
Net margin on interest earning assets			3.92%			3.91%			3.84%

(1) Includes tax equivalent adjustment of interest (assuming a 34% tax rate) for securities and loans of $442,000 and $107,000, respectively for 2015; $408,000 and $112,000, respectively for 2014; and $448,000 and $95,000, respectively for 2013.
(2) Average balance includes average non-accrual loan balances of $2,211,000 in 2015; $2,984,000 in 2014; and $5,162,000 in 2013.
(3) Interest income includes loan fees of $167,000 in 2015; $129,000 in 2014; and $207,000 in 2013.
(4) Average balance includes average unrealized gains of $782,000 in 2015; unrealized losses of $9,000 in 2014; and unrealized gains of $486,000 in 2013 on available for sale securities.
(5) Includes average federal reserve deposit account balances of $19,563,000 in 2015; $18,180,000 in 2014 and $30,699,000 in 2013.
(6) Includes $14,055,000 in 2015; $14,333,000 in 2014; and $14,624,000 in 2013 relating to goodwill and other intangible assets.
(7) Interest expense on deferred compensation balances totaling $98,000, $116,000 and $94,000 for 2015, 2014 and 2013, respectively, is excluded from interest expense.

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)	**2015 Compared to 2014 Increase (Decrease) Due To**			**2014 Compared to 2013 Increase (Decrease) Due To**		
Interest income on:	**Rate**	**Volume**	**Net**	**Rate**	**Volume**	**Net**
Loans	$ (159)	$ 1,030	$ 871	$ (838)	$ 1,188	$ 350
Taxable investment securities	93	(187)	(94)	101	90	191
Tax-exempt investment securities	(237)	354	117	(23)	(102)	(125)
Federal funds sold and other	4	6	10	2	(36)	(34)
Total interest earning assets	$ (299)	$ 1,203	$ 904	$ (758)	$ 1,140	$ 382
Interest expense on:						
Demand deposits	$ (45)	$ (16)	$ (61)	$ (52)	$ 31	$ (21)
Savings deposits	4	4	8	(2)	2	-
Time deposits	(76)	34	(42)	(358)	(160)	(518)
Securities sold under agreements to repurchase and overnight borrowings	2	(1)	1	(4)	(5)	(9)
Other borrowings	36	87	123	(19)	11	(8)
Subordinated debentures	3	-	3	(1)	-	(1)
Total interest bearing liabilities	$ (76)	$ 108	$ 32	$ (436)	$ (121)	$ (557)
Net interest income	$ (223)	$ 1,095	$ 872	$ (322)	$ 1,261	$ 939

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 $250,000 in 2015, compared to $400,000 in 2014, and $750,000 in 2013. The lower provision in 2014 and 2015 was a result of lower net loan charge-offs, loan delinquency rates, and specific reserves on impaired loans offset by growth in the commercial loan portfolio.

Net loan charge-offs totaled $154,000 in 2015, compared to $461,000 in 2014 and $967,000 in 2013.

Non-Interest Income

Total non-interest income increased $707,000, or 10.7% in 2015 compared to 2014. The increase is primarily attributed to a $539,000, or 168.4%, increase in earnings on life insurance assets and a $318,000, or 37.9% increase in net gains on loan sales. The growth in these areas was partially offset by a $219,000, or 11.0%, decline in service charges on deposit accounts. Total non-interest income decreased $631,000, or 8.7%, in 2014 compared to 2013. The decrease resulted from an $814,000, or 49.2%, decrease in net gains on loan sales, offset by a $64,000 increase in ATM and debit card fee income and a $51,000 increase in other customer fees.

The significant increase in earnings on life insurance assets was primarily due to life insurance policies paying out death benefits in excess of recorded cash values which totaled approximately $528,000.

Net securities gains of $26,000, $90,000, and $140,000 were recognized in 2015, 2014, and 2013, respectively. The gains resulted primarily from the sale of securities to fund loan growth.

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 gain at the time of the sale to the extent proceeds exceed the basis of the loan, excluding any value assigned to capitalized servicing rights. Southern originated real estate mortgage loans of $37,444,000 in 2015, compared to $25,395,000 in 2014, and $49,879,000 in 2013. Net gains on loan sales increased $318,000 in 2015 compared to 2014, and decreased $814,000 in 2014 compared to 2013.

Income and fees from automated teller machines (ATMs) and debit cards increased $61,000, or 4.8% in 2015 compared to 2014, and $64,000, or 5.3%, in 2014 compared to 2013. Increases for both years were primarily due to higher volumes of approved transactions.

Non-Interest Expense

Non-interest expense increased $565,000, or 3.1%, in 2015 compared to 2014. Salary and employee benefit costs increased $677,000, or 6.6%, in 2015 due largely to the elimination of the employee pension plan. In addition, the loss (gain) on the sale or write down of other real estate owned increased $153,000 in 2015 compared to 2014. The increase was due mostly to write downs on the book balance of the parcels held to reflect their current market values. Additional modest increases in expenses were noted in the equipment ($51,000); software maintenance ($44,000); ATM ($35,000); and, advertising and marketing ($7,000) areas. Occupancy costs declined $163,000, or 13.1% in 2015 compared to 2014 due largely to decreases in building maintenance and utility expenses. Additional more modest expense declines included the other real estate owned ($46,000); telecommunication ($42,000); FDIC deposit assessment ($40,000); professional and outside services ($27,000); printing, postage, and supplies ($25,000); and, amortization of other intangibles ($12,000) areas.

Other non-interest expense declined $47,000, or 3.2%, in 2015 as compared to 2014. Two areas had the largest changes year over year within this category. Costs incurred relating to default settlements for loans sold in the secondary market were $191,000 less in 2015 when compared to 2014. Conversely, due to a change in accounting rules, the bank wrote off its investment in a low income housing project which resulted in a $223,000 expense for the year. This was a result of the bank changing accounting methods to the proportional amortization method, whereas the equity method was previously being utilized.

Non-interest expense increased $282,000, or 1.6%, in 2014 compared to 2013. Occupancy costs increased $215,000, or 20.8%, in 2014 due to increased costs for snow removal and several small maintenance projects. Printing, postage and supplies decreased $50,000 in 2014 compared to 2013. Costs were elevated in 2013 as a result of customer mailings for the core system conversion and the new overdraft product. Professional and outside services decreased $147,000, or 11.1%, in 2014 due to a reduction nonperforming loans which reduced legal collection costs. Software maintenance decreased $165,000, or 16.7%, in 2014 compared to 2013. In 2013 the Bank recorded accelerated expense relating to the previous core processing system. ATM expenses increased in 2014 over 2013 $54,000, or 12.0%, due to higher volumes of activity and an increase in card losses stemming from retail stores system breaches. Loss (gain) on sale or write down of other real estate owned (OREO) resulted in a $180,000 increase in non-interest expense in 2014 as compared to 2013 as a result of the write down of $194,000 in

2014 on various commercial real estate properties held in OREO. Other OREO expenses increased $133,000, or 70.0%, in 2014 compared to 2013 due to real estate taxes paid and necessary repairs and maintenance incurred on the increased volume of properties held in OREO in 2014 as compared to 2013. Other non-interest expense increased $178,000, or 13.6%, in 2014 as compared to 2013 primarily due to $191,000 of costs incurred relating to default settlements for loans sold in the secondary market.

Income Taxes

Income tax provision was $1,950,000 in 2015, $1,811,000 in 2014 and $1,727,000 in 2013. 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 non-taxable feature of the income earned on such instruments. This resulted in a lower effective tax rate and reduced federal income tax expense of $354,000 in 2015, $337,000 in 2014 and $348,000 in 2013. Furthermore, tax-exempt income from earnings on life insurance assets resulted in a lower effective tax rate and reduced federal income tax expense by $290,000 in 2015, $109,000 in 2014, and $114,000 in 2013. Additional income tax information is reported in Note K to the consolidated financial statements.

Financial Condition

Total assets were $582,771,000 as of December 31, 2015, an increase of $39,426,000, or 7.3%, compared to December 31, 2014. Gross loans increased $11,877,000, or 2.9%, in 2015, with the growth occurring primarily in commercial real estate and construction loans. The securities portfolio increased $24,270,000, or 33.3%, in 2015, with the growth occurring in US Agencies and municipal bonds. The aforementioned growth was funded substantially with deposits. Deposit volumes increased $33,215,000, or 7.5%, during 2015. Growth in demand deposits, time deposits, and savings deposits more than offset a decline in money market accounts.

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2015, decreased $1,887,000, or 12.3%, compared to balances at December 31, 2014. Cash and cash equivalents decreased during 2015 as a result of increases in securities and the loan portfolio.

Federal Funds Sold

Federal funds sold totaled $6,941,000 at December 31, 2015, compared to $247,000 at December 31, 2014. In December of 2015, the Federal Reserve Bank's Federal Open Market Committee raised interest rates 25 basis points. This increase resulted in the overnight federal funds rate paid by Southern's primary correspondent bank moving higher than the rate being paid by the Federal Reserve.

Securities Available for Sale

The securities available for sale portfolio increased $24,270,000, or 33.3%, from December 31, 2014, to December 31, 2015. 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 $627,000 and $243,000 at December 31, 2015, and 2014, respectively. Management has concluded that unrealized 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, 2015, 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 $11,877,000, or 2.9%, in 2015. Gross loans increased $24,101,000, or 6.2%, in 2014. The increases in 2015 and 2014 were a result of increased loan demand.

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 $113,101,000 and $108,673,000 at December 31, 2015, and 2014, respectively. A high percentage of these commitments are priced at a variable interest rate, thus minimizing Southern's risk to changes in market interest rates.

Nonperforming Assets

Nonperforming assets include non-accrual 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 non-accrual when full collectability 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. In certain circumstances, 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		
	2015	**2014**	**2013**
	(Dollars in thousands)		
Nonaccrual loans:			
Commercial and commercial real estate	$ 1,151	$ 1,119	$ 1,661
Real estate mortgage	630	1,287	2,291
Consumer	46	24	10
	1,827	2,430	3,962
Loans contractually past due 90 days or more and still on accrual:			
Commercial and commercial real estate	991	269	-
Real estate mortgage	-	-	-
Consumer	-	5	-
	991	274	-
Accruing loans modified under troubled debt restructurings:			
Commercial and commercial real estate	1,395	1,418	2,551
Real estate mortgage	1,321	1,318	1,759
Consumer	-	-	-
	2,716	2,736	4,310
Total nonperforming loans	5,534	5,440	8,272
Other real estate owned	1,014	3,160	1,818
Total nonperforming assets	$ 6,548	$ 8,600	$ 10,090
Nonperforming loans to year-end loans	1.31%	1.33%	2.14%
Nonperforming assets to total assets	1.12%	1.58%	1.87%

The balance of nonaccrual restructured loans, which is included in nonaccrual loans, was $561,000 at December 31, 2015, $233,000 at December 31, 2014, and $601,000 at December 31, 2013.

Non-performing 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 slightly from December 31, 2014, to December 31, 2015. From December 31, 2013, to December 31, 2014, the balances had declined. At December 31, 2015, 2014, and 2013, Southern had loans of $4,543,000; $5,167,000; and, $8,272,000 respectively, which were considered impaired.

Other real estate owned of $1,014,000 at December 31, 2015, decreased $2,146,000, or 67.9% from December 31, 2014. During 2015 and 2014, loans of $559,000 and $1,871,000, respectively, were transferred to foreclosed assets.

In management's evaluation of the loan portfolio risks, any significant future increases in non-performing 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 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 accounting standards: 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, 2015, specific reserves totaled $434,000 compared to $630,000 at December 31, 2014, a decrease of $196,000, or 31.1%.

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

The allowance for loan losses was $5,273,000, or 1.25% of loans, at December 31, 2015, compared to $5,177,000, or 1.26% of loans, at December 31, 2014.

The allowance for loan losses at December 31, 2015, consisted of $1,801,000 from the historical loss experience component and specifically allocated reserves, leaving $3,472,000 from the other factors. This compares to $2,339,000 from the historical loss experience component and specifically allocated reserves and $2,838,000 from the other factors at December 31, 2014.

At December 31, 2015, 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 funding source. Total deposits increased 7.5%, or $33,215,000, in 2015 compared to 2014, and decreased 1.4%, or $6,130,000, in 2014 compared to 2013. 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, $12,599,000 at December 31, 2015, are maintained. Attracting and keeping traditional deposit relationships will continue to be a focus of Southern.

Subordinated Debentures

In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by Southern, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of $1,000 per security. Southern issued $5,155,000 of subordinated debentures to the trust in exchange for ownership of all of the common securities of the trust and the proceeds of the preferred securities sold by the trust. Southern is not considered the primary beneficiary of this trust, therefore the trust is not consolidated in Southern's financial statements, but rather the subordinated debentures are shown as a liability. Southern may redeem the subordinated debentures subject to the receipt by Southern of the proper approval of the Federal Reserve, if such approval is required under applicable capital guidelines or policies of the Federal Reserve. The subordinated debentures may be redeemed on January 7, April 7, July 7 and October 7 of each year either in whole or in integrals of $1,000 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures mature on April 6, 2034. The subordinated debentures are also redeemable in whole but not in part, from time to time upon the occurrence of specific events defined within the trust indenture. Southern has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarterly periods. Southern's investment in the common stock of the trust is $155,000 and is included in other assets.

The $5,000,000 in trust preferred securities is 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, 2015, was 3.07%.

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 $4,609,000, or 7.3% from December 31, 2014, to December 31, 2015, and $4,086,000, or 6.9%, from December 31, 2013, to December 31, 2014. The increases for both 2015 and 2014 were primarily attributable to net income offset by dividends to shareholders.

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.

With the implementation of BASEL III in 2015, regulatory agencies granted banks a one-time election to determine whether the capital component created by the net unrealized gain or loss on available for securities is included in Tier 1 capital. Southern elected not to include the net unrealized gain or loss on available for sale investments in Tier 1 capital. Therefore, the net unrealized gain or loss is not included in the capital ratios listed in Note U to the consolidated financial statements.

As of December 31, 2015, the capital ratios of the Bank exceeded the minimum thresholds to be categorized as “well-capitalized” under applicable regulations. Note U of our consolidated financial statements provides additional information regarding our capital ratios.

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. Cash and equivalents, 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.

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 $857,000 in 2015 and $255,000 in 2014. During 2015 and 2014, Southern averaged $19,563,000 and $18,180,000, 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, 2015, 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, 2015, $2 million of securities were pledged that could be used for future borrowings. In addition, Southern has $73.2 million of securities which are available to be pledged for future borrowings. Southern also has the ability to borrow $28.3 million from the Federal Home Loan Bank based on 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, 2015, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay Southern without prior regulatory approval was $14.0 million.

Impact of Inflation and Changing Prices

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

Commitments and Off-Balance Sheet Risk

Southern maintains off balance sheet financial instruments in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, letters of credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer at any time, as the customer's needs vary, as long as there is no violation of any condition established in the contract. Letters of credit are used to facilitate customers' trade transactions. Under standby letters of credit agreements, Southern agrees to honor certain commitments in the event that its customers are unable to do so. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. At December 31, 2015, Southern had commitments of $113,101,000 for lines of credit, $6,584,000 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. Management of interest rate sensitivity 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 12 and 24 month periods. A 100 bp declining scenario was modeled at December 31, 2015, even though the Federal Reserve target rate was 0.50%. Rate declines were floored in the model so that no rate fell below zero percent. 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 simulation's effect on net interest income is shown in the table below:

Ramp Change/ Dynamic	**12 month % Change**	**24 month % Change**	**Ramp Change/ Static**	**12 month % Change**	**24 month % Change**
+400	5.39%	21.88%	+400	4.56%	17.72%
+300	3.58%	16.55%	+300	2.96%	13.51%
+200	1.72%	10.44%	+200	1.32%	8.45%
+100	0.18%	3.80%	+100	0.00%	2.81%
-100	-1.42%	-3.12%	-100	-1.34%	-2.69%
-200	NA	NA	-200	NA	NA
-300	NA	NA	-300	NA	NA
-400	NA	NA	-400	NA	NA

Shock Change/ Dynamic	**12 month % Change**	**24 month % Change**	**Shock Change/ Static**	**12 month % Change**	**24 month % Change**
+400	11.75%	25.24%	+400	9.91%	19.98%
+300	8.95%	19.05%	+300	7.59%	15.18%
+200	5.29%	12.21%	+200	4.39%	9.69%
+100	1.11%	4.74%	+100	0.66%	3.50%
-100	-1.65%	-3.63%	-100	-1.44%	-3.07%
-200	NA	NA	-200	NA	NA
-300	NA	NA	-300	NA	NA
-400	NA	NA	-400	NA	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, a declining 100 bp was modeled at December 31, 2015. 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	25.04%
3% increase in market rates	19.40%
2% increase in market rates	13.69%
1% increase in market rates	6.92%
No change	0.00%
1% decrease in market rates	-7.52%
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, 2015, are within the guidelines set and approved by Southern's Board of Directors, except for the dynamic balance sheet in a rising 300 basis point environment, which slightly exceeded the policy limit. Management continues to monitor the ratios 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 T, "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. No material issues were noted during December 2015 that would have impacted the analysis within the goodwill impairment test.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

Management of Southern 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.

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

Management monitors the effectiveness of and compliance with established control systems through a continuous program of internal audit and credit examinations and recommends possible improvements thereto. Management believes that, as of December 31, 2015, Southern's system of internal controls has prevented or detected on a timely basis any occurrences that could be material to the financial statements and that timely corrective actions have been initiated when appropriate.

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

The 2015 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.

JH Castle

John H. Castle
Chairman and
Chief Executive Officer

Danice L Chartrand

Danice L. Chartrand
Chief Financial Officer

February 12, 2016

CliftonLarsonAllen

CliftonLarsonAllen LLP
CLAconnect.com

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

We have audited the accompanying consolidated financial statements of Southern Michigan Bancorp, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2015, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

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, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015 in accordance with accounting principles generally accepted in the United States.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Toledo, Ohio
March 2, 2016

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

	December 31, 2015	2014
ASSETS		
Cash	$ 3,642	$ 3,696
Due from banks	9,845	11,678
Cash and cash equivalents	13,487	15,374
Federal funds sold	6,941	247
Securities available for sale	97,150	72,880
Loans held for sale	328	483
Loans, net of allowance for loan losses of $5,273 - 2015 ($5,177 - 2014)	416,716	404,935
Premises and equipment, net	12,685	11,898
Accrued interest receivable	2,517	2,378
Cash surrender value of life insurance	11,939	11,299
Goodwill	13,422	13,422
Other intangible assets, net	489	761
Other assets	7,097	9,668
Total Assets	$ 582,771	$ 543,345
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Non-interest bearing	$ 101,186	$ 90,191
Interest bearing	376,299	354,079
Total deposits	477,485	444,270
Securities sold under agreements to repurchase and overnight borrowings	15,943	14,644
Accrued expenses and other liabilities	6,419	6,116
Other borrowings	10,000	10,000
Subordinated debentures	5,155	5,155
Total Liabilities	515,002	480,185
Shareholders' equity		
Preferred stock, 100,000 shares authorized; none issued or outstanding	-	-
Common stock, $2.50 par value:		
Authorized – 4,000,000 shares		
Issued and outstanding – 2,406,508 shares in 2015 (2,404,469 shares in 2014)	6,011	6,005
Additional paid-in capital	19,572	19,622
Retained earnings	42,029	37,741
Accumulated other comprehensive income/(loss), net	414	(208)
Unearned Employee Stock Ownership Plan (ESOP) shares	(257)	-
Total Shareholders' Equity	67,769	63,160
Total Liabilities and Shareholders' Equity	$ 582,771	$ 543,345

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,		
	2015	**2014**	**2013**
Interest income:			
Loans, including fees	$ 19,511	$ 18,635	$ 18,302
Securities:			
Taxable	742	836	645
Tax-exempt	877	794	879
Other	65	55	89
Total interest income	21,195	20,320	19,915
Interest expense:			
Deposits	1,218	1,313	1,853
Other	409	300	295
Total interest expense	1,627	1,613	2,148
Net Interest Income	19,568	18,707	17,767
Provision for loan losses	250	400	750
Net Interest Income after Provision for Loan Losses	19,318	18,307	17,017
Non-interest income:			
Service charges on deposit accounts	1,770	1,989	2,015
Trust fees	1,258	1,181	1,128
Net securities gains	26	90	140
Net gains on loan sales	1,157	839	1,653
Earnings on life insurance assets	859	320	335
ATM and debit card fee income	1,339	1,278	1,214
Other	904	909	752
Total non-interest income	7,313	6,606	7,237
Non-interest expense:			
Salaries and employee benefits	10,907	10,230	10,368
Occupancy, net	1,086	1,249	1,034
Equipment	725	674	709
Printing, postage and supplies	417	442	492
Telecommunication	250	292	274
Professional and outside services	1,148	1,175	1,322
Software maintenance	865	821	986
Amortization of other intangibles	272	284	296
ATM expenses	538	503	449
Advertising and marketing	324	317	275
FDIC deposit assessments	329	369	360
Other real estate owned expenses	277	323	190
Loss (gain) on sale or write down of other real estate owned	295	142	(38)
Other	1,442	1,489	1,311
Total non-interest expense	18,875	18,310	18,028
Income before income taxes	7,756	6,603	6,226
Income tax provision	1,950	1,811	1,727
Net Income	$ 5,806	$ 4,792	$ 4,499
Basic Earnings Per Common Share	$ 2.42	$ 1.99	$ 1.88
Diluted Earnings Per Common Share	$ 2.42	$ 1.99	$ 1.88

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

SOUTHERN MICHIGAN BANCORP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year Ended December 31,		
	2015	**2014**	**2013**
Net Income	$ 5,806	$ 4,792	$ 4,499
Other Comprehensive Income (Loss):			
Unrealized gain (loss) on available for sale securities	410	795	(1,536)
Accrued pension liability	558	67	138
Reclassification adjustments for net realized securities gains included in net income	(26)	(90)	(140)
	942	772	(1,538)
Income tax effect	320	263	(524)
Other comprehensive income (loss)	622	509	(1,014)
Total Comprehensive Income	$ 6,428	$ 5,301	$ 3,485

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, 2015, 2014 and 2013

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2013	$ 5,627	$ 17,700	$ 31,046	$ 297	$ (35)	$ 54,635
Net income for 2013			4,499			4,499
Net change in other comprehensive income items				(1,014)		(1,014)
Cash dividends declared - $.50 per share			(1,199)			(1,199)
Issuance of restricted stock (17,875 shares of common stock at $16.50 per share)	45	(45)				-
Vesting of restricted stock		193				193
Stock options exercised (25,330 shares)	63	225				288
Repurchase of common stock (25,628 shares)	(64)	(384)				(448)
Restricted stock forfeiture (920 shares)	(2)	2				-
Reclassification of ESOP liability	307	1,758				2,065
Reduction of ESOP obligation					35	35
Stock option expense		20				20
Balance at December 31, 2013	5,976	19,469	34,346	(717)	-	59,074
Net income for 2014			4,792			4,792
Net change in other comprehensive income items				509		509
Cash dividends declared - $.58 per share			(1,397)			(1,397)
Issuance of restricted stock (17,225 shares of common stock at $17.70 per share)	43	(43)				-
Vesting of restricted stock		226				226
Stock options exercised (14,025 shares)	35	144				179
Tax benefit from exercise of stock options		88				88
Repurchase of common stock (18,271 shares)	(46)	(285)				(331)
Restricted stock forfeiture (1,200 shares)	(3)	3				-
Stock option expense		20				20
Balance at December 31, 2014	6,005	19,622	37,741	(208)	-	63,160
Net income for 2015			5,806			5,806
Net change in other comprehensive income items				622		622
Cash dividends declared - $.63 per share			(1,518)			(1,518)
Issuance of restricted stock (17,050 shares of common stock at $21.05 per share)	43	(43)				-
Vesting of restricted stock		265				265
Stock options exercised (42,486 shares)	106	761				867
Tax benefit from exercise of stock options		127				127
Repurchase of common stock (57,497 shares)	(143)	(1,185)				(1,328)
Increase in ESOP obligation					(257)	(257)
Stock option expense		25				25
Balance at December 31, 2015	$ 6,011	$ 19,572	$ 42,029	$ 414	$ (257)	$ 67,769

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,		
	2015	**2014**	**2013**
Operating Activities			
Net income	$ 5,806	$ 4,792	$ 4,499
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	250	400	750
Depreciation of premises and equipment	815	810	859
Deferred income taxes	(494)	(495)	(51)
Amortization of other intangible assets	272	284	296
Net amortization of available-for-sale securities	518	671	567
Stock option and restricted stock grant compensation expense	290	246	213
Net gains on security calls and sales	(26)	(90)	(140)
Loans originated for sale	(37,444)	(25,395)	(49,879)
Proceeds on loans sold	38,756	25,866	53,193
Net gains on loan sales	(1,157)	(839)	(1,653)
Gain on life insurance proceeds	(528)	-	-
Net loss (gain) from sale or write down of other real estate owned	295	142	(38)
Net loss on disposal of premises and equipment	-	99	98
Net change in obligation under ESOP	62	-	35
Net change in:			
Accrued interest receivable	(139)	(27)	(292)
Cash surrender value	(331)	(320)	(335)
Other assets	405	1,560	(1,216)
Accrued expenses and other liabilities	964	(130)	801
Net cash from operating activities	8,314	7,574	7,707
Investing Activities			
Activity in available for sale securities:			
Proceeds on securities sold	1,659	29,613	7,327
Proceeds from maturities and calls	13,857	6,870	28,817
Purchases	(39,895)	(33,234)	(49,727)
Net change in federal funds sold	(6,694)	(99)	128
Loan originations and payments, net	(12,590)	(26,433)	(19,303)
Proceeds from sale of other real estate owned	2,409	713	1,784
Purchase of life insurance	(1,132)	-	-
Proceeds from life insurance	1,351	-	-
Proceeds from sale of equipment	-	-	7
Proceeds from sale of restricted stock	196	234	-
Additions to premises and equipment	(1,602)	(766)	(911)
Net cash from investing activities	(42,441)	(23,102)	(31,878)
Financing Activities			
Net change in deposits	33,215	(6,130)	6,230
Net change in securities sold under agreements to repurchase and overnight borrowings	1,299	(3,835)	2,345
Proceeds from other borrowings	10,319	40,799	-
Repayments of other borrowings	(10,319)	(30,799)	(1,039)
Stock options exercised	867	179	288
Purchase of ESOP shares	(319)	-	-
Cash dividends paid	(1,494)	(1,347)	(1,173)
Repurchase of common stock	(1,328)	(331)	(448)
Net cash from financing activities	32,240	(1,464)	6,203
Net change in cash and cash equivalents	(1,887)	(16,992)	(17,968)
Beginning cash and cash equivalents	15,374	32,366	50,334
Ending cash and cash equivalents	$ 13,487	$ 15,374	$ 32,366

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

SOUTHERN MICHIGAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. (the Company) is a Michigan corporation and registered bank holding company under the Bank Holding Company Act of 1956. 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 SMB 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.

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 collateral dependent. 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 when they become 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.

Under certain circumstances, the Bank may provide borrowers relief through loan restructurings. A restructuring of debt constitutes a troubled debt restructuring (TDR) if the Bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Concessions may include reduction of interest rates, extension of maturity dates, forgiveness of principal or interest due, or acceptance of other assets in full or partial satisfaction of the debt. TDR loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment, as previously described. TDR loans that have performed as agreed under the restructured terms for a period of 12 months or longer may cease to be reported as a TDR loan. However, the loan continues to be individually evaluated for impairment.

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 years 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.

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

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.

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.

Cash Surrender Value of Life Insurance: The Bank has purchased life insurance policies on certain key executives. Bank 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, 2015, 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 \$1,014,000 and \$3,160,000 at December 31, 2015, and 2014, 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 Based Compensation: The Company follows the requirements of "share-based payment transactions", using the modified prospective transition method. Under this method, the Company recognizes compensation cost for stock based compensation for all new or modified grants.

See Note M 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: The income tax provision 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. Employee Stock Ownership Plan 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): 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 Note S. 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 loans make up approximately 78% of the loan portfolio at December 31, 2015 (76% at December 31, 2014), and such loans are expected to be repaid from cash flow from operations of businesses. Residential mortgage loans make up approximately 20% of the loan portfolio at December 31, 2015 (22% at December 31, 2014), and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 2% of the loan portfolio at December 31, 2015 (2% at December 31, 2014), 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, 2015, and 2014.

Cash Balances: The Company maintains deposits with other correspondent banks. Certain of these deposits may exceed FDIC insured limits.

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, 2015 that will have a material future adverse effect on the consolidated financial statements.

Subsequent Events: Management evaluated subsequent events through March 2, 2016, the date the consolidated financial statements were available to be issued. Events or transactions occurring after December 31, 2015, but prior to when the consolidated financial statements were available to be issued, that provided additional evidence about conditions that existed at December 31, 2015, have been recognized in the consolidated financial statements for the year ended December 31, 2015. Events or transactions that provided evidence about conditions that did not exist at December 31, 2015, but arose before the consolidated financial statements were available to be issued, have not been recognized in the consolidated financial statements for the year ended December 31, 2015.

Reclassifications: Certain items in the 2014 and 2013 consolidated financial statements have been reclassified to conform to the current year presentation.

Adoption of New Accounting Standards: In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-04, "*Receivables-Troubled Debt Restructurings by Creditors*" to clarify when an in substance repossession or foreclosure occurs. That is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the receivable should be derecognized and the real estate property recognized. The amendments in ASU 2014-04 apply to all creditors who obtain physical possession of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable. The adoption of ASU 2014-04 on January 1, 2015, did not have a material impact on the Company's consolidated financial condition or results of operations.

In January 2014, the FASB issued ASU 2014-01, "*Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*". This update provides guidance to investors in affordable housing projects that qualify for the low-income housing credit. The ASU allows investors, in certain cases, to qualify for the use of the proportional amortization method. Under the proportional amortization method, an investor amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense. ASU 2014 -01 also introduces disclosure requirements for all investments in qualified affordable housing projects, regardless of the accounting method used. The amendments in ASU 2014-01 are effective for fiscal years beginning after December 15, 2014, with early adoption permitted. The adoption of ASU 2014-01 on January 1, 2015, did not have a material impact on the Company's consolidated financial condition or results of operations.

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

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, 2015, 2014, and 2013 is presented below:

	2015	2014	2013
Basic Earnings Per Common Share			
Net income (in thousands)	$ 5,806	$ 4,792	$ 4,499
Weighted average common shares outstanding	2,405,969	2,404,901	2,391,825
Less: Unallocated ESOP shares	(10,908)	(1,757)	(4,082)
Weighted average common shares outstanding for basic earnings per common share	2,395,061	2,403,144	2,387,743
Basic earnings per common share	$ 2.42	$ 1.99	$ 1.88
Diluted Earnings Per Common Share			
Net income (in thousands)	$ 5,806	$ 4,792	$ 4,499
Weighted average common shares outstanding for basic earnings per common share	2,395,061	2,403,144	2,387,743
Add: Dilutive effects of assumed exercises of stock options	4,783	3,612	7,006
Average shares and dilutive potential of common shares outstanding	2,399,844	2,406,756	2,394,749
Diluted earnings per common share	$ 2.42	$ 1.99	$ 1.88

Stock options for 78,230, 130,561, and 168,996 shares of common stock were not considered in computing diluted earnings per share for 2015, 2014, and 2013, respectively, because they were anti-dilutive.

NOTE C - SECURITIES

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

Available for Sale, December 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 32,434	$ 10	$ (114)	$ 32,330
U.S. Treasuries	6,954	18	(9)	6,963
States and political subdivisions	53,216	809	(54)	53,971
Mortgage-backed securities	12	-	-	12
Corporate security	3,907	-	(33)	3,874
Total	$ 96,523	$ 837	$ (210)	$ 97,150

Available for Sale, December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 27,057	$ 17	$ (125)	$ 26,949
U.S. Treasuries	6,935	10	(16)	6,929
States and political subdivisions	37,831	546	(185)	38,192
Mortgage-backed securities	19	-	-	19
Corporate security	795	-	(4)	791
Total	$ 72,637	$ 573	$ (330)	$ 72,880

Securities with unrealized losses at December 31, 2015, and 2014, that have not been recognized in income are as follows (in thousands):

2015	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	$ 23,059	$ (101)	$ 986	$ (13)	$ 24,045	$ (114)
U.S. Treasuries	1,989	(9)	-	-	1,989	(9)
States and political subdivisions	6,083	(32)	1,845	(22)	7,928	(54)
Corporate security	3,575	(31)	299	(2)	3,874	(33)
Total temporarily impaired	$ 34,706	$ (173)	$ 3,130	$ (37)	$ 37,836	$ (210)

2014	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	$ 7,270	$ (18)	$ 9,930	$ (107)	$ 17,200	$ (125)
U.S. Treasuries	-	-	1,981	(16)	1,981	(16)
States and political subdivisions	8,208	(96)	3,046	(89)	11,254	(185)
Corporate security	493	(1)	298	(3)	791	(4)
Total temporarily impaired	$ 15,971	$ (115)	$ 15,255	$ (215)	$ 31,226	$ (330)

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 the securities 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 bonds approach their maturity date.

NOTE C – SECURITIES (CONTINUED)

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

	2015	2014	2013
Proceeds	$ 1,659	$ 29,613	$ 7,327
Gross gains	23	89	140

The tax provision related to gross realized gains was $8,000, $30,000, and $48,000 for 2015, 2014, and 2013, respectively.

Gains on calls of securities were $3,000, $1,000, and $0 for 2015, 2014, and 2013, 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 2015 were as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 15,048	$ 15,041
Due from one to five years	52,241	52,267
Due from five to ten years	26,616	27,085
Due after ten years	2,606	2,745
Mortgage-backed securities	12	12
Total	$ 96,523	$ 97,150

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 $22,825,000 and $27,684,000, respectively, were pledged as collateral for repurchase accounts and for other purposes at December 31, 2015, and 2014.

At December 31, 2015, and 2014, the fair value of securities issued by the State of Michigan and all its political subdivisions totaled $41,986,000 and $27,744,000, respectively. No other securities of any single issuer were greater than 10% of shareholders' equity.

Investments in the Federal Home Loan Bank of Indianapolis stock totaled $1,270,000 and $1,467,000 at December 31, 2015, and 2014, respectively and are included in other assets because such investments are considered restricted. Such investments are recorded at cost and evaluated for impairment. Cash dividends received are recorded in other interest income.

At December 31, 2015, the Company had no investment in securities of issuers outside of the United States.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES

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

	2015	2014
Commercial	$ 87,558	$ 81,938
Real estate – commercial	221,305	208,857
Real estate – construction	20,762	21,553
Real estate mortgage	84,721	90,135
Consumer	7,643	7,629
	421,989	410,112
Less allowance for loan losses	(5,273)	(5,177)
Loans, net	$ 416,716	$ 404,935

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

Credit Risk Elements:
Commercial:
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 completion of the 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.

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 appraised 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.

Real Estate Mortgage and Consumer:
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 Federal Home Loan Mortgage Corporation 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.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The Bank's internal credit analysis staff reviews and validates credit risk on a periodic basis. In addition, an internal loan review is performed throughout the year. Credit analysts' results are presented to management. The internal loan reviews are presented to management and the Audit Committee. The credit analysts' results 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, 2015, and 2014, 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 activity of loans (in thousands) exceeding $60,000 in the aggregate to these individuals and their associates. All of these loans were made in the ordinary course of business, were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the Company and did not involve more than the normal risk of collectability or present other unfavorable features. None of these loans were in default at December 31, 2015. Other changes include adjustments for loans applicable to one reporting period that are excludable from the other reporting period including changes in the directorate.

	2015	2014	2013
Balance at January 1	$ 22,647	$ 13,410	$ 17,179
New loans, including renewals	13,914	7,413	3,474
Repayments	(17,594)	(5,949)	(3,557)
Other changes, net	(345)	7,773	(3,686)
Balance at December 31	$ 18,622	$ 22,647	$ 13,410

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $220,207,000 and $213,258,000 at December 31, 2015, and 2014, respectively.

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

	2015	2014	2013
Balance at January 1	$ 1,349	$ 1,448	$ 1,243
Additions	454	296	660
Amortized to expense	(372)	(395)	(455)
Balance at December 31	$ 1,431	$ 1,349	$ 1,448

No valuation allowance for capitalized mortgage servicing rights was considered necessary at December 31, 2015, or 2014, because the estimated fair value of such rights exceeded the carrying value.

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 may vary within the disclosures.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The following is an analysis of the allowance for loan losses activity by portfolio segment based on impairment method as of and for the years ended December 31, 2015, 2014, and 2013 (in thousands):

December 31, 2015	Commercial including Commercial Real Estate	Consumer	Real Estate Mortgage 1st Lien	Real Estate Mortgage Junior Lien	Total
Balance at January 1	$ 4,074	$ 45	$ 945	$ 113	$ 5,177
Provision (credit) for loan losses	338	(17)	(31)	(40)	250
Loans charged off	(225)	(22)	(152)	(10)	(409)
Recoveries	131	25	48	51	255
Balance at December 31	$ 4,318	$ 31	$ 810	$ 114	$ 5,273
Ending balance individually evaluated for impairment	$ 360	$ -	$ 74	$ -	$ 434
Ending balance collectively evaluated for impairment	3,958	31	736	114	4,839
Total	$ 4,318	$ 31	$ 810	$ 114	$ 5,273
December 31, 2014					
Balance at January 1	$ 4,037	$ 50	$ 1,034	$ 117	$ 5,238
Provision (credit) for loan losses	121	(14)	164	129	400
Loans charged off	(347)	(16)	(259)	(155)	(777)
Recoveries	263	25	6	22	316
Balance at December 31	$ 4,074	$ 45	$ 945	$ 113	$ 5,177
Ending balance individually evaluated for impairment	$ 538	$ -	$ 92	$ -	$ 630
Ending balance collectively evaluated for impairment	3,536	45	853	113	4,547
Total	$ 4,074	$ 45	$ 945	$ 113	$ 5,177
December 31, 2013					
Balance at January 1	$ 4,158	$ 57	$ 1,105	$ 135	$ 5,455
Provision for loan losses	154	26	504	66	750
Loans charged off	(772)	(50)	(590)	(85)	(1,497)
Recoveries	497	17	15	1	530
Balance at December 31	$ 4,037	$ 50	$ 1,034	$ 117	$ 5,238
Ending balance individually evaluated for impairment	$ 448	$ -	$ 161	$ -	$ 609
Ending balance collectively evaluated for impairment	3,589	50	873	117	4,629
Total	$ 4,037	$ 50	$ 1,034	$ 117	$ 5,238

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

Commercial loans also include demand deposit loan account charge-offs and recoveries amounting to $174,000 and $111,000, respectively, for the year ended December 31, 2015; $187,000 and $109,000, respectively, for the year ended December 31, 2014; and $226,000 and $127,000, respectively, for the year ended December 31, 2013.

The following is a summary of the recorded investment in loans, by portfolio segment and based on impairment method, as of December 31, 2015, and 2014 (in thousands):

December 31, 2015:	**Commercial including Commercial Real Estate**	**Consumer**	**Real Estate Mortgage 1st Lien**	**Real Estate Mortgage Junior Lien**	**Total**
Ending balance individually evaluated for impairment	$ 2,546	$ 47	$ 1,919	$ 31	$ 4,543
Ending balance collectively evaluated for impairment	336,828	6,292	63,928	10,398	417,446
Ending balance	$ 339,374	$ 6,339	$ 65,847	$ 10,429	$421,989
December 31, 2014:					
Ending balance individually evaluated for impairment	$ 2,538	$ 24	$ 2,507	$ 98	$ 5,167
Ending balance collectively evaluated for impairment	323,239	6,682	64,818	10,206	404,945
Ending balance	$ 325,777	$ 6,706	$ 67,325	$ 10,304	$410,112

The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2015, and December 31, 2014 (in thousands):

December 31, 2015	**Unpaid Principal Balance**	**Recorded Investment**	**Allowance for Loan Losses Allocated**
With no related allowance recorded:			
Commercial	$ 149	$ 149	$ -
Real estate - commercial	1,206	1,206	-
Real estate - construction	86	86	-
Real estate mortgage	690	655	-
Consumer	47	47	-
With an allowance recorded:			
Commercial	252	212	254
Real estate - commercial	343	313	10
Real estate - construction	-	-	-
Real estate mortgage	1,875	1,875	170
Consumer	-	-	-
Total	$ 4,648	$ 4,543	$ 434

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2014	**Unpaid Principal Balance**	**Recorded Investment**	**Allowance for Loan Losses Allocated**
With no related allowance recorded:			
Commercial	$ 26	$ 26	$ -
Real estate - commercial	94	94	-
Real estate - construction	88	88	-
Real estate mortgage	1.239	1,239	-
Consumer	24	24	-
With an allowance recorded:			
Commercial	421	363	302
Real estate - commercial	1,423	1,393	105
Real estate - construction	-	-	-
Real estate mortgage	2,011	1,940	223
Consumer	-	-	-
Total	$ 5,326	$ 5,167	$ 630

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

	2015	**2014**	**2013**
Average balance of impaired loans during the year	$ 4,855	$ 6,720	$ 8,630
Cash basis interest income recognized during the year	$ 146	$ 204	$ 300
Interest income recognized during the year	$ 192	$ 201	$ 309

The Company's loan portfolio also includes certain loans that have been modified in a 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.

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 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.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The following table summarizes the number and volume of TDRs the Company has recorded in its loan portfolio as of December 31, 2015, and 2014, as well as the number of TDR loans added each year and the amount of specific reserves in the allowance for loan losses relating to TDRs (dollars in thousands):

	Total			Added During the Year		
December 31, 2015	**Number of Loans**	**Amount**	**Specific Reserves Allocated**	**Number of Loans**	**Amount**	**Specific Reserves Allocated**
Commercial	3	$ 100	$ 4	-	$ -	$ -
Real estate - commercial	9	1,856	99	3	523	89
Real estate - construction	-	-	-	-	-	-
Real estate - mortgage	14	1,321	73	1	41	-
Consumer	-	-	-	-	-	-
Total	26	$ 3,277	$ 176	4	$ 564	$ 89
December 31, 2014						
Commercial	7	$ 220	$ 9	-	$ -	$ -
Real estate - commercial	6	1,416	105	1	141	56
Real estate - construction	-	-	-	-	-	-
Real estate - mortgage	14	1,333	84	-	-	-
Consumer	-	-	-	-	-	-
Total	27	$ 2,969	$ 198	1	$ 141	$ 56

The modification of the terms of loans that resulted in a TDR included one or a combination of a reduction of the stated interest rate of the loan or an extension of the maturity date or amortization period. The post-modified loan balance for TDR's was essentially the same as the pre-modified balance.

The Company has not committed to lend any additional funds to these borrowers.

Two loans that were modified as TDRs during 2015, totaling $510,000, are in default of the terms of their restructured agreements as of December 31, 2015.

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of December 31, 2015, and December 31, 2014, by class of loans (in thousands):

December 31, 2015	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	$ -	$ -	$ -	$ -	$ 270	$ 87,288	$ 87,558
Real estate - commercial	1,370	299	991	2,660	215	218,430	221,305
Real estate - construction	-	-	-	-	86	20,676	20,762
Real estate mortgage	173	54	-	227	1,210	83,284	84,721
Consumer	16	21	-	37	46	7,560	7,643
Total	$ 1,559	$ 374	$ 991	$ 2,924	$ 1,827	$ 417,238	$ 421,989

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2014	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	$ 22	$ 59	$ -	$ 81	$ 188	$ 81,669	$ 81,938
Real estate - commercial	110	128	269	507	269	208,081	208,857
Real estate - construction	-	-	-	-	88	21,465	21,553
Real estate mortgage	257	-	-	257	1,861	88,017	90,135
Consumer	42	11	5	58	24	7,547	7,629
Total	$ 431	$ 198	$ 274	$ 903	$ 2,430	$ 406,779	$ 410,112

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:

Pass: Loans classified as pass have no existing or known potential weaknesses deserving of management's close attention.

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.

As of December 31, 2015, and December 31, 2014, based on the most recent analysis performed, the risk category of loans by class of loans was as follows (in thousands):

December 31, 2015	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial	$ 81,272	$ 5,890	$ 396	$ -	$ -	$ 87,558
Real estate - commercial	203,427	16,109	1,769	-	-	221,305
Real estate - construction	15,157	197	86	-	5,322	20,762
Real estate - mortgage	10,919	2,062	1,031	-	70,709	84,721
Consumer	659	-	-	-	6,984	7,643
Total	$ 311,434	$ 24,258	$ 3,282	$ -	$ 83,015	$ 421,989

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

December 31, 2014	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial	$ 78,045	$ 3,511	$ 382	$ -	$ -	$ 81,938
Real estate - commercial	192,344	14,154	2,359	-	-	208,857
Real estate - construction	16,156	306	263	-	4,828	21,553
Real estate - mortgage	14,242	1,505	1,539	-	72,849	90,135
Consumer	185	20	-	-	7,424	7,629
Total	$ 300,972	$ 19,496	$ 4,543	$ -	$ 85,101	$ 410,112

NOTE E – PREMISES AND EQUIPMENT, NET

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

	2015	2014
Land	$ 2,339	$ 2,267
Buildings and improvements	18,269	17,224
Furniture and equipment	5,825	5,430
	26,433	24,921
Less accumulated depreciation	(13,748)	(13,023)
Totals	$ 12,685	$ 11,898

Depreciation of premises and equipment charged to operations was $815,000, $810,000, and $859,000 in 2015, 2014, and 2013, respectively.

Rent expense under operating leases amounted to $156,000, $133,000 and $135,000 in 2015, 2014, and 2013, respectively.

Lease commitments under noncancelable operating equipment leases at December 31, 2015, were as follows (in thousands):

2016	$ 187
2017	101
2018	76
2019	77
2020	78
Thereafter	1,109
Total	$ 1,628

NOTE F – OTHER INTANGIBLE ASSETS

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

	2015	2014
Gross carrying amount	$ 3,122	$ 3,122
Accumulated amortization	(2,633)	(2,361)
Unamortized balance	$ 489	$ 761

Amortization of core deposit intangible assets for the years ended December 31, 2015, 2014, and 2013 was $272,000, $284,000 and $296,000, respectively.

Estimated future amortization of core deposit intangible assets for each of the years subsequent to December 31, 2015, is as follows (in thousands):

2016	$ 260
2017	229

NOTE G – DEPOSITS

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

	2015	2014
Non-interest bearing checking	$ 101,186	$ 90,191
Interest bearing checking	145,742	127,298
Savings	72,626	66,869
Money market accounts	69,084	79,577
Time deposits	88,847	80,335
Totals	$ 477,485	$ 444,270

The carrying amount of time deposits over $250,000 at December 31, 2015, and 2014, was $11,480,000 and $15,454,000, respectively. Interest expense on these deposits was $85,000, $210,000, and $513,000 for the years ended December 31, 2015, 2014, and 2013, respectively.

At December 31, 2015, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2016	$ 40,481
2017	21,452
2018	9,446
2019	7,124
2020	10,344
Total	$ 88,847

Related party deposits were $12,826,000 and $14,510,000 at December 31, 2015, and 2014, respectively.

NOTE H – OTHER BORROWINGS

Other borrowings at December 31, 2015, and 2014, totaled $10,000,000 as of each date and consisted of advances from the Federal Home Loan Bank (FHLB) of Indianapolis. The December 31, 2015, borrowings have a fixed interest rate of 1.93% and principal due at maturity, June 26, 2020. The December 31, 3014, borrowings had a variable interest rate (0.43% at December 31, 2014) and principal was due at maturity, June 29, 2015.

Advances from the FHLB are secured by a blanket collateral agreement, 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, 2015, was approximately $73,207,000.

NOTE I – 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):

	2015	2014
At December 31:		
Outstanding balance	$ 15,943	$ 14,644
Average interest rate	0.20%	0.19%
Daily average for the year:		
Outstanding balance	$ 14,428	$ 14,713
Average interest rate	0.20%	0.19%
Maximum outstanding at any month end	$ 17,920	$ 15,598

At December 31, 2015, the Bank had a $3,000,000 line of credit arrangement available to purchase federal funds, with no outstanding borrowings.

NOTE J – SUBORDINATED DEBENTURES AND TRUST PREFERRED SECURITIES

In March 2004, Southern Michigan Bancorp Capital Trust I, a trust formed by the Company, closed a pooled private offering of 5,000 trust preferred securities with a liquidation amount of $1,000 per security. The Company issued $5,155,000 of subordinated debentures to the trust in exchange for ownership of all of the common 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, 2015, was 3.07%. Interest expense related to the subordinated debentures amounted to $154,000 in 2015, $151,000 in 2014, and $152,000 in 2013. The Company's investment in the common stock of the trust is $155,000 and is included in other assets.

NOTE K – INCOME TAXES

Income tax provision consists of the following (in thousands):

	2015	2014	2013
Current	$ 2,444	$ 2,306	$ 1,778
Deferred	(494)	(495)	(51)
Total income tax provision	$ 1,950	$ 1,811	$ 1,727

The deferred income tax credit consists of the tax effect of temporary differences, including the impact in 2013 of utilization of $350,000 of alternative minimum tax credit carryforwards.

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

	2015	2014	2013
Income tax at statutory rate	$ 2,637	$ 2,245	$ 2,117
Tax-exempt interest income, net	(354)	(337)	(348)
Earnings on life insurance assets	(290)	(109)	(114)
Low income housing partnership tax credits	(11)	-	-
Other items, net	(32)	12	72
Totals	$ 1,950	$ 1,811	$ 1,727

NOTE K – INCOME TAXES (CONTINUED)

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

	2015	2014
Deferred tax assets:		
Allowance for loan losses	$ 1,799	$ 1,769
Deferred compensation and supplemental retirement liability	1,343	1,097
Pension liability	-	190
Nonaccrual loan interest	177	108
Stock based compensation	235	220
Other	470	378
Total deferred tax assets	4,024	3,762
Deferred tax liabilities:		
Mortgage servicing rights	(487)	(459)
Goodwill	(211)	(211)
Purchase accounting adjustments	(237)	(331)
Net unrealized gain on available for sale securities	(213)	(83)
Depreciation	(287)	(262)
Other	(135)	(105)
Total deferred tax liabilities	(1,570)	(1,451)
Net deferred tax assets, included in other assets	$ 2,454	$ 2,311

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 2012.

The Company believes that it had no significant uncertain tax positions as of December 31, 2015, and 2014.

NOTE L – BENEFIT PLANS

Defined Benefit Pension Plan:

Effective September 1, 2015, The Southern Michigan Bank & Trust Pension Plan (Pension Plan) was terminated. The Company uses a December 31 measurement date for the Pension Plan.

Information about the Pension Plan is as follows (in thousands):

	2015	2014
Change in projected benefit obligation:		
Beginning benefit obligation	$ (2,168)	$ (1,909)
Interest cost	(96)	(93)
Actuarial loss	(103)	(204)
Benefits paid	2,367	38
Ending benefit obligation	-	(2,168)
Change in plan assets, at fair value:		
Beginning plan assets	1,580	1,158
Actual return	30	48
Employer contributions	783	438
Benefits paid	(2,367)	(38)
Plan expenses paid	(26)	(26)
Ending plan assets	-	1,580
Net amount recognized in accrued expenses and other liabilities–funded status	$ -	$ (588)

The accumulated benefit obligation for the Pension Plan was $0 and $2,168,000 at December 31, 2015, and 2014, respectively.

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

	2015	2014	2013
Components of net periodic benefit cost:			
Service cost, including plan expenses	$ 26	$ 26	$ 26
Interest cost	96	93	98
Expected return on plan assets	(47)	(41)	(101)
Recognized net actuarial loss	265	264	49
Settlement adjustment	413	-	188
Net periodic benefit cost	$ 753	$ 342	$ 260

At December 31, 2015, and 2014, net actuarial losses of $0 and $558,000, respectively, have not yet been recognized as a component of net periodic benefit cost. No net loss will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2016.

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

	2015	2014	2013
Discount rate on benefit obligation	4.5%	4.5%	4.0%
Long-term expected rate of return on plan assets	3.0%	3.0%	6.0%
Rate of compensation increase	N/A	N/A	N/A

NOTE L – BENEFIT PLANS (CONTINUED)

Asset Category	Target Allocation 2016	Percentage of Plan Assets at Year-end 2015	Percentage of Plan Assets at Year-end 2014	Weighted Average Long-Term Rate of Return - 2015
Equity securities	0%	0%	0%	0%
Debt securities	0%	0%	0%	0%
Cash and time certificates	0%	0%	100%	.20%
	0%	0%	100%	.20%

Prior to the Pension Plan termination, the pension plan assets were managed by the Bank's Trust Department. A written investment policy which we believed met the standards of the prudent investor rule was followed. In addition, Main Street Advisors, of Chicago, provided investment advisory services, guidance, and expertise.

Investments or debt obligations of Southern Michigan Bancorp, Inc. were not allowed as holdings within the Pension Plan.

The investments in the Pension Plan were managed for the benefit of the participants. They were structured to meet the cash flow necessary to pay retiring employees. ERISA guidelines for diversification of the investments were followed in all material respects and given due consideration to the plan's frozen status.

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

The fair value of Pension Plan assets at December 31, 2015, amounted to $0. There were no Pension Plan assets measured at fair value using significant unobservable inputs (Level 3) as of or for the years ended December 31, 2015, or 2014.

At December 31, 2015, there are no estimated future benefit payments from the Pension Plan as it was terminated in 2015 and all benefits were paid out.

NOTE L – BENEFIT PLANS (CONTINUED)

Employee Stock Ownership Plan: The Company has an employee stock ownership plan (ESOP) for substantially all full-time employees. The ESOP 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 ESOP are held in trust by the Bank and administrative costs of the ESOP are borne by the Company. Expense charged to operations for contributions to the ESOP totaled $246,000, $241,000, and $239,000 in 2015, 2014, and 2013, respectively.

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

	2015	2014
Allocated shares	129,806	133,227
Unallocated shares	12,000	762
Total ESOP shares	141,806	133,989

The fair value of allocated shares held by the ESOP is $3,291,000 and $2,804,000 at December 31, 2015, and 2014, 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. In 2015, for all periods covered, these amounts were reclassified from liabilities into shareholders' equity in accordance with ASC 718-40-25 *Employee Stock Ownership Plans*.

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, 2015, ranged from 3.92% to 6.82%. There were two new participants in the plan during 2015. Deferred compensation expense was $266,000, $228,000, and $210,000 in 2015, 2014, and 2013, respectively. The liability for deferred compensation benefits was $2,582,000 and $2,398,000 at December 31, 2015, and 2014, respectively, and is included in accrued expenses and other liabilities in the accompanying consolidated balance sheets.

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. The SERP was terminated in 2015 for current executives. Expense associated with the SERP totaled $48,000, $9,000, and $14,000 in 2015, 2014, and 2013, respectively. Liabilities associated with the SERP totaled $188,000 and $158,000 at December 31, 2015, and 2014, 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 terminated 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. Expense associated with the 2011 SERP amounted to $507,000 in 2015, $392,000 in 2014, and $108,000 in 2013. Liabilities associated with the 2011 SERP totaled $1,179,000 and $672,000 at December 31, 2015, and 2014, respectively.

NOTE M – STOCK BASED COMPENSATION

The Company has stock based compensation plans as described below. Total compensation cost charged against income for those plans was $291,000, $246,000, and $213,000 in 2015, 2014, and 2013, respectively.

On May 8, 2014, shareholders of the Company approved the Southern Michigan Bancorp, Inc. Stock Incentive Plan of 2014 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 400,000 shares of common stock are available under the plan. At December 31, 2015, 375,175 shares were available for issuance under the plan.

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

	2015	**2014**	**2013**
Risk-free interest rate	0.67%	0.38%	0.27%
Expected option life	8 years	8 years	8 years
Expected stock price volatility	23.26%	23.62%	23.58%
Dividend yield	2.84%	2.81%	2.82%
Weighted-average fair value of options granted during year	$3.80	$2.70	$2.51

NOTE M – STOCK BASED COMPENSATION (CONTINUED)

A summary of the activity in the stock based compensation plans for 2015 follows:

Stock Options

	Shares Subject to Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	162,366	$ 22.55		
Granted	7,775	21.05		
Exercised	(42,486)	20.41		
Forfeited	(25,290)	25.76		
Outstanding at end of year	102,365	$ 22.54	2.5 years	$ 288,000
Exercisable at year-end	86,815	$ 23.13	1.4 years	$ 193,000

	2015	2014	2013
Intrinsic value of options exercised	$140,000	$77,000	$155,000
Cash received from option exercise	867,000	179,000	288,000
Tax benefit realized from option exercises	127,000	88,000	-

As of December 31, 2015, there was $15,000 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 one year.

Restricted Stock – Restricted shares may be issued under the 2014 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, 2015, 2014, and 2013 was $341,000, $267,000, and $265,000, respectively. As of December 31, 2015, there was $630,000 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 2.7 years.

A summary of activity for restricted stock for 2015 follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2015	48,515	$ 14.99
Granted	17,050	21.05
Vested	(15,885)	21.45
Nonvested at December 31, 2015	49,680	$ 17.47

NOTE N – COMMITMENTS

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

At December 31, 2015, and 2014, 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, 2015, and 2014, commitments under outstanding standby letters of credit were $6,584,000 and $3,233,000, respectively.

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

	2015	2014
Fixed rate	$ 10,292	$ 8,833
Variable rate	102,809	99,840
Totals	$ 113,101	$ 108,673

The fixed rate commitments have stated interest rates ranging from 1.25% to 15.00%. The terms of the above commitments range from 1 to 240 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 O – 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, 2015, using the most restrictive of these conditions, the aggregate cash dividends that the Bank could pay the Company without prior regulatory approval was approximately $14.0 million.

NOTE P – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents the activity and accumulated balances for the components of other comprehensive income (loss) for the years ended December 31, 2015, and 2014 (in thousands):

	Unrealized Gains (Losses) Available-for-Sale Securities	Defined Benefit Pension Plan	Total Accumulated Other Comprehensive Income (Loss)
Balance at January 1, 2014	$ (305)	$ (412)	$ (717)
Other comprehensive income (loss) before reclassifications	795	(197)	598
Amounts reclassified from accumulated other comprehensive income (loss)	(90)	264	174
Current year other comprehensive income (loss), before tax	705	67	772
Income tax effect	(240)	(23)	(263)
Current year other comprehensive income (loss), net of tax	465	44	509
Balance at December 31, 2014	$ 160	$ (368)	$ (208)
Other comprehensive income (loss) before reclassifications	410	293	703
Amounts reclassified from accumulated other comprehensive income (loss)	(26)	265	239
Current year other comprehensive income (loss), before tax	384	558	942
Income tax effect	(130)	(190)	(320)
Current year other comprehensive income (loss), net of tax	254	368	622
Balance at December 31, 2015	$ 414	$ -	$ 414

The pre-tax amount reclassified from accumulated other comprehensive income for available-for-sale securities is reported as "net securities gains" in the 2015 consolidated statement of income. The pre-tax amount reclassified from accumulated other comprehensive loss for the defined benefit pension plan is included in the computation of net periodic pension costs as "recognized net actuarial loss" as disclosed in Note L.

Accumulated other comprehensive gain/(loss) amounted to $414,000 at December 31, 2015, and $(208,000) at December 31, 2014, consisting of the following (in thousands):

	2015	2014
Unrealized gain on available-for-sale securities, net of income taxes of $213 in 2015 and $83 in 2014	$ 414	$ 160
Pension liability, net of income taxes of $0 in 2015 and $190 in 2014	-	(368)
Total	$ 414	$ (208)

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

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

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

Balance Sheets	**December 31,**	
	2015	**2014**
Assets		
Cash and cash equivalents	$ 444	$ 645
Investment in subsidiary bank	70,877	66,193
Investment in non-banking subsidiary	182	183
Premises and equipment, net	791	751
Other assets	1,055	943
Total Assets	$ 73,349	$ 68,715
Liabilities and Shareholders' Equity		
Dividends payable	$ 385	$ 361
Other liabilities	40	39
Subordinated debentures	5,155	5,155
Shareholders' equity	67,769	63,160
Total Liabilities and Shareholders' Equity	$ 73,349	$ 68,715

Statements of Income	**Year ended December 31,**		
	2015	**2014**	**2013**
Dividends from subsidiary bank	$ 2,005	$ 1,686	$ 1,461
Interest income	5	-	1
Interest expense	(157)	(151)	(152)
Rental income from subsidiary bank	137	137	137
Other expenses	(380)	(396)	(332)
	1,610	1,276	1,115
Federal income tax credit	(135)	(140)	(118)
	1,745	1,416	1,233
Equity in net income, less dividends received from:			
Subsidiary bank	4,062	3,378	3,267
Non-banking subsidiary	(1)	(2)	(1)
Net Income	$ 5,806	$ 4,792	$ 4,499

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

Statements of Cash Flows	Year ended December 31, 2015	2014	2013
Operating Activities			
Net income	$ 5,806	$ 4,792	$ 4,499
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received from:			
Subsidiary bank	(4,062)	(3,378)	(3,267)
Non-banking subsidiary	1	2	1
Stock option and restricted stock grant compensation expense	290	246	213
Depreciation of premises and equipment	31	31	31
Net change in obligation under ESOP	(257)	-	35
Other, net	16	(46)	12
Net cash from operating activities	1,825	1,647	1,524
Investing Activities			
Additions to premises and equipment	(71)	-	-
Net cash from investing activities	(71)	-	-
Financing Activities			
Repayments of other borrowings	(319)	-	-
Proceeds from other borrowings	319	-	-
Cash dividends paid	(1,494)	(1,347)	(1,173)
Stock options exercised	867	267	288
Repurchase of common stock	(1,328)	(331)	(448)
Net cash from financing activities	(1,955)	(1,411)	(1,333)
Net change in cash and cash equivalents	(201)	236	191
Beginning cash and cash equivalents	645	409	218
Ending cash and cash equivalents	$ 444	$ 645	$ 409

NOTE R – SUPPLEMENTAL CASH FLOW DISCLOSURES

The following supplemental cash flow disclosures are provided for the years ended December 31, 2015, 2014, and 2013 (in thousands):

	2015	2014	2013
Cash paid during the year for:			
Interest	$ 1,613	$ 1,624	$ 2,168
Income taxes	2,155	2,070	1,920
Non-cash operating activities:			
Change in deferred income taxes on net unrealized gain (loss) on available for sale securities	130	240	(570)
Change in deferred income taxes on pension liability	190	23	46
Change in pension liability	(558)	(67)	(138)
Non-cash investing activities:			
Change in unrealized gain (loss) on available for sale securities	384	705	(1,676)
Transfers from loans to other real estate owned	559	1,871	1,930
Transfers of land and building to other real estate owned	-	325	-

NOTE S – FAIR VALUE INFORMATION

The following methods and assumptions were used by the Company in estimating fair values for financial instruments, as well as an indication of where the instrument falls within the fair value hierarchy, which is described in greater detail in Note T.

Cash and cash equivalents: The carrying amount reported in the balance sheet approximates fair value resulting in a level 1 classification.

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. Securities are classified as either level 1, 2, or 3. See Footnote T for the hierarchy level breakdown.

Loans, net: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a level 3 classification. 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 resulting in a level 3 classification. The allowance for loan losses is considered to be a reasonable estimate of discount for credit quality concerns.

Loans held for sale: The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a level 2 classification.

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) resulting in a level 2 classification. 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 resulting in a level 2 classification.

Securities sold under agreements to repurchase, overnight borrowings and federal funds sold: The carrying amount reported in the balance sheet approximates fair value resulting in a level 2 classification.

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 resulting in a level 2 classification.

Subordinated debentures: The carrying amount reported in the balance sheet approximates fair value of the variable-rate subordinated debentures. The fair value is estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a level 3 classification.

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

NOTE S – FAIR VALUE INFORMATION (CONTINUED)

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, 2015, and 2014, 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, 2015, and 2014 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):

	Fair Value Hierarchy	2015		2014	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 13,487	$ 13,487	$ 15,374	$ 15,374
Federal funds sold	Level 1	6,941	6,941	247	247
Securities available for sale	See Note T	97,150	97,150	72,880	72,880
Loans held for sale	Level 3	328	328	483	483
Loans, net of allowance for loan losses	Level 3	416,716	414,852	404,935	405,137
Accrued interest receivable	Level 1	2,517	2,517	2,378	2,378
Financial liabilities:					
Deposits	Level 2	$ (477,485)	$ (478,296)	$ (444,270)	$ (444,858)
Securities sold under agreements to repurchase and overnight borrowings	Level 1	(15,943)	(15,943)	(14,644)	(14,644)
Other borrowings	Level 2	(10,000)	(9,844)	(10,000)	(10,001)
Subordinated debentures	Level 3	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	Level 1	(91)	(91)	(77)	(77)

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.

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

NOTE T – 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 T – 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 or at estimated discounted cash flows if the credit is performing. 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 and level 3 inputs, including recent appraisals and customized discounting criteria including discounting of appraisals based on age or changes in property or market conditions. These discounts generally range from 10% to 55%, and include a discount for estimated selling costs of 10%. Estimated cash flows are discounted considering the loan rate and current market rates and generally range from 3.6% to 10.5%. 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 discounted appraisals and reflect a market value approach. These discounts generally range from 25% to 55%. Due to the significance of unobservable inputs used in estimating fair value, OREO has been classified as level 3.

The following table summarizes financial and nonfinancial assets (there were no financial or nonfinancial liabilities) measured at fair value as of December 31, 2015, and 2014, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

2015	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
Recurring:				
Securities available for sale:				
U.S. Treasuries	$ 6,963	$ -	$ -	$ 6,963
Federal agencies	32,330	-	-	32,330
States and political subdivisions	-	34,811	19,160	53,971
Mortgage-backed securities	-	12	-	12
Corporate security	3,874	-	-	3,874
Total available for sale	$ 43,167	$ 34,823	$ 19,160	$ 97,150
Nonrecurring:				
Impaired loans	$ -	$ -	$ 4,109	$ 4,109
Other real estate owned:				
Commercial	$ -	$ -	$ 958	$ 958
Residential Real Estate	$ -	$ -	$ 56	$ 56

NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)

2014	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Recurring:				
Securities available for sale:				
U.S. Treasuries	$ 6,929	$ -	$ -	$ 6,929
Federal agencies	26,949	-	-	26,949
States and political subdivisions	-	33,996	4,196	38,192
Mortgage-backed securities	-	19	-	19
Corporate security	791	-	-	791
Total available for sale	$ 34,669	$ 34,015	$ 4,196	$ 72,880
Nonrecurring:				
Impaired loans	$ -	$ -	$ 4,537	$ 4,537
Other real estate owned:				
Commercial	$ -	$ -	$ 2,721	$ 2,721
Residential Real Estate	-	-	439	439

Impaired loans are reported net of an allowance for loan losses of $434,000 at December 31, 2015, and $630,000 at December 31, 2014.

Other real estate owned, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount as of December 31, 2015, of $1,014,000, which is made up of the balance of $1,144,000, net of a valuation allowance of $130,000. Other real estate owned had a net carrying amount of $3,160,000, made up of the balance of $3,398,000, net of a valuation allowance of $238,000, at December 31, 2014.

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 years ended December 31, 2015, and 2014 (in thousands):

	2015	2014
Balance at January 1	$ 4,196	$ 2,713
Net maturities and calls	(4,550)	(484)
Unrealized net gains/(losses) included in other comprehensive income	(81)	14
Purchases	14,330	1,953
Transfers to level 3	5,265	-
Balance at December 31	$ 19,160	$ 4,196

NOTE U – 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. These capital requirements were modified in 2013 with the Basel III capital rules, which establish a new comprehensive capital framework for U.S. banking organizations. The Company and Bank became subject to the new rules on January 1, 2015, with a phase-in period for many of the new provisions.

NOTE U – REGULATORY MATTERS (CONTINUED)

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, among other things, accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

In February of 2015, the Board of Governors of the Federal Reserve System adopted final amendments to the Small Bank Holding Company Policy Statement (Regulation Y, Appendix C) (the "Policy Statement") that, among other things, raised from $500 million to $1 billion the asset threshold to qualify for the Policy Statement. The Company qualifies for treatment under the Policy Statement and is no longer subject to consolidated capital rules.

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**
2015						
Total Capital to risk weighted assets						
Consolidated	$64,077	13.3%	N/A	N/A	N/A	N/A
Bank	62,185	12.9	38,548	8.0%	$48,186	10.0%
Tier 1 (Core) Capital to risk weighted assets						
Consolidated	58,804	12.2	N/A	N/A	N/A	N/A
Bank	56,912	11.8	28,911	6.0	38,548	8.0
Common Tier 1 Capital to risk weighted assets (CET1)*						
Consolidated	58,804	12.2	N/A	N/A	N/A	N/A
Bank	56,912	11.8	21,684	4.5	31,321	6.5
Tier 1 (Core) Capital to average assets						
Consolidated	58,804	10.2	N/A	N/A	N/A	N/A
Bank	56,912	9.9	23,025	4.0	28,782	5.0

*The CET-1 ratio was effective January 1, 2015.

	Amount	Ratio	Amount	Ratio	Amount	Ratio
2014						
Total capital (to risk weighted assets)						
Consolidated	$59,486	13.6%	$34,971	8.0%	N/A	N/A
Bank	57,519	13.2	34,850	8.0	$43,562	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	54,309	12.4	17,486	4.0	N/A	N/A
Bank	52,342	12.0	17,425	4.0	26,137	6.0
Tier 1 capital (to average assets)						
Consolidated	54,309	10.3	21,184	4.0	N/A	N/A
Bank	52,342	9.9	21,133	4.0	26,417	5.0

NOTE V – QUALIFIED AFFORDABLE HOUSING PROJECT INVESTMENTS

The Company invests in qualified investment housing projects. At December 31, 2015, and 2014, the balance of the investment for qualified affordable housing projects was $488,000 and $500,000. These balances are reflected in the other assets line on the consolidated balance sheets. Total unfunded commitments related to the investments in qualified affordable housing projects totaled $433,000 and $462,000 at December 31, 2015, and 2014. The Company expects to fulfill these commitments during the year ending 2029.

During the years ended December 31, 2015, and 2014, the Company recognized amortization expense of $11,000 and $0, respectively, which was included within income tax expense on the consolidated statements of income.

Additionally, during the years ended December 31, 2015, and 2014, the Company recognized tax credits and other benefits from its investment in affordable housing tax credits of $14,000 and $0, respectively.

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
2015						
First Quarter	$ 5,125	$ 4,745	$ 75	$ 1,209	$ .50	$ .50
Second Quarter	5,249	4,849	75	1,880	.78	.78
Third Quarter	5,391	4,966	50	1,523	.64	.64
Fourth Quarter	5,430	5,008	50	1,194	.50	.50
2014						
First Quarter	$ 4,997	$ 4,534	$ -	$ 1,102	$ .46	$ .46
Second Quarter	5,060	4,664	225	1,146	.48	.48
Third Quarter	5,103	4,715	100	1,292	.54	.54
Fourth Quarter	5,160	4,794	75	1,252	.51	.51

SELECTED FINANCIAL DATA

(in thousands, except per share data)

	Year Ended December 31				
	2015	2014	2013	2012	2011
Total interest income	$ 21,195	$ 20,320	$ 19,915	$ 19,991	$ 19,387
Net interest income	19,568	18,707	17,767	17,174	15,636
Provision for loan losses	250	400	750	1,350	1,050
Net income	5,806	4,792	4,499	4,350	3,402
Per share data					
Basic and diluted earnings per share	2.42	1.99	1.88	1.84	1.46
Cash dividends declared	.63	.58	.50	.37	.22
Balance sheet data:					
Gross loans	421,989	410,112	386,011	369,605	332,804
Deposits	477,485	444,270	450,400	444,170	420,511
Other borrowings	10,000	10,000	-	1,039	7,751
Equity	67,769	63,160	59,074	56,700	53,161
Total assets	582,771	543,345	539,459	528,860	509,220
Return on average assets	1.02%	.87%	.84%	.84%	.68%
Return on average equity (1)	8.82	7.79	7.72	7.84	6.62
Dividend payout ratio (2)	26.15	29.15	26.65	20.23	15.23
Average equity to average assets (1)	11.52	11.18	10.94	10.73	10.23

(1) Average equity used in the above table includes common shares subject to a repurchase obligation held in the Company's ESOP plan and 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 Pink under the symbol SOMC. The sale 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 7, 2016, there were 2,417,561 shares of Southern common stock issued and outstanding held by 347 holders of record.

The following table sets forth the range of high and low closing sales prices and dividends declared on the Company's common stock for the two most recent fiscal years:

	2014			2015		
	Closing Price		Cash Dividends Declared	Closing Price		Cash Dividends Declared
Quarter Ended	High	Low		High	Low	
March 31	$ 17.75	$ 17.30	$ .13	$ 23.51	$ 21.05	$ .15
June 30	19.25	17.51	.15	23.10	21.95	.16
September 30	20.00	18.90	.15	24.54	22.50	.16
December 31	21.30	19.60	.15	25.71	24.01	.16

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