2018 ANNUAL REPORT

SOUTHERN MICHIGAN BANCORP, INC

View from inside Southern's Three Rivers Branch conference room.

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MESSAGE TO OUR SHAREHOLDERS

John Castle | Chairman and CEO

Southern Michigan Bancorp, Inc. attained record earnings of $8,125,000 in 2018, an increase of $2,704,000, or 49.9 percent, over 2017 results of $5,421,000. Earnings per share were $3.52 for 2018, compared to $2.30 in 2017. Fourth quarter net income was $1,824,000, or $0.79 per share, compared to $739,000, or $0.32 per share in the fourth quarter of 2017. The tax reform enacted in December, 2017 significantly impacted Southern's 2017 results as we incurred an income tax charge of $989,000, or $0.42 per share, in the fourth quarter. However, a strong earnings performance in 2018 allowed us to earn back $988,000 of the one time-charge in tax savings.

Southern's financial performance for 2018 was positively impacted by ongoing growth in the balance sheet, including loans and deposits; continued strong asset quality; lower federal income tax rates; and increased interest rates. Southern ended 2018 with total assets at a year-end record $738.8 million, which is $26.5 million higher than the 2017 level of $712.3 million. Loan totals increased to $532.0 million as of December 31, 2018, as compared to $523.4 million at year-end 2017. Deposits finished the year at a record high of $605.9 million. This was an increase of $28.8 million over December 31, 2017, which was $577.1 million.

Southern's return on average assets and return on average equity for 2018 was 1.11 percent and 11.21 percent, respectively. Our return on average tangible equity, which is total shareholders' equity, less goodwill and other intangibles, was 13.87 percent.

Delinquent loans at December 31, 2018 totaled $4.787 million, or 0.90 percent of gross loans. Non-performing assets totaled $5.642 million at year-end, or 0.77 percent of total assets. Southern's provision expense for loan losses totaled $250,000 for 2018, an increase of $75,000 from $175,000 in provision expense in 2017. The allowance for loan losses at December 31, 2018 was $5,117,000, or 0.96 percent of loans. Net charge-offs for 2018 totaled $142,000, or 0.03 percent of loan totals.

The board of directors approved an increase in the quarterly cash dividend from $0.21 per share to $0.22 per share, beginning with the July, 2018 dividend payment. The new annualized rate of $0.88 per share represented a dividend yield of 2.31 percent, based on the year-end market price of $38.10 per share.

> "Southern Michigan Bancorp, Inc. attained record earnings of $8,125,000 in 2018, an increase of $2,704,000, or 49.9 percent..."
>
> - John Castle

As a part of our ongoing strategy to develop the Kalamazoo/Portage region, we purchased Improved Funding Techniques, a wealth management firm owned by Joseph Spoerl, who has joined the bank as vice president and wealth management officer. Joe began his career working for American National and Old Kent Bank and has worked in Kalamazoo more than forty years. He brings a wealth of knowledge and has an extensive list of clients and contacts throughout the region.

Our continued growth and success in Kalamazoo County led to leasing a new office suite within the Trade Centre Complex in Portage, doubling the size of our former office. We anticipate moving into our new offices at 650 Trade Centre by late summer. Our Portage-based Business Development, Commercial Lending, and Wealth Management groups will be joined by Retail and Mortgage Lending personnel in the new offices.

This past year, Southern partnered with StrategyCorps, an industry-leading FinTech company based out of Nashville, Tennessee, to introduce a new line of rewards-based checking accounts. Our Premium and Perks Checking Accounts with Southern Rewards, powered by BaZing, offer attractive benefits for customers, including cell phone protection, ID theft aid, roadside assistance, $10,000 accidental death coverage, as well as exclusive access to over 450,000 national and local discounts for shopping, dining, travel and more. All of these features are housed in an easily accessible mobile app for smart phones and tablets. These new accounts have proven to be relevant and valuable to our customers, and we continue to receive positive feedback.

Our 2018 Annual Report highlights two important new clients of the bank. Comcast Urethane is a producer of polyurethane foam used in items such as exercise equipment, off-road truck cabs, safety products, medical equipment, and military and aerospace components. President and Owner Todd Cutter, along with General Manager Mark Warner, operate the 14,000 square foot facility in Marshall.

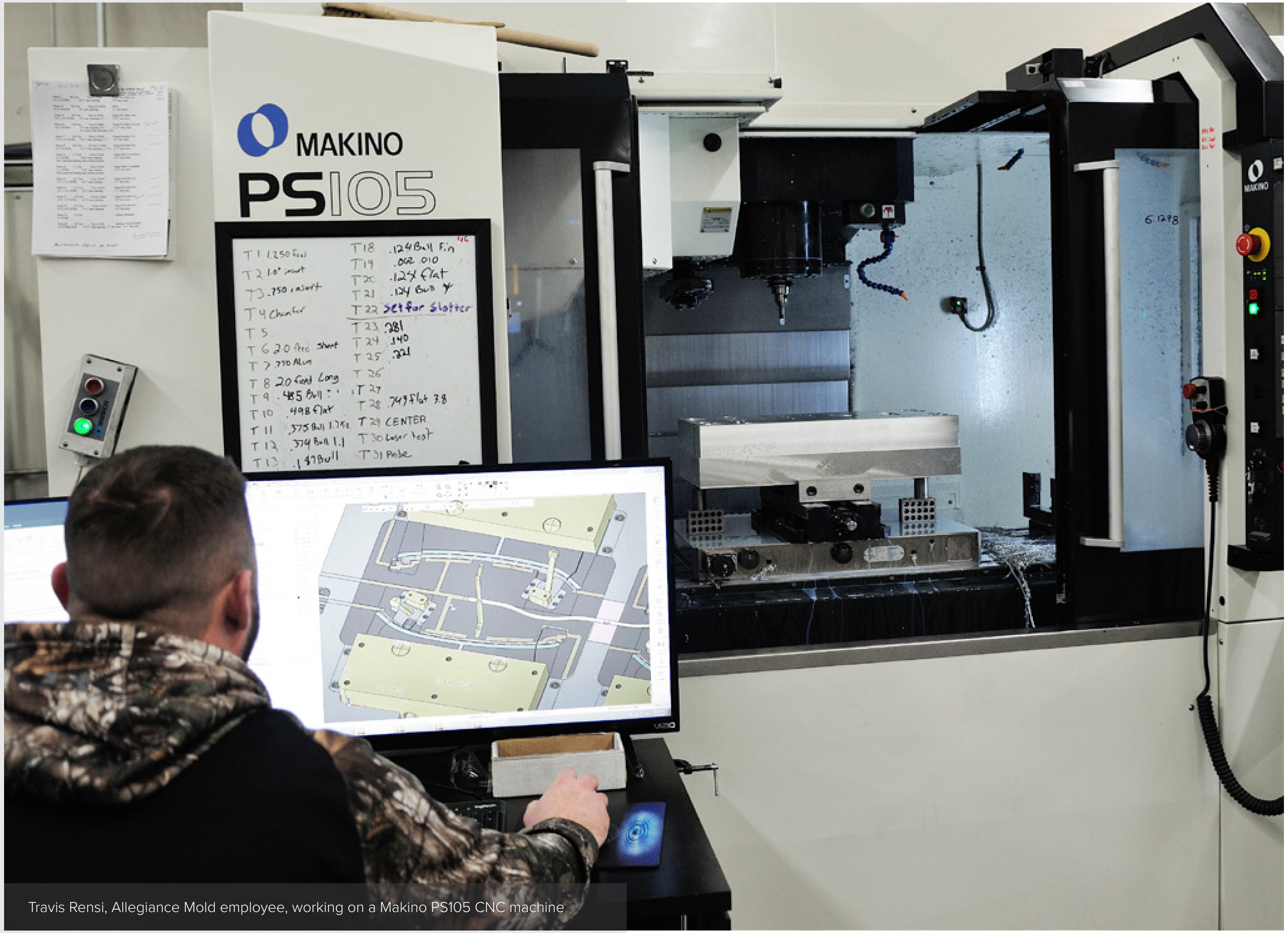
Allegiance Mold designs and manufactures molds to be used for injection molding primarily in the medical, automotive and furniture industries. President Ted Stender and his wife, Office Manager Erica Stender, founded their new company in 2018 in Portage.

Like Southern, these companies prioritize great customer service and a commitment to their employees, as well as their communities. We are proud to recognize and join in their success.

On behalf of Southern's directors, management team and staff, thank you for your continued support.

Sincerely,

John H. Castle
Chairman and Chief Executive Officer



Travis Rensi, Allegiance Mold employee, working on a Makino PS105 CNC machine

ALLEGIANCE MOLD

Employee Centered, Customer Focused, and Technology Driven

Ted Stender, president of Allegiance Mold in Portage, has worked in the mold making industry his whole life. "You start young and you don't get out of it," he says of himself, as well as Shop Director Matt Harmon, who began working in the field right out of high school. Founded in September, 2018, Allegiance Mold is a young company, featuring a skilled workforce of twelve employees. They design and manufacture steel and aluminum molds to be used for the injection molding process primarily in the medical, automotive, and furniture industries. Unique to their shop, employees are cross-trained, basically creating a production line, which allows multiple workers to focus on one mold in order to complete a project more quickly and efficiently. Most mold production manufacturers in the industry feature one person following the entire process from beginning to end; a slower and less efficient practice.

Allegiance Mold takes pride in using only American-made products, providing their clients with the highest quality materials. In addition to a superior product, they offer

Ted Stender explains Allegiance Mold's manufacturing processes to the Southern Team. (Pictured left to right) Kurt Miller, President of SMB&T; Tim Kilmartin, Kalamazoo Regional President; Ted Stender, President and Owner of Allegiance Mold; John Castle, Chairman and CEO of SMB&T; Erica Stender, Officer Manager of Allegiance Mold

outstanding service by making all their own deliveries and providing hands-on customer support. "If a customer calls, we are there," says Stender.

Truly a family business, all members have contributed to the success of the new company. Erica Stender worked as a nurse for Bronson Hospital for over twenty years before joining her husband as office manager. Their thirteen-year-old daughter came up with the name of the business (because of her dad's allegiance to his employees and customers) and their seventeen-year-old son designed the company logo.

It is the company's philosophy, however, that is key to its success. ECT - Employees, Customers, and Technology - describes their core belief that, "great employees will get you good customers and good customers will pay for technology." Ted Stender explains that all three are needed for them to thrive in such a highly technical business. His focus is on making sure his employees are allowed to grow with the company through training and advancement opportunities. Harmon adds, "It's a process of moving up and learning through experience."

> **Tim came to me with solutions before I even had to ask for them... He figured it out in a 'real' way rather than an 'unreal' way compared to other banks.**
>
> \- Ted Stender

The Allegiance Mold relationship with Southern Michigan Bank and Trust began on Thanksgiving Day at Biggby Coffee. Kalamazoo Regional President Tim Kilmartin met with Ted and Erica Stender to discuss the financial resources they needed to get Allegiance Mold up and running. "Tim came to me with solutions before I even had to ask for them," Ted Stender says. "He figured it out in a 'real' way rather than an 'unreal' way compared to other banks."

"From day one, we have been impressed with the whole team at Allegiance," said Kilmartin. "They brought incredible industry knowledge and have always done whatever it took to make the company a success. They have a strong focus on customer service and turning things around quickly. We have the same mindset at Southern so it makes them a great fit for us."

Erica Stender, Office Manager, discusses the origins of Allegiance Mold with Becky Olds, Marketing Coordinator of SMB&T, and Cammy Fleckenstein, Portage Branch Manager/Officer.

Allegiance utilizes many of Southern's products and services, such as business checking, personal accounts, commercial loan and commercial credit line, as well as eServices, including cash management, business bill pay, Remote Deposit Capture, mobile deposit, PayCards and corporate credit cards. Erica Stender appreciates Southern's hands-on approach to customer service that helped her gain confidence in her new role and continues to serve as a resource in navigating the business's everyday banking needs. "Their systems are definitely over and above what I have ever experienced in the past," she says. "When I have a question, I call and get a walk-through right over the phone. Everything has been very easy."

"I like looking back from the very beginning with all the road blocks and seeing what we have overcome," Harmon recalls. "I just like to reflect on everyone's success together as a team."

The Allegiance Mold team

COMCAST URETHANE

Simplifying Processes, Maintaining Transparency and Increasing Efficiency

"We've done some really great things, but our best days are still ahead of us," says Todd Cutter, president and owner of Comcast Urethane, as he shares the company's unique thirty-seven-year story. General Manager Mark Warner and Warehouse Manager Tina Galusha, have been part of the operation for thirty-five of those years, and Cutter credits their knowledge and experience for much of the company's success.

Comcast is a producer of molded microcellular urethane foam for industry. Serving over forty customers, the company manufactures parts for lift trucks, exercise equipment, off-road trucks and tractors, the commercial construction industry, and medical and safety products. Operating out of a 14,000 square-foot facility in Marshall, Michigan, Comcast holds a competitive advantage with pentane-blown foam. Pentane provides for the lowest cost and highest quality skin foam. The company has been running pentane for over twenty-five years, and has built a solid reputation for outstanding quality and delivery performance. "This team, now over twenty strong, knows what they are doing," says Cutter.

A former auto executive, Cutter has led teams in durable goods manufacturing for over twenty-five years. With a background in program management and information technology, as well as an M.B.A. from the University of Michigan, he has the confidence and skill set to engage across the full scope of any business. He purchased Comcast in February of 2016 and became just the third owner in the company's history. With almost no knowledge of the industry, his goal was to understand the business from the ground up. For several months prior to taking over, he worked alongside employees on the floor, learning about the production process, as well as the culture of the company.

Todd Cutter, President and Owner of Comcast Urethane, gives the Southern team a tour of their manufacturing facility.

Todd Cutter demonstrates the quality tests that Comcast performs to ensure the chemicals are blended in the right ratio to produce correct foam density. (Pictured left to right) Doug Kiessling, Regional VP/Commercial Loan Manager; Kara Mead, VP Marshall Branch Manager/Commercial Loan Officer; John Castle, Chairman and CEO; Nick Grabowski, Executive VP/Head of Lending; Kurt Miller, President; and Laurel Walkup, VP/Business eServices Manager

As the new owner, Cutter almost immediately added employee benefits such as service anniversary and performance bonus programs, as well as a sustainable plan to increase wages. Those moves resulted in a positive change in employee morale over the past three years, and when combined with other strategic actions, have helped drive dramatic improvements in sales, quality, productivity, capacity and overall profitability. Cutter emphasizes giving back to the team he calls, "instrumental in building the business into what it is today." A framed picture of every employee can be seen at the entrance of the company as well.

Cutter talks about a key tenet of how he operates, which is to try to make things as simple as possible. Whether with customers, suppliers, or employees, he says, "If we can do things simply, we immediately hold an advantage." Cutter is known by many to be rather incessant: "Number one, be transparent about what we are trying to accomplish. Number two, give people a chance to have skin in the game and earn something of value. Number three, treat everyone with respect. That includes holding ourselves and others accountable." More succinctly, he says, "to do what we say we will do."

> **"Southern stood out over the competition in terms of competence and caliber of individuals I encountered, throughout the entire process."**
>
> - Todd Cutter

Warner agrees, "Transparency is key, and employees know that what we tell them is meaningful." He recalls a particular problem they faced, encountering a build-up of over $20,000 in unnecessary scrap. Cutter devised a plan that included communicating the magnitude of the issue and eliminating the source of the problem. When fixed, $20,000 was shared across the team. Mark emphasizes, "That opened some eyes pretty quickly."

In terms of new business development, Cutter credits Warner saying, "Mark is at the center of what we are doing. He has really driven the growth in the business." Warner says new relationships can begin anywhere from someone bringing a sketch on a napkin to a fully modeled CAD file and asking, "Can you do this?" Heather Newcomb, Comcast's office manager says, "Mark finds it hard to say no." Smiling, she adds, "He can do a lot of things."

While analyzing the potential of a Comcast deal, Cutter was referred to Southern Michigan Bank and Trust by several colleagues. He met with Kurt Miller, SMB&T president, to talk about lending options and becoming a financial partner. Miller states, "Working with Todd to evaluate the purchase of Comcast and consider the financing necessary to go forward, I felt confident that this was going to be a success story. And it certainly has been."

Cutter says, "Southern stood out over the competition in terms of competence and caliber of individuals I encountered, throughout the entire process." Of particular help was Vice President and Marshall Branch Manager Kara Mead. "Kara is fantastic in every way. Her professionalism, courtesy and diligence really stand out." He adds, "We were able to customize exactly what we wanted and needed."

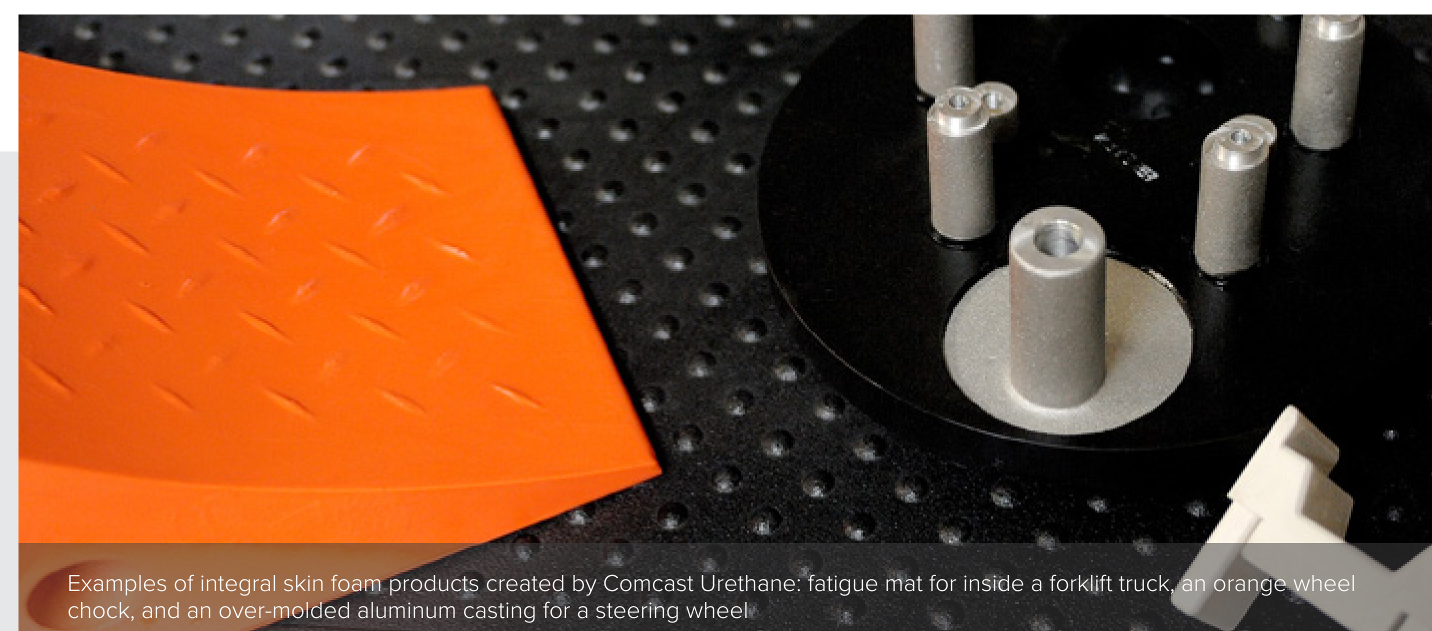
Cutter again credits Mead's involvement in helping with his most recent project, completion of a 2,000 square-foot warehouse expansion. "We've been tight on space for enough raw materials to manage our growth, but we now have enough room to be able to support a second shift when that opportunity comes."

Doug Kiessling and Mark Warner, General Manager of Comcast Urethane review before and after photos of their recent warehouse expansion.

Comcast currently utilizes checking, health savings accounts, corporate credit cards, and a line of credit. Cutter and Newcomb agree, "We still need to implement ACH cash management with key suppliers, and consider bill pay as well." After closing their accounts with their previous bank, they found the transition to be very smooth. "Southern is so friendly and easy to call, and if we have an issue, we are able to get it resolved quickly."

Mead says, "Todd is a dream customer. He knows what he wants, and how he is going to achieve it. He knows all the details, the ins and outs of his business."

Reflecting on Comcast's relationship with SMB&T, Cutter is quick to remind, "There are still more opportunities to explore. Southern continues to be our partner of choice. They are not just a small town bank. They have proven to be so much more."



Examples of integral skin foam products created by Comcast Urethane: fatigue mat for inside a forklift truck, an orange wheel chock, and an over-molded aluminum casting for a steering wheel

FOR THE YEAR	2018	2017
Net interest income	$25,284,000	$22,583,000
Provision for loan losses	250,000	175,000
Non-interest income	6,455,000	6,408,000
Non-interest expense	21,929,000	20,353,000
Net income	8,125,000	5,421,000
PER SHARE		
Basic earnings	$3.52	$2.30
Diluted earnings	3.51	2.29
Cash dividends declared	0.87	0.83
AT YEAR END		
Assets	$738,831,000	$712,345,000
Gross loans	531,974,000	523,447,000
Allowance for loan loss	5,117,000	5,009,000
Deposits	605,893,000	577,144,000
Other borrowings	28,500,000	39,500,000
Shareholders' equity	75,527,000	70,037,000
RATIOS		
Return on average assets	1.11%	0.80%
Return on average equity	11.21%	7.64%
Total risk-based capital ratio	11.95%	11.08%
ALLL as percentage of loans	0.96%	0.96%

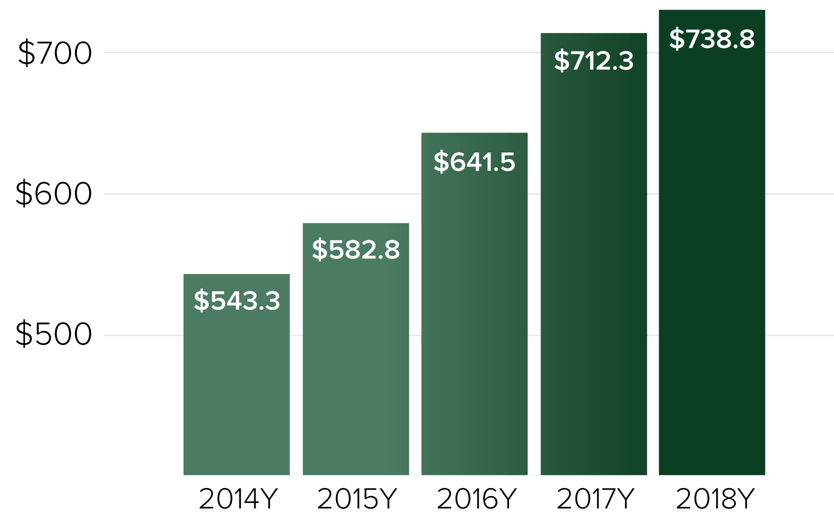
Southern Michigan Bancorp, Inc. is a bank holding company. The Company's wholly-owned subsidiary, Southern Michigan Bank & Trust (SMB&T) offers individuals, businesses, institutions and governmental agencies a full range of commercial banking services primarily in the southern Michigan communities in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

View from inside Southern's Three Rivers Branch

$738.8

Total Assets

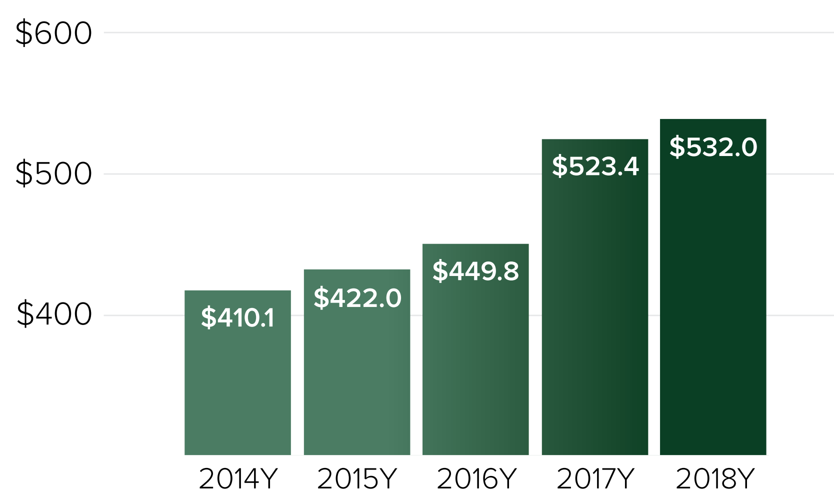
Note: Data in $ millions



$532.0

Total Loans

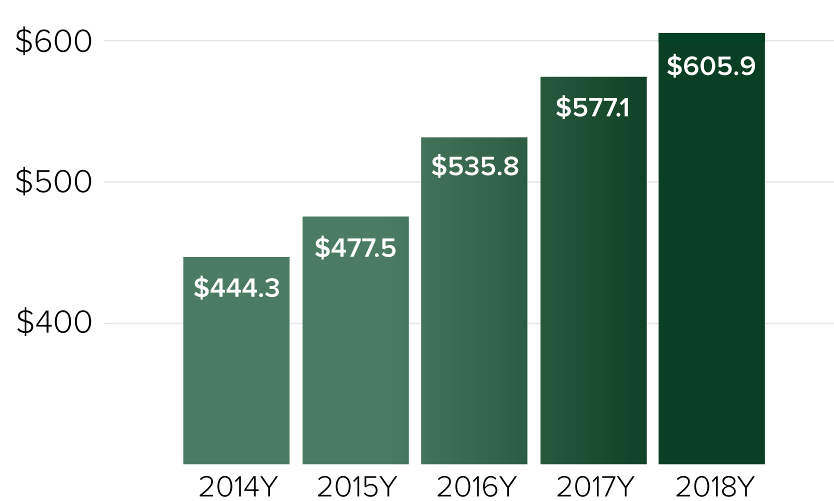
Note: Data in $ millions
(excludes loans held for sale)



$605.9

Total Deposits

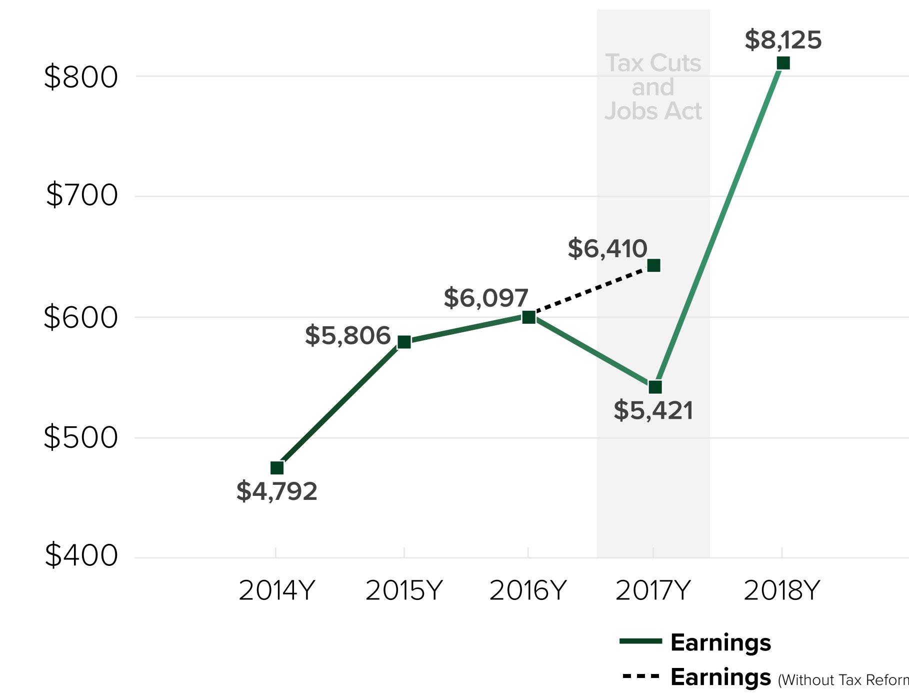
Note: Data in $ millions



$8,125

Net Income

Note: Data in thousands.
The graph illustrates the impact of the Tax Cuts and Jobs Act on Net Income which passed on December 22, 2017.



$38.10

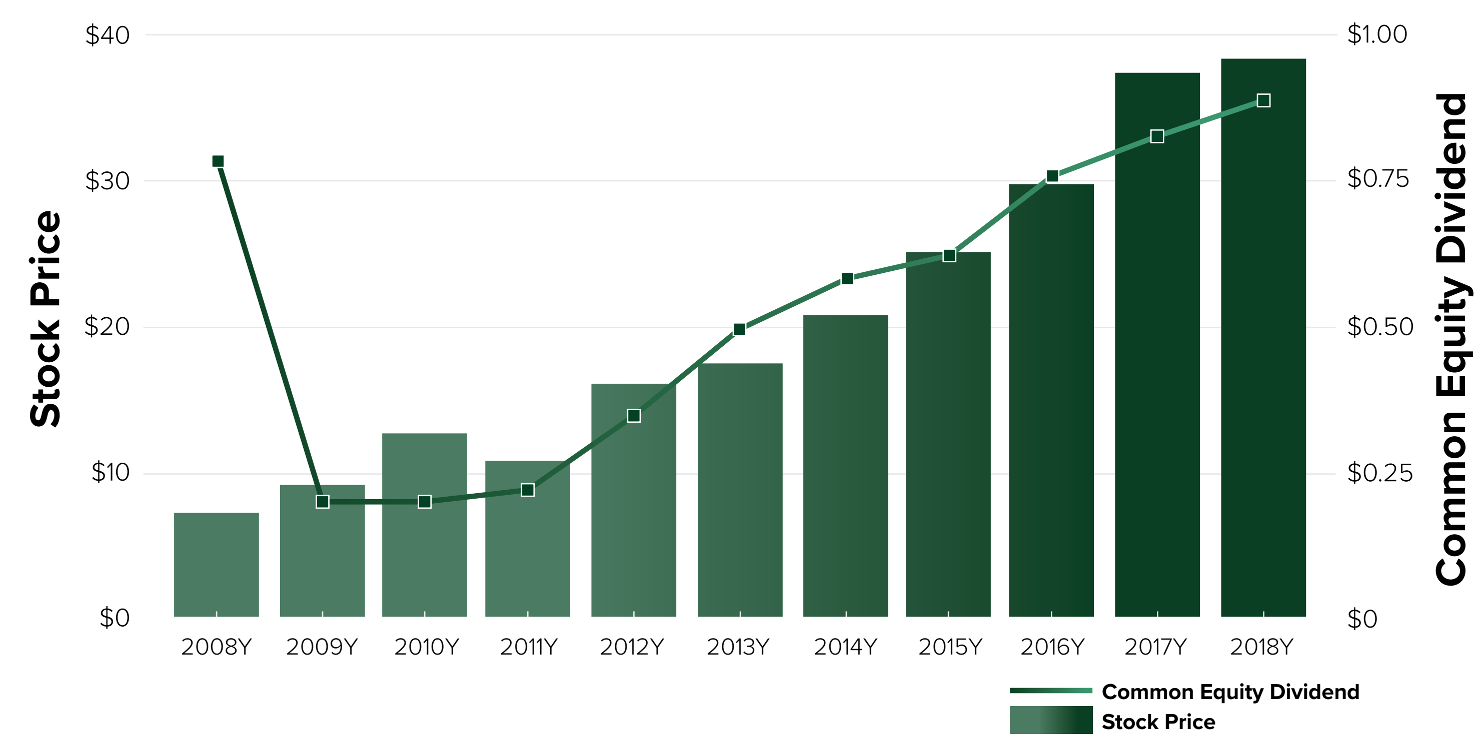
Stock Price

End of the year stock price

$0.87

Common Equity Dividend

Common Equity Dividends Declared



SMB AND SMB&T EXECUTIVE STAFF

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

SMB AND SMB&T BOARD OF DIRECTORS

Dean Calhoun
Calhoun Corporation

John H. Castle
Chairman / Chief Executive Officer of SMB, Inc. and SMB&T

Charles James Scott Clark
Clark Logic

H. Kenneth Cole
Retired Executive

Patrick H. Flannery
Hillsdale College

Gary H. Hart
Retired Executive

Nolan E. (Rick) Hooker
Best American Car Washes

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

Gregory J. Hull

Thomas E. Kolassa

Thomas D. Meyer

Jane L. Randall

COMMERCIAL LOANS

Sarah Headley
Regional Vice President /
Commercial Loan Manager

Douglas W. Kiessling
Regional Vice President /
Commercial Loan Manager

Tom Swoish
Regional Vice President /
Commercial Loan Manager

Deb Davis
Vice President

Corey Donner
Vice President

Rachel Doty
Vice President

Adam Losinski
Vice President

Greg Miller
Vice President

Jim Sobeske
Vice President

RETAIL LOANS

Derek Naylor
First Vice President /
Head of Retail Lending

Phyllis Wingate
Vice President /
Head of Retail Loan Operations

Connie Caudill
Assistant Vice President /
Senior Collections Manager

DeAnne Hawley
Vice President

Shari Kline
Vice President

Diane Krimmel
Assistant Vice President

Tina Mack
Assistant Vice President / Retail Loan Operations Manager

Stephanie Best
Retail Loan Officer

RETAIL BANKING

Eric Anglin
Senior Vice President of Retail Banking Services /
Chief Deposit Officer

Lori Neill
Vice President / Retail Banking Operations Manager

COLDWATER MAIN & EAST CHICAGO BRANCHES
Deb Larr
Branch Manager

BATTLE CREEK BRANCH
Lisa Walker
Vice President /
Branch Manager

MARSHALL BRANCH
Kara Mead
Vice President /
Commercial Loan Officer /
Branch Manager

HILLSDALE & CAMDEN BRANCHES
Jennifer Crist
Assistant Vice President /
Regional Branch Manager

UNION CITY BRANCH
Tim Fox
Assistant Vice President /
Retail Loan Officer /
Branch Manager

TEKONSHA BRANCH
Dawn Copas
Branch Manager

CENTREVILLE & CONSTANTINE BRANCHES
Tina Cronkhite
Vice President /
Regional Branch Manager

MENDON BRANCH
Doreen Tobin
Assistant Vice President /
Branch Manager

THREE RIVERS BRANCH
Sharon Bachinski
Assistant Vice President /
Branch Manager

PORTAGE BRANCH
Cammy Fleckenstein
Branch Manager

PORTAGE TRADE CENTRE
Tim Kilmartin
Kalamazoo Regional President

Mary Marshall
Vice President /
Wealth Management Officer

Tom Schlueter
Vice President of Market Development

Joseph Spoerl
Vice President /
Wealth Management Officer

eSERVICES

Laurel Walkup
Vice President /
Business eServices Manager

FINANCE

Kevin Vaughn
First Vice President of Finance

INFORMATION TECHNOLOGY

Greg Sopcak
First Vice President /
Head of Information Technology

Joseph Duke
Network Administrator

MARKETING

Quinn White
Vice President /
Head of Marketing

OPERATIONS

Angie Smith
First Vice President /
Head of Operations

Maggie Usher
Assistant Vice President /
Operations Manager

Becky Omo
Assistant Vice President /
Deposit Operations Manager

Vikki Kline
Core System Administrator

RISK MANAGEMENT

Petrea Schumacher
Vice President /
Risk Management Officer

Robyn Tate
BSA Officer

WEALTH MANAGEMENT

Matt Moses
Senior Vice President /
Head of Wealth Management

Melissa Barlow
Vice President /
Senior Investment Officer

R. David Rumsey
Vice President /
Senior Investment Officer

Michael Depew
Wealth Management Operations Manager

ANNUAL MEETING

The annual meeting of shareholders of Southern Michigan Bancorp, Inc. will be held on Thursday, May 9, 2019 at 4:00 p.m. local time, at the ProMedica Community Care and Conference Center, located at 370 E. Chicago Street, 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.astfinancial.com
Phone:	(718) 921-8124
Toll Free:	(800) 937-5449
Email:	info@amstock.com
Address:	6201 15th Avenue Brooklyn, NY 11219

MARKET MAKERS

D.A. Davidson & Co.
Dublin, Ohio
(800) 394-9230

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

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

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

MARKET INFORMATION

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 "anticipates," "believes," "expects," "forecasts," "intends," "is likely," "may," "plans," or "projects," and variations of such words and similar expressions. 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, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment), involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. 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. Southern Michigan Bancorp, Inc. undertakes no obligation to update, clarify or revise forward-looking statements whether as a result of new information, future events, or otherwise.

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 registered financial holding company. Southern wholly owns Southern Michigan Bank & Trust (the Bank), Southern Michigan Bancorp Capital Trust I (a Delaware statutory trust), SMB Risk Management, Inc. (a Nevada captive insurance company), 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 box 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 fourteen banking offices located in Battle Creek, Camden, Centreville, Coldwater, Constantine, Hillsdale, Marshall, Mendon, Portage, Tekonsha, Three Rivers, and Union City, Michigan.

At December 31, 2018, on a consolidated basis, we had assets of $739 million, deposits of $606 million, a net loan portfolio of $527 million, trust assets under management totaling $294 million, and shareholders' equity of $76 million.

Results of Operations

Southern's net income for 2018 was $8,125,000, compared to $5,421,000 in 2017, an increase of $2,704,000, or 49.88%. Tax reform legislation passed in 2017 resulted in federal income tax expense declining $1,607,000, or 52.83%, in 2018. In addition, net interest income increased $2,701,000. Provision for loan losses of $250,000 was expensed in 2018, up from $175,000 in 2017. Non-interest income increased 0.73%, or $47,000, to $6,455,000 in 2018. Non-interest expense increased 7.74%, or $1,576,000, to $21,929,000 in 2018. The following is a summary of percentage changes from the prior year for various financial statement elements:

	Percent Change from Prior Year			**Percent Change from Prior Year**	
	2018	**2017**		**2018**	**2017**
Net interest income	11.96%	11.70%	Total assets	3.72%	11.04%
Provision for loan losses	42.86%	75.00%	Securities available-for-sale	-3.56%	-4.35%
Non-interest income	0.73%	-6.47%	Gross loans	1.63%	16.37%
Non-interest expense	7.74%	8.63%	Allowance for loan losses	2.16%	3.45%
Federal income tax	-52.83%	42.48%	Deposits	4.98%	7.71%
Net income	49.88%	-11.09%	Shareholders' equity	7.84%	-0.13%

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 11.21% in 2018, 7.64% in 2017, and 8.69% in 2016. The return on average assets was 1.11% in 2018, 0.80% in 2017, and 1.00% in 2016.

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 an FTE basis is not in accordance with Generally Accepted Accounting Principles (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 on the following page.

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 2018, Southern's net interest margin (FTE) was 3.84%, compared to 3.79% for 2017. Southern's interest rate spread was 3.65%, compared to 3.67% in 2017. The decline in the interest spread was due to funding costs increasing at a slightly faster rate than asset yields in terms of basis point cost. Growth in interest expense from interest bearing liabilities was 66.20% in 2018, compared to 2017. This outpaced the increase in interest income from earning assets, which grew 15.91% in 2018, compared to 2017. However, given the volume of interest income in relation to interest expense, the net effect remained positive as net interest income (FTE) increased $2,380,000, compared to 2017.

For 2017, Southern's net interest margin (FTE) was 3.79%, compared to 3.78% in 2016. Southern's interest rate spread was 3.67% in 2017, compared to 3.69% in 2016. The decline in the interest spread was due to funding costs increasing at a slightly faster rate than asset yields in terms of basis point cost. Growth in interest expense from interest bearing liabilities was 55.61% in 2017, compared to 2016. This outpaced the increase in interest income from earning assets, which grew 14.77% in 2017, compared to 2016. However, given the volume of interest income in relation to interest expense, the net effect remained positive as net interest income (FTE) increased $2,395,000, compared to 2016.

The following table presents a summary of net interest income (FTE) for 2018, 2017, and 2016.

Table 1: Average Balances and Tax Equivalent Interest Rates

(Dollars in Thousands)	2018 Average Balance	2018 Interest	2018 Yield/ Rate	2017 Average Balance	2017 Interest	2017 Yield/ Rate	2016 Average Balance	2016 Interest	2016 Yield/ Rate
ASSETS									
Interest earning assets:									
Loans(1)(2)(3)	$ 532,056	$ 26,935	5.06%	$ 480,194	$ 23,043	4.80%	$ 423,240	$ 20,085	4.75%
Taxable investment securities(4)	61,911	1,328	2.15	61,984	1,183	1.91	58,753	1,023	1.74
Tax-exempt investment securities(1)	39,732	1,118	2.81	43,213	1,373	3.18	41,787	1,324	3.17
Federal funds sold and other(5)	35,440	659	1.86	28,457	318	1.12	28,969	150	0.52
Total interest earning assets	669,139	30,040	4.49	613,848	25,917	4.22	552,749	22,582	4.09
Non-interest earning assets:									
Cash and due from banks	12,243			11,777			12,287		
Other assets(6)	54,833			53,263			51,124		
Less allowance for loan losses	(4,963)			(4,893)			(5,051)		
Total assets	$ 731,252			$ 673,995			$ 611,109		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing liabilities:									
Demand deposits	$ 257,377	$ 1,209	0.47%	$ 244,583	$ 529	0.22%	$ 235,647	$ 475	0.20%
Savings deposits	90,077	95	0.11	83,439	47	0.06	75,090	20	0.03
Time deposits	127,170	1,970	1.55	105,839	1,177	1.11	88,280	789	0.89
Securities sold under agreements to repurchase and overnight borrowings	12,897	31	0.24	12,643	33	0.26	12,581	34	0.27
Other borrowings	31,061	820	2.64	25,819	647	2.51	10,070	198	1.97
Subordinated debentures	5,155	251	4.87	5,155	200	3.88	5,155	177	3.43
Total interest bearing liabilities(7)	523,737	4,376	0.84	477,478	2,633	0.55	426,823	1,693	0.40
Non-interest bearing liabilities:									
Demand deposits	129,923			118,967			108,116		
Other	5,079			6,640			5,969		
Shareholders' equity	72,513			70,910			70,201		
Total liabilities and shareholders' equity	$ 731,252			$ 673,995			$ 611,109		
Net interest income		$ 25,664			$ 23,284			$ 20,889	
Interest rate spread			3.65%			3.67%			3.69%
Net margin on interest earning assets			3.84%			3.79%			3.78%

(1) Includes tax equivalent adjustment of interest (assuming a 21% tax rate in 2018; and, a 34% tax rate in 2017 and 2016) for securities and loans of $235,000 and $23,000, respectively, for 2018; $467,000 and $99,000, respectively, for 2017; and, $450,000 and $101,000, respectively, for 2016.
(2) Average balance includes average non-accrual loan balances of $1,275,000 in 2018, $1,010,000 in 2017, and $1,287,000 in 2016.
(3) Interest income includes loan fees of $447,000 in 2018, $263,000 in 2017, and $210,000 in 2016.
(4) Average balance includes average unrealized loss of $2,056,000 in 2018, unrealized loss of $200,000 in 2017, and unrealized gains of $1,207,000 in 2016.
(5) Includes average federal reserve deposit account balances of $31,942,000 in 2018, $19,465,000 in 2017, and $2,269,000 in 2016.
(6) Includes $13,737,000 in 2018, $13,543,000 in 2017, and $13,789,000 in 2016 relating to goodwill and other intangible assets.
(7) Interest expense on deferred compensation balances totaling $122,000, $135,000, and $121,000 for 2018, 2017, and 2016, 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. The changes are 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)	2018 Compared to 2017 Increase (Decrease) Due To:			2017 Compared to 2016 Increase (Decrease) Due To:		
Interest income on:	Rate	Volume	Net	Rate	Volume	Net
Loans	$ 1,313	$ 2,579	$ 3,892	$ 227	$ 2,731	$ 2,958
Taxable investment securities	146	(1)	145	102	58	160
Tax-exempt investment securities	(150)	(105)	(255)	4	45	49
Federal funds sold and other	249	92	341	171	(3)	168
Total interest earning assets	$ 1,558	$ 2,565	$ 4,123	$ 504	$ 2,831	$ 3,335
Interest expense on:						
Demand deposits	$ 651	$ 29	$ 680	$ 36	$ 18	$ 54
Savings deposits	44	4	48	25	2	27
Time deposits	524	269	793	214	174	388
Securities sold under agreements to repurchase and overnight borrowings	(3)	1	(2)	(1)	-	(1)
Other borrowings	36	137	173	67	382	449
Subordinated debentures	51	-	51	23	-	23
Total interest bearing liabilities	$ 1,303	$ 440	$ 1,743	$ 364	$ 576	$ 940
Net interest income	$ 255	$ 2,125	$ 2,380	$ 140	$ 2,255	$ 2,395

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 the following: specific credit reviews; historical loan loss experiences; 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 2018, compared to $175,000 in 2017, and $100,000 in 2016. The modest increase in provision in 2018 results from an increase in the volume of specific reserves assigned to impaired loans.

Net loan charge-offs totaled $142,000, compared to $8,000 in 2017 and $531,000 in 2016.

Non-Interest Income

Total non-interest income increased $47,000, or 0.7%, when comparing 2018 to 2017. The increase is primarily attributed to a $369,000, or 22.3%, increase in trust fees and a $109,000, or 6.6%, increase in service charges on deposit accounts. These improvements offset the $145,000, or -19.4%, decrease in net gains on loan sales, as well as the $161,000 loss taken on the sale of investments.

Total non-interest income decreased $443,000, or -6.5%, when comparing 2017 to 2016. The decrease is primarily attributed to a $297,000, or -28.4%, reduction in net gains on loan sales and a $99,000, or -97.1%, decrease in net securities gains. The decline in these areas was somewhat offset by a $109,000, or 7.0%, increase in trust fees

Net securities losses of $161,000 were recognized in 2018, while net securities gains of $3,000 and $102,000 were recognized in 2017 and 2016, respectively. The losses in 2018 resulted from an investment portfolio restructure that will improve future portfolio earnings. The gains in 2017 and 2016 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 to 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 for sale on the secondary market of $19,675,000 in 2018, comparted to $23,592,000 in 2017 and $34,546,000 in 2016. Net gains on loan sales decreased $145,000 when comparing 2018 to 2017, and decreased $297,000 when comparing 2017 to 2016.

Income and fees from automated teller machines (ATMs) and debit cards increased $48,000 , or 3.5% when comparing 2018 to 2017, and decreased $5,000, or -0.4%, when comparing 2017 to 2016. The increase in 2018 was primarily due to higher volumes of approved transactions and the decrease in 2017 was a result of lower ATM fees being charged to bank customers.

Non-Interest Expense

Non-interest expense increased $1,576,000, or 7.7%, when comparing 2018 to 2017. Salary and employee benefit costs increased $793,000, or 6.6%, in 2018. In addition, software maintenance expenses increased $273,000, or 22.0%, equipment expense increased $183,000, or 18.9%, and advertising and marketing expense increased $127,000, or 40.1%. Additional, more modest expense increases included professional and outside services ($117,000), occupancy expense ($76,000), telecommunication expense ($41,000), ATM expense ($33,000), and FDIC deposit assessments ($6,000). Expense declines were noted in the following areas: amortization of other intangibles ($196,000); and, printing, postage, supplies ($12,000).

Other non-interest expense increased $135,000, or 9.5%, when comparing 2018 to 2017. The four most significant factors in the increase were the absence of a non-recurring gain on the sale of fixed assets ($39,000), increased freight/courier expense ($37,000), increased correspondent banking charges ($26,000), and increased trust expenses ($25,000).

Non-interest expense increased $1,617,000, or 8.6%, when comparing 2017 to 2016. Salary and employee benefit costs increased $1,521,000, or 14.5%, in 2017. In addition, software maintenance increased $197,000, or 18.9%, and equipment expenses increased $133,000, or 16.0%, in 2017. Additional modest increases in expenses were noted in the professional and outside services ($97,000), as well as telecommunications ($14,000) areas. ATM expenses declined $187,000, or 27.7%, when comparing 2017 to 2016. Additional, more modest expense declines included advertising and marketing ($33,000); amortization of other intangibles ($31,000); FDIC deposit assessment ($13,000); occupancy cost ($5,000); and, printing, postage, and supplies ($4,000).

Other non-interest expense decreased $72,000, or 4.8%, when comparing 2017 to 2016. Five areas had the largest changes year-over-year within this category. Miscellaneous expenses declined $97,000 due to the reduction of fraudulent activity in 2017, as compared to 2016. Expenses associated with the holding of other real estate owned and the gain or loss on the sale of other real estate each declined in 2017 when compared to 2016. The declines totaled $67,000 and $57,000, respectively. Conversely, trust expense increased $65,000 in 2017, compared to 2016, and a significant portion of the Michigan Business Tax refund accrued in 2016 was non-recurring, and decreased $70,000 in 2017.

Income Taxes

Income tax provision was $1,435,000 in 2018, $3,042,000 in 2017, and $2,135,000 in 2016. The Tax Cuts and Jobs Act signed on December 22, 2017, reduced corporate federal tax rate from 34% to 21%, effective January 1, 2018. This benefited income tax expense in 2018. However, in 2017, Southern was required to re-measure the deferred tax assets and liabilities recorded using the enacted rate at which we expect them to be recovered or settled. The effect of this re-measurement was recorded to income tax expense in 2017 and resulted in additional income tax expense of $989,000.

Tax-exempt income continues to have an 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 it reduced federal income tax expense by $194,000 in 2018, $362,000 in 2017, and $354,000 in 2016. Furthermore, tax-exempt income from the captive insurance company reduced federal income tax by $146,000 in 2018, $239,000 in 2017, and $168,000 in 2016. Finally, tax-exempt income from earnings on life insurance assets resulted in a lower effective tax rate and reduced federal income tax expense by $82,000 in 2018, $127,000 in 2017, and $128,000 in 2016. Additional income tax information is reported in Note K to the consolidated financial statements.

Financial Condition

Total assets were $738,831,000 as of December 31, 2018, an increase of $26,486,000, or 3.7%, compared to December 31, 2017. Gross loans increased $8,527,000, or 1.6%, in 2018, with the growth occurring primarily in commercial real estate. The securities portfolio decreased $3,745,000, or 3.6%, in 2018, with declines in US Agencies and state and political subdivisions outpacing the increase in asset-backed securities. Deposit volumes increased $28,749,000, or 5.0%, during 2018. The growth occurred in interest bearing checking deposits, money market demand accounts, and non-interest bearing deposits, while savings deposits and time deposits declined. Borrowings decreased $11,000,000, or 27.9%, in 2018. The decline in borrowings were attributed to the maturity of a $10,000,000 FHLB borrowing and principal reduction of a term loan with United Banker's Bank totaling $1,000,000.

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2018, increased $37,320,000, or 214.2%, compared to balances at December 31, 2017. Cash and cash equivalents increased during 2018 due to deposit growth coupled with declines in investments, outpacing loan growth. Also a majority of the federal funds sold balance shifted to cash due to a slightly higher rate of return on the cash balances.

Federal Funds Sold

Federal funds sold totaled $1,065,000 at December 31, 2018, compared to $18,492,000 at December 31, 2017. The Bank sells excess overnight funds to its primary correspondent in lieu of maintaining the balances in interest bearing deposit accounts when there is a higher interest rate being paid by correspondents. The decline in federal funds sold balances is attributed to the lower interest rate being paid in relation to interest bearing deposit accounts.

Securities Available-for-Sale

The available-for-sale securities portfolio decreased $3,745,000, or 3.6%, from December 31, 2017, to December 31, 2018. The portfolio is monitored and securities or federal funds are purchased as deemed prudent by the Asset Liability Management Committee (ALCO).

The available-for-sale securities portfolio had an unrealized loss of $1,647,000 at December 31, 2018, and an unrealized loss of $929,000 at December 31, 2017. 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, 2018, 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 $8,527,000, or 1.6%, in 2018. Gross loans increased $73,632,000, or 16.4%, in 2017. The increases in 2018 and 2017 were primarily a result of increased loan demand in the across the Coldwater and Portage regions.

Loan commitments consisting of unused credit card and home equity lines, available amounts on revolving lines of credit, and other approved loans that have not been funded were and $150,883,000 and $146,784,000 at December 31, 2018, and 2017, respectively. The 2018 commitments consist of $97,786,000 in fixed-rate commitments and $53,097,000 in variable rate commitments.

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		
	2018	**2017**	**2016**
Non-accrual loans:	(Dollars in thousands)		
Commercial, commercial real estate, and agriculture	$ 3,477	$ 45	$ 74
Real estate mortgage	887	815	932
Consumer	11	16	17
	4,375	876	1,023
Loans contractually past due 90 days or more and still on accrual:			
Commercial, commercial real estate, and agriculture	96	105	417
Real estate mortgage	-	-	23
Consumer	-	6	26
	96	111	466
Accruing loans modified under troubled debt restructurings:			
Commercial, commercial real estate, and agriculture	340	341	432
Real estate mortgage	732	893	1,007
Consumer	-	-	-
	1,072	1,234	1,439
Total nonperforming loans (1)	5,543	2,221	2,620
Other real estate owned	99	84	308
Total nonperforming assets	$ 5,642	$ 2,305	$ 2,928
Nonperforming loans to year-end loans	1.04%	0.42%	0.58%
Nonperforming assets to total assets	0.77%	0.32%	0.46%

(1) In 2016, one loan, totaling $308,000, is in both the 90 days past due category and the accruing loans under troubled debt restructurings. This loan is only included once in the total nonperforming line.

The balance of non-accrual restructured loans, which is included in non-accrual loans, was $541,000 at December 31, 2018, $430,000 at December 31, 2017, and $481,000 at December 31, 2016.

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated for in the allowance for loan losses, where appropriate. Nonperforming loans increased from December 31, 2017, to December 31, 2018, and decreased slightly from December 31, 2016, to December 31, 2017. At December 31, 2018, 2017, and 2016, Southern had loans of $6,100,000; $2,902,000; and, $2,462,000, respectively, which were considered impaired.

Other real estate owned assets at December 31, 2018, totaled $99,000, an increase of $15,000, or 17.9%, from December 31, 2017. During 2018 and 2017, loans of $81,000 and $190,000, respectively, were transferred to foreclosed assets.

In management's evaluation of the loan portfolio risks, any significant future increases in nonperforming loans are dependent largely on the economic environment. In a deteriorating or uncertain economy, management applies assumptions that are more conservative 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, 2018, specific reserves totaled $526,000, compared to $41,000 at December 31, 2017, an increase of $485,000.

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 the following: current economic conditions; delinquency and charge-off trends; loan volume; portfolio mix; concentrations of credit; lending policies and procedures; changes in the loan review function; changes in underlying collateral; and, lending personnel.

The allowance for loan losses was $5,117,000, or 0.96% of total loans, at December 31, 2018, compared to $5,009,000, or 0.96% of total loans, at December 31, 2017.

The allowance for loan losses at December 31, 2018, consisted of $835,000 from the historical loss experience component and specifically allocated reserves, leaving $4,282,000 from the other factors. This compares to $809,000 from the historical loss experience component and specifically allocated reserves and $4,200,000 from the other factors at December 31, 2017.

At December 31, 2018, 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 5.0%, or $28,749,000, in 2018 compared to 2017; and, increased 7.7%, or $41,299,000, in 2017 compared to 2016. The majority of deposits are derived from core client sources, relating to long-term relationships with local individual, business, and public clients. A modest amount of brokered deposits, $8,528,000 at December 31, 2018, is maintained. In addition, the Bank had $16,759,000 in listing service deposits as of December 31, 2018. Attracting and keeping traditional deposit relationships will continue to be a focus of Southern.

Other Borrowings

Southern borrowed $10,000,000 in May 2017 from United Bankers Bank that was used to fund a stock repurchase and to provide a capital infusion into the Bank. The note's rate was fixed at 4.5% with a five-year term. At December 31, 2018, $8,500,000 was outstanding on the term loan.

As another funding source, Southern obtains advances from the Federal Home Loan Bank (FHLB). The advances are secured by a blanket collateral agreement with the FHLB giving them an unperfected security interest in select 1-4 family mortgage and commercial real estate loans. FHLB advances are used as an alternative funding source to paying a premium for long-term deposits. At December 31, 2018, Southern had $20,000,000 in FHLB advances with interest rates between 1.73% and 1.93%, with a weighted average rate of 1.83%.

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 and may occur 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, 2018, was 5.19%.

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 $5,490,000, or 7.8%, from December 31, 2017, to December 31, 2018, and decreased $94,000, or 0.1%, from December 31, 2016, to December 31, 2017. The increases in 2018 were primarily attributable to net income offset by dividends to shareholders. The slight decline in 2017 was due to Southern repurchasing common stock shares that totaled $5,031,000 in reductions to common stock and additional paid-in capital.

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 in which all institutions are placed: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. 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 a 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 time period.

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- sale 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, 2018, 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 the Bank's branches is maintained at its lowest practical level.

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 $834,000 in 2018 and $6,867,000 in 2017. During 2018 and 2017, Southern averaged $31,942,000 and $19,465,000, 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, 2018, Southern had $33 million in line of credit availability, including $23 million of overnight federal funds lines, with two correspondent banks. In addition, collateral has been pledged at the Federal Reserve Bank "Discount Window". At December 31, 2018, $2 million of securities were pledged that could be used for future borrowings. Southern also has the ability to borrow $67 million from the Federal Home Loan Bank based on collateral pledged. Southern has $70 million of unencumbered securities, which could be pledged at the Federal Home Loan Bank or Federal Reserve Discount Window to secure additional borrowing capacity.

Southern's principal source of funds to pay cash dividends is the dividends paid by the Bank from its earnings. Dividend amounts are restricted under current banking laws and regulations. Capital guidelines adopted by federal and state regulatory agencies, as well as restrictions imposed by law, limit the amount of cash dividends the Bank can pay to Southern. At December 31, 2018, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay Southern without prior regulatory approval was $17.0 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 customers at any time, as the customers' 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, 2018, Southern had loan commitments of $150,883,000, $2,925,000 in standby letters of credit, and no commitments under commercial letters of credit outstanding.

These arrangements have credit risk similar to 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. The changes include ramped and shocked increases of 1%, 2%, 3%, and 4% to interest rates on both a static and dynamic balance sheet over 12 and 24 month timeframes. A 1% and 2% declining scenario was also modeled at December 31, 2018. 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. All of the results from the December 31, 2018, model run are within the guidelines established by the Board of Directors.

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	4.29%	6.74%	+400	4.83%	7.57%
+300	3.41%	5.36%	+300	3.82%	6.00%
+200	2.44%	3.85%	+200	2.71%	4.28%
+100	1.27%	2.01%	+100	1.41%	2.23%
-100	-1.39%	-2.41%	-100	-1.53%	-2.62%
-200	-2.45%	-3.83%	-200	-2.71%	-4.25%
-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	8.27%	9.63%	+400	8.57%	9.93%
+300	6.69%	7.70%	+300	6.93%	7.95%
+200	5.03%	5.62%	+200	5.21%	5.82%
+100	2.83%	3.04%	+100	2.93%	3.16%
-100	-3.46%	-3.78%	-100	-3.56%	-3.91%
-200	-6.26%	-6.26%	-200	-8.24%	-8.77%
-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, only a 100 bp and 200 bp decline was modeled at December 31, 2018. The following table illustrates the percent change in equity based on changes in market interest rates:

	Change in market value of equity
4% increase in market rates	12.88%
3% increase in market rates	10.47%
2% increase in market rates	7.61%
1% increase in market rates	4.28%
No change	0.00%
1% decrease in market rates	-5.86%
2% decrease in market rates	-17.25%
3% decrease in market rates	NA%
4% decrease in market rates	NA%

The results of the simulations at December 31, 2018, are within the guidelines set and approved by Southern's Board of Directors. 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 consolidated 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 consolidated 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. A summary of significant accounting policies of Southern are detailed in Note A to the consolidated financial statements.

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 classification, 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 loss 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 a 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 analyses, 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 2018 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, 2018, 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 2018 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.

Danice L Chartrand

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

February 15, 2019

CliftonLarsonAllen LLP
CLAconnect.com

SOUTHERN MICHIGAN BANCORP, INC.
REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying consolidated financial statements of Southern Michigan Bancorp, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, 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, 2018, 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 consolidated 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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, 2018 and 2017, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2018 in accordance with accounting principles generally accepted in the United States of America.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Toledo, Ohio
March 5, 2019

A member of Nexia International

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

	December 31, 2018	December 31, 2017
ASSETS		
Cash	$ 5,804	$ 4,177
Due from banks	48,937	13,244
Cash and cash equivalents	54,741	17,421
Federal funds sold	1,065	18,492
Securities available-for-sale	101,439	105,184
Loans held for sale	-	515
Loans, net of allowance for loan losses of $5,117 – 2018 ($5,009 – 2017)	526,857	518,438
Premises and equipment, net	14,296	14,265
Accrued interest receivable	3,294	3,211
Cash surrender value of life insurance	15,685	14,796
Goodwill	13,422	13,422
Other intangible assets, net	327	-
Other assets	7,705	6,601
Total Assets	$ 738,831	$ 712,345
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits		
Non-interest bearing	$ 129,923	$ 129,098
Interest bearing	475,970	448,046
Total deposits	605,893	577,144
Securities sold under agreements to repurchase and overnight borrowings	15,342	13,950
Accrued expenses and other liabilities	8,414	6,559
Other borrowings	28,500	39,500
Subordinated debentures	5,155	5,155
Total Liabilities	663,304	642,308
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 – 2,315,505 shares in 2018 (2,316,779 shares in 2017)	5,783	5,787
Additional paid-in capital	15,246	15,415
Retained earnings	55,972	49,747
Accumulated other comprehensive loss, net	(1,301)	(613)
Unearned Employee Stock Ownership Plan (ESOP) shares	(173)	(299)
Total Shareholders' Equity	75,527	70,037
Total Liabilities and Shareholders' Equity	$ 738,831	$ 712,345

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, 2018	2017	2016
Interest income:			
Loans, including fees	$ 26,912	$ 22,944	$ 19,984
Securities:			
Taxable	1,328	1,183	1,023
Tax-exempt	883	906	874
Other	659	318	150
Total interest income	29,782	25,351	22,031
Interest expense:			
Deposits	3,274	1,753	1,284
Other	1,224	1,015	530
Total interest expense	4,498	2,768	1,814
Net Interest Income	25,284	22,583	20,217
Provision for loan losses	250	175	100
Net Interest Income After Provision for Loan Losses	25,034	22,408	20,117
Non-interest income:			
Service charges on deposit accounts	1,751	1,642	1,594
Trust fees	2,027	1,658	1,549
Net securities gains/(losses)	(161)	3	102
Net gains on loan sales	604	749	1,046
Earnings on life insurance assets	389	374	377
ATM and debit card fee income	1,422	1,374	1,379
Other	423	608	804
Total non-interest income	6,455	6,408	6,851
Non-interest expense:			
Salaries and employee benefits	12,843	12,050	10,529
Occupancy, net	1,406	1,330	1,335
Equipment	1,150	967	834
Printing, postage, and supplies	409	421	425
Telecommunication	338	297	283
Professional and outside services	1,492	1,375	1,278
Software maintenance	1,513	1,240	1,043
Amortization of other intangibles	33	229	260
ATM expenses	522	489	676
Advertising and marketing	444	317	350
FDIC deposit assessments	225	219	232
Other	1,554	1,419	1,491
Total non-interest expense	21,929	20,353	18,736
Income before income taxes	9,560	8,463	8,232
Income tax provision	1,435	3,042	2,135
Net Income	$ 8,125	$ 5,421	$ 6,097
Basic Earnings Per Common Share	$ 3.52	$ 2.30	$ 2.54
Diluted Earnings Per Common Share	$ 3.51	$ 2.29	$ 2.54

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, 2018	2017	2016
Net Income	$ 8,125	$ 5,421	$ 6,097
Other Comprehensive Income (Loss):			
Unrealized gain (loss) on available-for-sale securities	(879)	596	(2,047)
Reclassification adjustments for net realized securities gains/(losses) included in net income	161	(3)	(102)
	(718)	593	(2,149)
Income tax effect	151	(202)	731
Other comprehensive income (loss)	(567)	391	(1,418)
Total Comprehensive Income	$ 7,558	$ 5,812	$ 4,679

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, 2018, 2017, and 2016:

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2016	$ 6,011	$ 19,572	$ 42,029	$ 414	$ (257)	$ 67,769
Net income for 2016			6,097			6,097
Net change in other comprehensive income items				(1,418)		(1,418)
Cash dividends declared – $.76 per share			(1,844)			(1,844)
Issuance of restricted stock (19,900 shares of common stock at $25.25 per share)	50	(50)				-
Vesting of restricted stock		344				344
Restricted stock forfeiture	(1)	1				-
Stock options exercised (75,935 shares)	190	1,595				1,785
Tax benefit from exercise of stock options		25				25
Repurchase of common stock (95,425 shares)	(239)	(2,276)				(2,515)
Net increase in ESOP obligation					(147)	(147)
Stock option expense		35				35
Balance at December 31, 2016	6,011	19,246	46,282	(1,004)	(404)	70,131
Net income for 2017			5,421			5,421
Net change in other comprehensive income item				391		391
Cash dividends declared – $.83 per share			(1,956)			(1,956)
Issuance of restricted stock (66,000 shares of common stock at $29.90 per share)	165	(165)				-
Vesting of restricted stock		689				689
Restricted stock forfeiture	(5)	5				-
Stock options exercised (75,935 shares)	26	215				241
Repurchase of common stock (163,965 shares)	(410)	(4,621)				(5,031)
Net decrease in ESOP obligation					105	105
Stock option expense		46				46
Balance at December 31, 2017	5,787	15,415	49,747	(613)	(299)	70,037
Net income for 2018			8,125			8,125
Net change in other comprehensive income item				(567)		(567)
Reclass tax rate change effect on unrealized gain/loss			121	(121)		-
Cash dividends declared – $.87 per share			(2,021)			(2,021)
Issuance of restricted stock (12,200 shares of common stock at $37.15 per share)	31	(31)				-
Vesting of restricted stock		738				738
Restricted stock forfeiture	(2)	2				-
Stock options exercised (22,355 shares)	56	415				471
Repurchase of common stock (35,346 shares)	(89)	(1,366)				(1,455)
Net decrease in ESOP obligation					126	126
Stock option expense		73				73
Balance at December 31, 2018	$ 5,783	$ 15,246	$ 55,972	$ (1,301)	$ (173)	$ 75,527

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, 2018	2017	2016
Operating Activities			
Net income	$ 8,125	$ 5,421	$ 6,097
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	250	175	100
Depreciation of premises and equipment	1,300	1,052	989
Deferred income taxes	(81)	938	447
Amortization of other intangible assets	33	229	260
Net amortization of available-for-sale securities	356	476	652
Stock option and restricted stock grant compensation expense	811	735	379
Net (gains)/losses on security calls and sales	161	(3)	(102)
Loans originated for sale	(19,675)	(23,592)	(34,546)
Proceeds on loans sold	20,794	23,910	35,836
Net gains on loan sales	(604)	(749)	(1,046)
Net (gain) loss from sale or write down of other real estate owned	(40)	(10)	47
Net gain/(loss) on disposal of premises and equipment	(1)	41	(34)
Net change in obligation under ESOP	126	105	62
Net change in:			
Accrued interest receivable	(83)	(340)	(354)
Cash surrender value	(389)	(374)	(377)
Other assets	(857)	(756)	(1,288)
Accrued expenses and other liabilities	1,832	(326)	389
Net cash from operating activities	12,058	6,932	7,511
Investing Activities			
Activity in available-for-sale securities:			
Proceeds on securities sold	9,458	7,058	7,592
Proceeds from maturities and calls	10,854	11,717	32,927
Purchases	(17,802)	(13,876)	(56,031)
Net change in federal funds sold	17,427	(6)	(11,545)
Loan originations and payments, net	(8,750)	(73,830)	(28,900)
Proceeds from sale of other real estate owned	106	424	1,201
Acquisition of investment advisory firm	(360)	-	-
Purchase of Federal Home Loan Bank stock	-	755	-
Purchase of life insurance	(500)	-	(2,106)
Proceeds from sale of equipment	15	274	46
Additions to premises and equipment	(1,345)	(2,834)	(1,114)
Net cash from investing activities	9,103	(70,318)	(57,930)
Financing Activities			
Net change in deposits	28,749	41,299	58,360
Net change in securities sold under agreements to repurchase and overnight borrowings	1,392	639	(2,632)
Proceeds from other borrowings	30,000	40,000	200
Repayments of other borrowings	(41,000)	(10,700)	-
Stock options exercised	471	241	1,785
Purchase of ESOP shares	-	-	(209)
Cash dividends paid	(1,998)	(1,961)	(1,737)
Repurchase of common stock	(1,455)	(5,031)	(2,515)
Net cash from financing activities	16,159	64,487	53,252
Net Change in Cash and Cash Equivalents	37,320	1,101	2,833
Beginning cash and cash equivalents	17,421	16,320	13,487
Ending Cash and Cash Equivalents	$ 54,741	$ 17,421	$ 16,320

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

NOTE A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Industry Segments: Southern Michigan Bancorp, Inc. (the Company) is a Michigan corporation and registered financial holding company. The Company's principal activity is the ownership and management of its wholly-owned subsidiary bank, Southern Michigan Bank & Trust (the Bank). The Bank offers individuals, businesses, institutions, and government agencies a full range of commercial banking services. The customer base is located primarily in the southwest Michigan communities in which the Bank has branches, 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 its wholly-owned subsidiaries, SMB Risk Management, Inc., 27 Marshall Street, LLC, and the Bank. On November 18, 2015, 27 Marshall Street, LLC was formed as a wholly-owned subsidiary of the Company. On May 31, 2016, SMB Risk Management, Inc., a captive insurance company incorporated in Nevada, was formed as a wholly-owned subsidiary of the Company. 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. All inter-company transactions and balances are eliminated in consolidation.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) 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 an undeterminable period of time and not intended to be held until 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. There were no held to maturity securities as of December 31, 2017, or 2018.

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.

Loans are considered impaired when full contractual payment under the loan terms is not expected. Impairment is measured 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 as potentially impaired 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 fair value of mortgage servicing rights retained on loans sold. Mortgage servicing rights are amortized to expense 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 of 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 resulting from acquisitions is not amortized, but is tested for impairment annually. As part of its testing, the Company first assesses the qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the Company determines the fair value of a reporting unit is less than its carrying amount using these qualitative factors, the Company compares the fair value of the goodwill with its carrying amount, and then measures impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill.

Significant judgment is applied when goodwill is assessed for impairment. If qualitative factors indicate the potential for impairment, then further analysis includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. At December 31, 2018, the Company believes the Bank does not have any indicators of potential impairment.

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 and acquired customer relationship intangibles. 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 $99,000 and $84,000 at December 31, 2018, and 2017, 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 the carrying amount or fair value, less the 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.

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

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 positions 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 are 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.

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 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 84% of the loan portfolio at December 31, 2018 (84% at December 31, 2017), and such loans are expected to be repaid from cash flow from operations of businesses. Residential mortgage loans make up approximately 14% of the loan portfolio at December 31, 2018 (14% at December 31, 2017), and are collateralized by mortgages on residential real estate. Consumer loans make up approximately 2% of the loan portfolio at December 31, 2018 (2% at December 31, 2017), 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, 2018, and 2017.

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, 2018, that will have a material future adverse effect on the consolidated financial statements.

Subsequent Events: Management evaluated subsequent events through March 5, 2019, the date the consolidated financial statements were available to be issued. Events or transactions occurring after December 31, 2018, but prior to when the consolidated financial statements were available to be issued, that provided additional evidence about conditions that existed at December 31, 2018, have been recognized in the consolidated financial statements for the year ended December 31, 2018. Events or transactions that provided evidence about conditions that did not exist at December 31, 2018, 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, 2018.

New Accounting Standards: On January 1, 2018, the Company adopted ASU 2014-09, *Revenue from Contracts with Customers,* and all subsequent amendments to the ASU (collectively, "ASC 606"), which (i) creates a single framework for recognizing revenue from contracts with customers that falls within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of non-financial assets, such as OREO. The majority of the Company's services that fall within the scope of ASC 606 are presented within non-interest income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include service charges on deposits, interchange income, trust fees, and the sale of OREO. See Note W, Revenue From Contracts With Customers, for further discussion on the Company's accounting policies for revenue sources within the scope of ASC 606.

The Company adopted ASC 606 using the modified retrospective method; it was applied to all contracts not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018, are presented under ASC 606, while prior period amounts continue to be reported in accordance with legacy GAAP. The adoption of ASC 606 did not result in a change to the accounting for any of the in-scope revenue streams; as such, no cumulative effect adjustment was recorded.

The Company adopted ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* on January 1, 2018. ASU 2016-01 amends previous guidance by: (i) requiring equity investments with readily determinable fair values to be measured at fair value with changes in fair value recognized in net income; (ii) allowing an entity to measure equity investments that do not have readily determinable fair values at either fair value or cost minus impairment, if any, plus or minus changes in observable prices, with changes in measurement recognized in net income; (iii) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (iv) eliminating the requirement to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet; (v) requiring use the of exit price notion when measuring the fair value of financial instruments for disclosure purposes; (vi) requiring recognition of changes in the fair value related to instrument-specific credit risk in other comprehensive income if the fair value option for financial liabilities is elected; (vii) requiring separate presentations in the financial statements of financial assets and financial liabilities by measurement category; and (viii) clarifying that an entity should evaluate the need for a valuation allowance on deferred tax assets related to available-for-sale securities in combination with the entity's other deferred tax assets. The adoption of ASU 2016-01 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 A – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

On January 1, 2018, the Company adopted ASU No. 2016-15, *Statement of Cash Flows (Topic 320) – Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 provides cash flow statement classification guidance for certain transactions, including how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flow. The adoption of ASU 2016-15 did not have a material impact on the Company's consolidated financial condition or results of operations.

In February 2018, the FASB issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 22*0) to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. Adoption of ASU 2018-02 in 2018 resulted in a reclassification of $121,000 from accumulated other comprehensive loss to retained earnings.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. Under ASU 2016-02, the Company will be required to recognize the following for all leases (with the exception of short-term leases): (i) a right-to-use asset, which is an asset representing the lessee's right to use, or control the use of, a specified asset for the lease term; and (ii) a lease liability, which is a liability representing the lessee's obligation to make lease payments arising from a lease, measured on a discounted basis. ASU 2016-02 requires a modified retrospective transition approach for leases existing at, or entering into after, the beginning of the earliest comparative period presented in the financial statements. ASU 2016-02 is effective for the Company, beginning January 1, 2019. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial condition and results of operations.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. This update, effective for the Company beginning January 1, 2021, will change the accounting for credit losses on loans and debt securities. For loans, the proposal will require an expected credit loss model rather than the current incurred loss model to determine the allowance for credit losses. The expected credit loss model would estimate losses for the estimated life of the financial asset. In addition, the guidance will modify the other-than-temporary impairment model for available-for-sale debt securities to require an allowance for credit impairment instead of a direct write-down, which will allow for reversal of credit impairments in future periods. The Company has identified a software solution that will assist in estimating the allowance for loan loss under ASU 2016-13. Loan level data has been identified and collection efforts have started. The adoption of ASU 2016-13 may result in a material increase to the allowance for loan losses balance. A one-time, cumulative effect adjustment to the allowance for loan losses will be recognized as of the beginning of the first reporting period in which the new standard is effective. The Company is evaluating the impact on the consolidated financial condition and results of operations.

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, 2018, 2017, and 2016 is presented below:

	2018	2017	2016
Basic Earnings Per Common Share			
Net income (in thousands)	$ 8,125	$ 5,421	$ 6,097
Weighted average common shares outstanding	2,320,024	2,370,777	2,410,619
Less: Unallocated ESOP shares	(10,431)	(15,092)	(14,154)
Weighted average common shares outstanding for basic earnings per common share	2,309,593	2,355,685	2,396,465
Basic earnings per common share	$ 3.52	$ 2.30	$ 2.54
Diluted Earnings Per Common Share			
Net income (in thousands)	$ 8,125	$ 5,421	$ 6,097
Weighted average common shares outstanding for basic earnings per common share	2,309,593	2,355,685	2,396,465
Add: Dilutive effects of assumed exercises of stock options	3,309	7,650	6,681
Average shares and dilutive potential of common shares outstanding	2,312,902	2,363,335	2,403,146
Diluted earnings per common share	$ 3.51	$ 2.29	$ 2.54

In 2018, 2017, and 2016 there were no stock options considered anti-dilutive.

NOTE C – SECURITIES

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

Available-for-sale, December 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 39,837	$ 2	$ (967)	$ 38,872
U.S. Treasuries	2,021	-	(39)	1,982
States and political subdivisions	57,781	232	(866)	57,147
Corporate securities	499	-	(1)	498
Asset-backed securities	2,948	1	(9)	2,940
Total	$ 103,086	$ 235	$ (1,882)	$ 101,439

Available-for-sale, December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agencies	$ 41,931	$ -	$ (896)	$ 41,035
U.S. Treasuries	2,032	-	(32)	2,000
States and political subdivisions	62,146	538	(539)	62,145
Mortgage-backed securities	4	-	-	4
Total	$ 106,113	$ 538	$ (1,467)	$ 105,184

Securities with unrealized losses at December 31, 2018, and 2017, that have not been recognized in income are as follows (in thousands):

2018	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	$ -	$ -	$ 37,872	$ (967)	$ 37,872	$ (967)
U.S. Treasuries	-	-	1,982	(39)	1,982	(39)
State and political subdivisions	11,890	(166)	24,671	(700)	36,561	(866)
Corporate bonds	498	(1)			498	(1)
Asset-backed securities	993	(9)	-	-	993	(9)
Total temporarily impaired	$ 13,381	$ (176)	$ 64,525	$ (1,706)	$ 77,906	$ (1,882)

2017	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	$ 14,619	$ (131)	$ 26,416	$ (765)	$ 41,035	$ (896)
U.S. Treasuries	-	-	2,000	(32)	2,000	(32)
States and political subdivisions	22,093	(172)	9,445	(367)	31,538	(539)
Total temporarily impaired	$ 36,712	$ (303)	$ 37,861	$ (1,164)	$ 74,573	$ (1,467)

Unrealized losses have not been recognized through the income statement, 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/(losses) are listed below (in thousands):

	2018	2017	2016
Proceeds	$ 9,458	$ 7,058	$ 7,592
Net gains/(losses)	(161)	3	98

The tax provision/(benefit) related to net realized gains/(losses) was ($34,000), $1,000, and $33,000 for 2018, 2017, and 2016, respectively.

Gains on calls of securities were $0 for 2018 and 2017, and $4,000 for 2016.

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Contractual maturities of debt securities at year-end 2018 were as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 11,208	$ 11,168
Due from one to five years	67,082	65,729
Due from five to ten years	13,754	13,405
Due after ten years	11,042	11,137
Total	$ 103,086	$ 101,439

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 $31,166,000 and $28,829,000, respectively, were pledged as collateral for repurchase accounts and for other purposes at December 31, 2018, and 2017.

At December 31, 2018, and 2017, the fair value of securities issued by the State of Michigan and all its political subdivisions totaled $33,676,000 and $43,224,000, 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 $2,025,000 at December 31, 2018, and 2017, 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.

The Company had no investment in securities of issuers outside of the United States as of December 31, 2018, or 2017.

NOTE D – LOANS AND ALLOWANCE FOR LOAN LOSSES

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

	2018
Commercial real estate	$ 301,583
Commercial	83,078
Agriculture	60,572
Real estate mortgage	75,283
Consumer	11,458
	531,974
Less allowance for loan losses	(5,117)
Loans, net	$ 526,857

	2017
Commercial	$ 109,432
Real estate – commercial	300,458
Real estate – construction	30,473
Real estate – mortgage	75,518
Consumer	7,566
	523,447
Less allowance for loan losses	(5,009)
Loans, net	$ 518,438

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

Credit Risk Elements – Commercial Real Estate, Commercial, and Agriculture:
Loans to commercial real estate, commercial, and agricultural borrowers 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, the underlying collateral when 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.

Commercial real estate loans are also subject to underwriting standards unique to real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial 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 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 real estate loans based on collateral and risk rating criteria. The Bank typically requires personal guarantees on these loans. The Bank's commercial real estate loans are secured largely by properties located in its primary market area.

Commercial operating loans are underwritten with an emphasis on cash flow analysis and are generally secured by a first priority lien on the general assets of the business. Loan-to-value limits vary and are dependent upon the nature and type of the underlying collateral, as well as the financial strength of the borrower. Commercial loans are generally guaranteed by the principal(s). The Bank's commercial lending is principally done in its primary market area.

Agriculture loans are primarily made for real estate or operating purposes. Agricultural real estate loans are evaluated based upon cash flow first, and then as loans secured by real estate. 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. Agricultural operating loans are underwritten with reliance upon current and projected cash flows. Security for the operating loans is generally provided through first priority liens on agricultural assets. Crop and hail insurance is required for most agricultural borrowers, as is the guaranty of the principal(s). The Bank's agricultural lending is done primarily in its operating area.

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 personal guarantees on these loans. The Bank's construction loans are secured predominantly by properties located in its primary market area.

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

Credit Risk Elements – 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 predominantly by properties located in its primary market area.

The Bank's internal credit analysis staff reviews and validates credit risk on a periodic basis. In addition, an independent loan review is performed annually. Credit analysts' results are presented to management. The independent loan review is 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, 2018, 2017, and 2016, 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 table below summarizes the aggregate loan activity (in thousands) exceeding $60,000 for 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, 2018. Other changes include adjustments for loans applicable to one reporting period that are excludable from the other reporting period, including changes in the directorate.

	2018	2017	2016
Balance at January 1	$ 24,472	$ 20,222	$ 18,622
New loans, including renewals	19,880	12,494	7,170
Repayments	(20,683)	(8,244)	(5,570)
Change in related parties	(6,747)	-	-
Balance at December 31	$ 16,922	$ 24,472	$ 20,222

The unpaid principal balance of mortgage loans serviced for others, which are not included on the consolidated balance sheet, was $205,151,000 and $213,490,000 at December 31, 2018, and 2017, respectively.

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

	2018	2017	2016
Balance at January 1	$ 1,368	$ 1,436	$ 1,431
Additions	243	291	379
Amortized to expense	(337)	(359)	(374)
Balance at December 31	$ 1,274	$ 1,368	$ 1,436

No valuation allowance for capitalized mortgage servicing rights was considered necessary at December 31, 2018, or 2017, because the estimated fair value of such rights exceeded the carrying value.

In evaluating the allowance for loan losses, loans in 2018 were analyzed according to their regulatory reporting code. Previously, loans were analyzed based on the department originating the loan (commercial, mortgage, or consumer), which in some instances differed from 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 loss activity, listed by portfolio segment. Information is based on impairment method as of, and for the years ended, December 31, 2018, 2017, and 2016 (in thousands):

December 31, 2018	**Commercial Real Estate**	**Commercial**	**Agriculture**	**Real Estate Mortgage**	**Consumer**	**Total**
Balance at January 1	$ 2,794	$ 1,041	$ 601	$ 531	$ 42	$ 5,009
Provision (credit) for loan losses	440	(296)	17	(41)	130	250
Loans charged off	-	(4)	-	(82)	(174)	(260)
Recoveries	2	1	-	16	99	118
Balance at December 31	$ 3,236	$ 742	$ 618	$ 424	$ 97	$ 5,117
Ending balance individually evaluated for impairment	$ 415	$ -	$ 81	$ 30	$ -	$ 526
Ending balance collectively evaluated for impairment	2,821	742	537	394	97	4,591
Total	$ 3,236	$ 742	$ 618	$ 424	$ 97	$ 5,117

December 31, 2017	**Commercial including Commercial Real Estate**	**Consumer**	**Real Estate Mortgage 1st Lien**	**Real Estate Mortgage Junior Lien**	**Total**
Balance at January 1	$ 4,135	$ 21	$ 603	$ 83	$ 4,842
Provision (credit) for loan losses	232	(12)	(40)	(5)	175
Loans charged off	(160)	(5)	(120)	(1)	(286)
Recoveries	221	16	31	10	278
Balance at December 31	$ 4,428	$ 20	$ 474	$ 87	$ 5,009
Ending balance individually evaluated for impairment	$ 2	$ -	$ 29	$ 10	$ 41
Ending balance collectively evaluated for impairment	4,426	20	445	77	4,968
Total	$ 4,428	$ 20	$ 474	$ 87	$ 5,009
December 31, 2016					
Balance at January 1	$ 4,318	$ 31	$ 810	$ 114	$ 5,273
Provision for loan losses	294	21	(174)	(41)	100
Loans charged off	(601)	(41)	(57)	(28)	(727)
Recoveries	124	10	24	38	196
Balance at December 31	$ 4,135	$ 21	$ 603	$ 83	$ 4,842
Ending balance individually evaluated for impairment	$ 13	$ -	$ 75	$ -	$ 88
Ending balance collectively evaluated for impairment	4,122	21	528	83	4,754
Total	$ 4,135	$ 21	$ 603	$ 83	$ 4,842

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

In 2018, consumer loans also included demand deposit loan account charge-offs and recoveries. These amounted to $149,000 and $92,000, respectively, for the year ended December 31, 2018. In 2016 and 2017, commercial loans included demand deposit loan account charge-offs and recoveries. These amounted to $148,000 and $86,000, respectively, for the year ended December 31, 2017; and, $156,000 and $109,000, respectively, for the year ended December 31, 2016.

The following is a summary of the recorded investment in loans, by portfolio segment, and based on impairment method, as of December 31, 2018, and 2017 (in thousands):

December 31, 2018:	Commercial Real Estate	Commercial	Agriculture	Real Estate Mortgage	Consumer	Total
Ending balance individually evaluated for impairment	$ 3,659	$ -	$ 314	$ 2,116	$ 11	$ 6,100
Ending balance collectively evaluated for impairment	297,924	83,078	60,258	73,167	11,447	525,874
Ending balance	$ 301,583	$ 83,078	$ 60,572	$ 75,283	$ 11,458	$ 531,974

December 31, 2017:	Commercial including Commercial Real Estate	Consumer	Real Estate Mortgage 1st Lien	Real Estate Mortgage Junior Lien	Total
Ending balance individually evaluated for impairment	$ 851	$ 16	$ 2,008	$ 27	$ 2,902
Ending balance collectively evaluated for impairment	451,509	4,713	53,074	11,249	520,545
Ending balance	$ 452,360	$ 4,729	$ 55,082	$ 11,276	$ 523,447

The following tables present loans individually evaluated for impairment by class of loans, as of December 31, 2018, and December 31, 2017 (in thousands):

December 31, 2018	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
With no related allowance recorded:			
Commercial Real Estate	$ 269	$ 269	$ -
Commercial	-	-	-
Agriculture	233	233	-
Real Estate Mortgage	1,087	1,000	-
Consumer	11	11	-
With an allowance recorded:			
Commercial Real Estate	3,390	3,390	415
Commercial	-	-	-
Agriculture	81	81	81
Real Estate Mortgage	1,116	1,116	30
Consumer	-	-	-
Total	$ 6,187	$ 6,100	$ 526

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

December 31, 2017	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
With no related allowance recorded:			
Commercial	$ 20	$ 20	$ -
Real estate – commercial	491	491	-
Real estate – construction	-	-	-
Real estate – mortgage	1,187	1,170	-
Consumer	16	16	-
With an allowance recorded:			
Commercial	-	-	-
Real estate – commercial	340	340	2
Real estate – construction	-	-	-
Real estate – mortgage	865	865	39
Consumer	-	-	-
Total	$ 2,919	$ 2,902	$ 41

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

	2018	2017	2016
Average balance of impaired loans during the year	$ 4,501	$ 2,682	$ 3,502
Cash basis interest income recognized during the year	$ 464	$ 123	$ 93
Interest income recognized during the year	$ 415	$ 117	$ 127

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, 2018, and 2017. It also shows 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, 2018	Number of Loans	Amount	Specific Reserves Allocated	Number of Loans	Amount	Specific Reserves Allocated
Commercial Real Estate	2	$ 173	$ -	-	$ -	$ -
Commercial	-	-	-	-	-	-
Agriculture	2	233	-	-	-	-
Real Estate Mortgage	13	1,267	23	1	104	-
Consumer	-	-	-	-	-	-
Total	17	$ 1,673	$ 23	1	$ 104	$ -
December 31, 2017						
Commercial	-	$ -	$ -	-	$ -	$ -
Real estate – commercial	6	771	-	-	-	-
Real estate – construction	-	-	-	-	-	-
Real estate – mortgage	11	893	18	-	-	-
Consumer	-	-	-	-	-	-
Total	17	$ 1,664	$ 18	-	$ -	$ -

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

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

The loan modified during 2018 remained in nonaccrual status as of December 31, 2018.

The following table presents the aging of the recorded investment in past due and nonaccrual loans, as of December 31, 2018, and December 31, 2017. It is shown by class of loans (in thousands):

December 31, 2018	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 Real Estate	$ 55	$ -	$ 96	$ 151	$ 3,390	$ 298,042	$ 301,583
Commercial	-	-	-	-	-	83,078	83,078
Agriculture	32	-	-	32	87	60,453	60,572
Real Estate Mortgage	129	90	-	219	887	74,177	75,283
Consumer	1	9	-	10	11	11,437	11,458
Total	$ 217	$ 99	$ 96	$ 412	$ 4,375	$ 527,187	$ 531,974

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

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

December 31, 2017	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	$ 265	$ -	$ -	$ 265	$ 14	$ 109,153	$ 109,432
Real estate – commercial	87	34	285	406	31	300,021	300,458
Real estate – construction	-	-	-	-	-	30,473	30,473
Real estate – mortgage	190	37	-	227	815	74,476	75,518
Consumer	10	4	6	20	16	7,530	7,566
Total	$ 552	$ 75	$ 291	$ 918	$ 876	$ 521,653	$ 523,447

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 them based upon each loan's credit risk. This analysis includes all loans from the commercial loan department and 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 the full collection or liquidation highly questionable and improbable, based on the currently existing facts, conditions, and values.

As of December 31, 2018, and December 31, 2017, based on the most recent analysis performed, the risk category of loans by class of loans was as follows (in thousands):

December 31, 2018	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial Real Estate	$ 293,699	$ 3,084	$ 4,800	$ -	$ -	$ 301,583
Commercial	81,365	1,713	-	-	-	83,078
Agriculture	47,884	12,374	314	-	-	60,572
Real Estate Mortgage	20,906	827	421	-	53,129	75,283
Consumer	6,875	29	-	-	4,554	11,458
Total	$ 450,729	$ 18,027	$ 5,535	$ -	$ 57,683	$ 531,974

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

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
Commercial	$ 103,279	$ 6,139	$ 14	$ -	$ -	$ 109,432
Real estate – commercial	289,823	9,010	1,625	-	-	300,458
Real estate – construction	24,700	918	-	-	4,855	30,473
Real estate – mortgage	10,407	1,912	494	-	62,705	75,518
Consumer	1,776	41	-	-	5,749	7,566
Total	$ 429,985	$ 18,020	$ 2,133	$ -	$ 73,309	$ 523,447

NOTE E – PREMISES AND EQUIPMENT, NET

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

	2018	2017
Land	$ 2,185	$ 2,185
Buildings and improvements	18,973	18,886
Furniture and equipment	7,629	6,656
	28,787	27,727
Less accumulated depreciation	(14,491)	(13,462)
Totals	$ 14,296	$ 14,265

Depreciation of premises and equipment charged to operations was $1,300,000, $1,052,000, and $989,000 in 2018, 2017, and 2016, respectively.

Rent expense under operating leases amounted to $175,000, $167,000, and $249,000 in 2018, 2017, and 2016, respectively.

Lease commitments under non-cancelable operating equipment leases at December 31, 2018, were as follows (in thousands):

2019	$ 142
2020	141
2021	139
2022	141
2023	86
Thereafter	871
Total	$ 1,520

NOTE F – OTHER INTANGIBLE ASSETS

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

	2018		2017	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Core deposit intangibles	$ -	$ -	$ 3,122	$ 3,122
Other acquired relationship intangibles	360	33	-	-
Total	$ 360	$ 33	$ 3,122	$ 3,122

Aggregate amortization expense for the years ended December 31, 2018, 2017, and 2016, was $33,000, $229,000, and $260,000, respectively.

Estimated amortization expense for each of the next five years is $36,000 per year.

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

NOTE G – DEPOSITS

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

	2018	2017
Non-interest bearing checking	$ 129,923	$ 129,098
Interest bearing checking	191,048	154,917
Savings	81,724	93,995
Money market accounts	79,951	71,456
Time deposits	123,247	127,678
Totals	$ 605,893	$ 577,144

The carrying amount of time deposits over $250,000 at December 31, 2018, and 2017, was $37,057,000 and $44,856,000, respectively. Interest expense on these deposits was $812,000, $359,000, and $127,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

At December 31, 2018, scheduled maturities of time deposits were as follows for the years ending December 31 (in thousands):

2019	$ 61,075
2020	33,090
2021	16,302
2022	7,360
2023	5,420
Total	$ 123,247

Related party deposits were $5,043,000 and $16,794,000 at December 31, 2018, and 2017, respectively.

NOTE H – OTHER BORROWINGS

Other borrowings at December 31, 2018, and 2017, included $20,000,000 and $30,000,000, respectively, in advances from the Federal Home Loan Bank (FHLB) of Indianapolis. Principal is due at maturity for the advances outstanding at December 31, 2018. Each advance has a fixed interest rate ranging from 1.73% - 1.93%, with a weighted average rate of 1.83%.

All of the advances from the FHLB are secured by a blanket collateral agreement, which gives the FHLB an unperfected security interest in certain 1-4 family mortgage, home equity, and commercial real estate loans. Eligible FHLB loan collateral at December 31, 2018, and 2017, was approximately $134,832,000 and $138,501,000, respectively.

On May 9, 2017, the Company entered into a loan agreement with United Bankers Bank (UBB), consisting of a $10 million term loan, maturing in five years with a fixed rate equal to 4.5% percent. Repayment terms require quarterly principal payments of $250,000 each, plus interest with a final balloon payment of all outstanding principal and interest due upon maturity. The loan requires compliance with various specified financial covenants and is secured by all outstanding shares of the Bank's stock. At December 31, 2018, and 2017, $8,500,000 and $9,500,000, respectively, was outstanding under the loan. In addition, the Company has a $10 million variable rate line of credit available with UBB. At December 31, 2018, there was no balance outstanding on the line.

At December 31, 2018, scheduled principal reductions on other borrowings were as follows for the years ending December 31 (in thousands):

	FHLB	UBB	Total
2019	$ -	$ 1,000	$ 1,000
2020	10,000	1,000	11,000
2021	-	1,000	1,000
2022	-	5,500	5,500
2023	-	-	-
2024 and thereafter	10,000	-	10,000
Total other borrowings	$ 20,000	$ 8,500	$ 28,500

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):

	2018	2017
At December 31:		
Outstanding balance	$ 15,342	$ 13,950
Average interest rate	0.26%	0.25%
Daily average for the year:		
Outstanding balance	$ 12,896	$ 12,643
Average interest rate	0.24%	0.26%
Maximum outstanding at any month end	$ 16,168	$ 14,778

At December 31, 2018 and 2017, the Bank has $23,000,000 and $8,000,000, respectively, line of credit arrangements 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, 2018, was 5.19%. Interest expense related to the subordinated debentures amounted to $251,000 in 2018, $200,000 in 2017, and $177,000 in 2016. The Company's investment in the common stock of the trust is $155,000 and is included in other assets.

NOTE K – INCOME TAXES

On December 22, 2017, H.R. 1, commonly known as the Tax Cuts and Jobs Act (the Act) was signed into law. The Act reduces the corporate federal tax rate from 34% to 21%, effective January 1, 2018. As a result, the Company was required to re-measure its deferred tax assets and liabilities using the enacted rate at which the deferred tax assets and liabilities are expected to be recovered or settled. The effect of this re-measurement is recorded in the year the tax law is enacted. For 2017, the re-measurement of the Company's net deferred tax asset resulted in additional income tax expense of $989,000.

NOTE K – INCOME TAXES (CONTINUED)

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

	2018	2017	2016
Current	$ 1,516	$ 2,104	$ 1,688
Deferred	(81)	(51)	447
Effect of federal tax law change	-	989	-
Total income tax provision	$ 1,435	$ 3,042	$ 2,135

Income tax provision calculated at the statutory federal income tax rate of 21% for 2018 and 34% for 2017 and 2016, differs from actual income tax provision as follows (in thousands):

	2018	2017	2016
Income tax at statutory rate	$ 2,008	$ 2,877	$ 2,799
Tax-exempt interest income, net	(194)	(362)	(354)
Earnings on life insurance assets	(82)	(127)	(128)
Low income housing partnership tax credits	(43)	(47)	(38)
Captive insurance	(146)	(239)	(168)
Stock based compensation	(159)	(88)	(25)
Effect of federal tax law change	-	989	-
Other items, net	51	39	49
Totals	$ 1,435	$ 3,042	$ 2,135

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

	2018	2017
Deferred tax assets:		
Allowance for loan losses	$ 1,075	$ 1,052
Deferred compensation and supplemental retirement liability	1,007	932
Net unrealized loss on available-for-sale securities	346	195
Nonaccrual loan interest	98	85
Stock based compensation	183	177
Other	213	206
Total deferred tax assets	2,922	2,647
Deferred tax liabilities:		
Mortgage servicing rights	(267)	(287)
Goodwill	(130)	(130)
Purchase accounting adjustments	(32)	(41)
Depreciation	(482)	(423)
Prepaid expenses	(140)	(134)
Other	(42)	(35)
Total deferred tax liabilities	(1,093)	(1,050)
Net deferred tax assets included in other assets	$ 1,829	$ 1,597

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 2015.

SMB Risk Management, Inc. has elected, under IRC Section 831(b), to be taxed only on its investment income, which excludes the premium payments received under its insurance contracts from taxable income.

The Company believes that it had no significant uncertain tax positions as of December 31, 2018, and 2017.

NOTE L – BENEFIT PLANS

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 $341,000, $394,000, and $268,000 in 2018, 2017, and 2016, respectively.

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

	2018	2017
Allocated shares	140,798	129,256
Unallocated shares	7,000	12,400
Total ESOP shares	147,798	141,656

The fair value of allocated shares held by the ESOP is $5,364,000 and $4,795,000 at December 31, 2018, and 2017, 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.

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, 2018, was 3.82%. Deferred compensation expense was $305,000, $342,000, and $471,000 in 2018, 2017, and 2016, respectively. The liability for deferred compensation benefits was $3,279,000 and $3,047,000 at December 31, 2018, and 2017, 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 $0, $1,000, and $1,000 in 2018, 2017, and 2016, respectively. Liabilities associated with the SERP totaled $0 at December 31, 2018, and 2017.

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 $128,000 in 2018, $107,000 in 2017, and $103,000 in 2016. Liabilities associated with the 2011 SERP totaled $1,517,000 and $1,389,000 at December 31, 2018, and 2017, 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 $811,000, $735,000, and $379,000 in 2018, 2017, and 2016, respectively.

The Southern Michigan Bancorp, Inc. Stock Incentive Plan of 2014 was created 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, 2018, 246,158 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. Forfeitures are recognized as they occur.

	2018	2017	2016
Risk-free interest rate	1.76%	1.21%	0.92%
Expected option life	8 years	8 years	8 years
Expected stock price volatility	22.55%	23.37%	23.56%
Dividend yield	2.69%	2.79%	2.83%
Weighted-average fair value of options granted during year	$ 6.68	$ 5.13	$ 4.18

A summary of the activity in the stock based compensation plans for 2018 follows:

<u>Stock Options</u>

	Shares Subject to Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	34,405	$ 23.30		
Granted	14,200	37.15		
Exercised	(22,355)	21.03		
Forfeited	-			
Outstanding at end of year	26,250	$ 32.73	8.2 years	$ 141,000
Exercisable at year-end	2,200	$ 16.82	4.4 years	$ 47,000

	2018	2017	2016
Intrinsic value of options exercised	$ 487,000	$ 110,000	$ 227,000
Cash received from options exercise	471,000	241,000	1,785,000
Tax benefit realized from options exercises	159,000	88,000	25,000

As of December 31, 2018, there was $31,000 of total, unrecognized compensation cost related to non-vested stock options granted under the plans. The cost is expected to be recognized over a weighted average period of one year.

NOTE M – STOCK BASED COMPENSATION (CONTINUED)

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, 2018, 2017, and 2016 was $1,056,000, $532,000, and $427,000, respectively. As of December 31, 2018, there was $1,741,000 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 2.8 years.

A summary of activity for restricted stock for 2018 follows:

	Shares	Weighted Average Grant Date Fair Value
Non-vested at January 1, 2018	98,515	$ 27.18
Granted	12,200	37.15
Vested	(28,147)	25.49
Forfeited	(483)	30.17
Non-vested at December 31, 2018	82,085	$ 29.22

NOTE N – COMMITMENTS

Various commitments 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, 2018, and 2017, 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, 2018, and 2017, commitments under outstanding standby letters of credit were $2,925,000 and $8,795,000, respectively.

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

	2018	2017
Fixed rate	$ 53,097	$ 59,593
Variable rate	97,786	87,191
Totals	$ 150,883	$ 146,784

The fixed rate commitments have stated interest rates ranging from 3.50% to 15.00%. The terms of the above commitments range from 1 to 240 months.

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

Certain executives of the Bank have employment contracts containing change of control clauses. The employment contracts provide for the payment of 2.99 times the officers' base salaries and bonuses, should the officers be terminated in the event of a change of control.

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

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, 2018, using the most restrictive of these conditions, the aggregate cash dividends the Bank could pay the Company without prior regulatory approval was approximately $17.0 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, 2018, and 2017 (in thousands):

	Unrealized Gains (Losses) Available-for-Sale Securities
Balance at January 1, 2017	$ (1,004)
Other comprehensive income before reclassifications	596
Amounts reclassified from accumulated other comprehensive loss	(3)
Current year other comprehensive income, before tax	593
Income tax effect	(202)
Current year other comprehensive income, net of tax	391
Balance at December 31, 2017	$ (613)
Other comprehensive loss before reclassifications	(879)
Amounts reclassified from accumulated other comprehensive income	161
Current year other comprehensive loss, before tax	(718)
Income tax effect	151
Current year other comprehensive loss, net of tax	(567)
Reclassification effect from tax rate change	(121)
Balance at December 31, 2018	$ (1,301)

Accumulated other comprehensive loss amounted to $(1,301,000) at December 31, 2018, and $(613,000) at December 31, 2017, consisting of the following (in thousands):

	2018	2017
Unrealized loss on available-for-sale securities, net of income taxes of $(346) in 2018 and $(195) in 2017	$ (1,301)	$ (613)

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, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$ 719	$ 1,166
Investment in subsidiary bank	85,289	80,533
Investment in non-banking subsidiaries	1,706	1,634
Premises and equipment, net	698	729
Other assets	1,412	1,247
Total Assets	$ 89,824	$ 85,309
Liabilities and Shareholders' Equity		
Dividends payable	$ 510	$ 487
Other liabilities	132	130
Other borrowings	8,500	9,500
Subordinated debentures	5,155	5,155
Shareholders' equity	75,527	70,037
Total Liabilities and Shareholders' Equity	$ 89,824	$ 85,309

Statements of Income	Year ended December 31, 2018	2017	2016
Dividends from subsidiary bank	$ 3,258	$ 3,048	$ 3,041
Dividends from non-banking subsidiaries	640	-	-
Interest income	5	6	4
Interest expense	(664)	(501)	(179)
Rental income from subsidiary bank	137	137	137
Other expenses	(957)	(938)	(711)
	2,419	1,752	2,292
Federal income tax credit	(311)	(334)	(255)
	2,730	2,086	2,547
Equity in net income, less dividends received from:			
Subsidiary bank	5,323	2,627	3,056
Non-banking subsidiaries	72	708	494
Net Income	$ 8,125	$ 5,421	$ 6,097

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

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

Statements of Cash Flows	Year ended December 31, 2018	2017	2016
Operating Activities			
Net income	$ 8,125	$ 5,421	$ 6,097
Adjustments to reconcile net income to net cash from operating activities:			
Equity in net income, less dividends received from:			
Subsidiary bank	(5,323)	(2,627)	(3,056)
Non-banking subsidiary	(72)	(708)	(494)
Stock option and restricted stock grant compensation expense	811	735	379
Depreciation of premises and equipment	31	31	31
Net change in obligation under ESOP	126	105	(147)
Other, net	(163)	87	(164)
Net cash from operating activities	3,535	3,044	2,646
Investing Activities			
Capital investment in subsidiary	-	(5,000)	(250)
Net cash from investing activities	-	(5,000)	(250)
Financing Activities			
Repayments of other borrowings	(1,000)	(700)	-
Proceeds from other borrowings	-	10,000	200
Cash dividends paid	(1,998)	(1,961)	(1,737)
Stock options exercised	471	241	1,785
Repurchase of common stock	(1,455)	(5,031)	(2,515)
Net cash from financing activities	(3,982)	2,549	(2,267)
Net change in cash and cash equivalents	(447)	593	129
Beginning cash and cash equivalents	1,166	573	444
Ending cash and cash equivalents	$ 719	$ 1,166	$ 573

NOTE R – SUPPLEMENTAL CASH FLOW DISCLOSURES

The following supplemental cash flow disclosures are provided for the years ended December 31, 2018, 2017, and 2016 (in thousands):

	2018	2017	2016
Cash paid during the year for:			
Interest	$ 4,471	$ 2,661	$ 1,795
Income taxes	1,125	1,960	2,425
Non-cash operating activities:			
Change in deferred income taxes on net unrealized gain (loss) on available-for-sale securities	(151)	202	(731)
Non-cash investing activities:			
Change in unrealized gain (loss) on available-for-sale securities	(718)	593	(2,149)
Transfers from loans to other real estate owned	81	190	543

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 for gaining an indication of where the instrument falls within the fair value hierarchy. This is described in greater detail in Note T.

Cash and cash equivalents: The carrying amount reported in the balance sheet approximates fair value and results 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 bond 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 have no significant change in credit risk, fair values are based on carrying values and result in a Level 3 classification. The fair values for other loans are estimated using discounted cash flows analyses, using interest rates currently offered for loans with similar terms to borrowers of similar credit quality and result in a Level 3 classification.

Loans held for sale: The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors and results 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 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) and result 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 based on the FHLB yield curve, 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 and results in a Level 2 classification.

Other borrowings: The fair value of other borrowings is estimated using discounted cash flows analyses using the FHLB yield curve. This results 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. Such analyses are based on the current borrowing rates for similar types of borrowing arrangements. This results 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, 2018, and 2017, 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, 2018, and 2017, 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. Furthermore, 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	2018 Carrying Amount	2018 Fair Value	2017 Carrying Amount	2017 Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 54,741	$ 54,741	$ 17,421	$ 17,421
Federal funds sold	Level 1	1,065	1,065	18,492	18,492
Securities available-for-sale	See Note T	101,439	101,439	105,184	105,184
Loans held for sale	Level 2	-	-	515	515
Loans, net of allowance for loan losses	Level 3	526,857	521,528	518,438	516,554
Accrued interest receivable	Level 1	3,294	3,294	3,211	3,211
Financial liabilities:					
Deposits	Level 2	$ (605,893)	$ (604,172)	$ (577,144)	$ (579,230)
Securities sold under agreements to repurchase and overnight borrowings	Level 2	(15,342)	(15,342)	(13,950)	(13,950)
Other borrowings	Level 2	(28,500)	(27,660)	(39,500)	(39,519)
Subordinated debentures	Level 3	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	Level 1	(245)	(245)	(218)	(218)

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 related 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. In the absence of a principal market, the most advantageous market for the asset or liability is used. 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 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: 1) quoted prices for similar assets or liabilities in active markets; 2) quoted prices for identical, or similar, assets or liabilities in markets that are not active; 3) inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.); or 4) inputs 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 non-financial 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, when 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, which include the discounting of appraisals based on age, changes in the 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; such discounts generally range from 3.6% to 7.8%. 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 non-financial assets (there were no financial or non-financial liabilities) measured at fair value as of December 31, 2018, and 2017. Information is segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

2018	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Recurring:				
Securities available-for-sale:				
U.S. Treasuries	$ 1,982	$ -	$ -	$ 1,982
Federal agencies	-	38,872	-	38,872
States and political subdivisions	-	37,503	19,644	57,147
Corporate securities	-	498	-	498
Asset-backed securities	-	2,940	-	2,940
Total available-for-sale	$ 1,982	$ 79,813	$ 19,644	$ 101,439
Nonrecurring:				
Impaired loans	$ -	$ -	$ 5,574	$ 5,574
Other real estate owned:				
Commercial	$ -	$ -	$ 18	$ 18
Residential real estate	$ -	$ -	$ 81	$ 81

NOTE T – FAIR VALUE MEASUREMENTS (CONTINUED)

2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Recurring:				
Securities available-for-sale:				
U.S. Treasuries	$ 2,000	$ -	$ -	$ 2,000
Federal agencies	41,035	-	-	41,035
States and political subdivisions	-	42,860	19,285	62,145
Mortgage-backed securities	-	4	-	4
Total available-for-sale	$ 43,035	$ 42,864	$ 19,285	$ 105,184
Nonrecurring:				
Impaired loans	$ -	$ -	$ 2,861	$ 2,861
Other real estate owned:				
Commercial	$ -	$ -	$ 33	$ 33
Residential real estate	$ -	$ -	$ 51	$ 51

In 2018, the Company changed bond accounting firms. This resulted in fair values for only U.S. Treasuries being determined using Level 1 inputs. All of the federal agencies previously priced using Level 1 inputs were priced using Level 2 inputs as of December 31, 2018. This resulted in $41,035,000 of transfers from Level 1 pricing to Level 2 pricing during 2018.

Impaired loans are reported net of an allowance for loan losses of $526,000 at December 31, 2018, and $41,000 at December 31, 2017.

Other real estate owned, which is measured at the lower of carrying or fair value, less costs to sell, had a net carrying amount of $99,000 as of December 31, 2018, ($118,000, net of a valuation allowance of $19,000). Other real estate owned had a net carrying amount of $84,000 at December 31, 2017, ($103,000, net of a valuation allowance of $19,000).

The following is a reconciliation of the beginning and ending balances of securities available-for-sale. These are measured at fair value on a recurring basis, using significant unobservable (Level 3) inputs during the years ended December 31, 2018, and 2017 (in thousands):

	2018	2017
Balance at January 1	$ 19,285	$ 19,901
Net maturities and calls	(5,040)	(5,194)
Unrealized net gains/(losses) included in other comprehensive income	282	(180)
Purchases	2,433	4,758
Transfer to Level 3	2,805	-
Transfer to Level 2	(121)	-
Balance at December 31	$ 19,644	$ 19,285

Three municipal bonds with a fair value of $2,805,000 as of December 31, 2018, were transferred out of Level 2 and into Level 3 due to a lack of observable market data for those investments. One municipal bond with a fair value of $121,000 as of December 31, 2018, was transferred from Level 3 to Level 2 because observable market data became available for that investment.

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 established 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.

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 and asset growth are limited, while plans for capital restoration are required.

Under the amended Small Bank Holding Company Policy Statement (Regulation Y, Appendix C) (the “Policy Statement”) the Company qualifies for treatment as a small bank holding company 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
2018						
Total Capital to risk weighted assets:						
Consolidated	$ 73,197	12.0%	N/A	N/A	N/A	N/A
Bank	77,959	12.8	$ 48,755	8.0%	$ 60,943	10.0%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	68,080	11.1	N/A	N/A	N/A	N/A
Bank	72,842	12.0	36,566	6.0	48,755	8.0
Common Tier 1 Capital to risk weighted assets (CET1):						
Consolidated	68,080	11.1	N/A	N/A	N/A	N/A
Bank	72,842	12.0	27,424	4.5	39,613	6.5
Tier 1 (Core) Capital to average assets:						
Consolidated	68,080	9.3	N/A	N/A	N/A	N/A
Bank	72,840	9.9	29,303	4.0	36,629	5.0

NOTE U – REGULATORY MATTERS (CONTINUED)

2017

Total Capital to risk weighted assets:						
Consolidated	$ 67,237	11.1%	N/A	N/A	N/A	N/A
Bank	72,733	12.1	$ 48,293	8.0%	$ 60,366	10.0%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	62,228	10.3	N/A	N/A	N/A	N/A
Bank	67,724	11.2	36,220	6.0	48,293	8.0
Common Tier 1 Capital to risk weighted assets (CET1):						
Consolidated	62,228	10.3	N/A	N/A	N/A	N/A
Bank	67,724	11.2	27,165	4.5	39,238	6.5
Tier 1 (Core) Capital to average assets:						
Consolidated	62,228	9.0	N/A	N/A	N/A	N/A
Bank	67,724	9.8	27,581	4.0	34,476	5.0

NOTE V – QUALIFIED AFFORDABLE HOUSING PROJECT INVESTMENTS

The Company invests in qualified investment housing projects. At December 31, 2018, and 2017, the balance of the investment for qualified affordable housing projects was $839,000 and $402,000, respectively. 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 $480,000 and $190,000 at December 31, 2018, and 2017. The Company expects to fulfill these commitments during the year ending 2033.

During the years ended December 31, 2018, 2017, and 2016, the Company recognized amortization expense of $63,000, $45,000 and $41,000, respectively, which was included within income tax expense on the consolidated statements of income.

Additionally, during the years ended December 31, 2018, 2017, and 2016, the Company recognized tax credits and other benefits from its investment in affordable housing tax credits of $43,000, $47,000 and $38,000, respectively.

NOTE W – REVENUE FROM CONTRACTS WITH CUSTOMERS

The Company's primary sources of revenue include net interest income, service charges and fees, trust fees, gains on the sale of loans, earnings on life insurance assets, and ATM and debit card fee income. Net interest income, gains on the sale of loans and earnings on life insurance assets are outside of the scope of ASC 606, *Revenue from Contracts with Customers*. Other sources of revenue fall within the scope of ASC 606 and are primarily recognized within "Non-interest income" in the Consolidated Statements of Income.

The Company recognizes revenue when the performance obligations related to the transfer of goods or services under the terms of a contract are satisfied. Some obligations are satisfied at a point in time, while others are satisfied over a period of time. Revenue is recognized as the amount of consideration expected to be received in exchange for transferring goods or services to a customer and is segregated based on the nature of product and services offered as part of contractual arrangements. Generally, these sources of revenue are earned at the time the service is delivered or over the course of a monthly period and they do not result in any contract asset or liability balance at any given period end. As a result, there were no contract assets or liabilities recorded. Revenue within the scope of ASC 606 is discussed in the following paragraphs.

NOTE W - REVENUE FROM CONTRACTS WITH CUSTOMERS (CONTINUED)

Service charges on deposit accounts include fees and other charges the Company receives to provide various services, including but not limited to, monthly service fees, account analysis fees, providing overdraft services, and accepting and executing stop-payment orders. The consideration includes both fixed (e.g., monthly service fees) and transaction fees (i.e., stop-payment fee). Fixed fees are recognized over the period of time the service is provided while transaction fees are recognized when a specific service is rendered to the customer.

Trust fees include fee income generated from investment management services. Services are rendered over a period of time, over which revenue is recognized.

ATM and debit card fees primarily include debit card interchange and network revenues. Debit card interchange and network revenues are earned on debit card transactions conducted through payment networks such as MasterCard and Pulse. Interchange income is recognized concurrently with the delivery of services on a daily basis. Interchange and network revenues are presented gross of interchange expenses, which are presented separately as a component of non-interest expense.

Other non-interest income include check orders, wire transfer fees, check cashing fees, cash management fees, and other service charges totaling $331,000 during 2018. The Company's performance obligation for cash management fees is generally satisfied, and therefore, revenue is recognized over the period in which the service is provided. Check orders, wire transfer fees, check cashing fees and other deposit account related fees are largely transaction based, and therefore, the performance obligation is satisfied and related revenue recognized, at a point in time. These fees are included in the Other category of Non-interest income.

Net gain or loss on sales of other real estate is recognized at the time the sale is complete, including sales that are seller financed, as receipt of all payments is expected.

Contract Balances
A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest income streams are largely based on transactional activity, or standard month-end revenue accruals, such as asset management fees based on month-end market values. Consideration is most often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of December 31, 2018, the Company did not have a material amount of contract balances.

NOTE X – 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
2018						
First Quarter	$ 6,983	$ 6,081	$ -	$ 1,802	$ 0.78	$ 0.78
Second Quarter	7,328	6,307	-	2,216	0.96	0.96
Third Quarter	7,657	6,402	-	2,283	0.99	0.98
Fourth Quarter	7,814	6,494	250	1,824	0.79	0.79
2017						
First Quarter	$ 5,820	$ 5,321	$ -	$ 1,446	$ 0.59	$ 0.59
Second Quarter	6,114	5,579	-	1,493	0.63	0.63
Third Quarter	6,587	5,753	175	1,743	0.76	0.75
Fourth Quarter	6,830	5,930	-	739	0.32	0.32

Selected Financial Data

(in thousands, except per share data)

	Year Ended December 31				
	2018	2017	2016	2015	2014
Total interest income	$ 29,782	$ 25,351	$ 22,031	$ 21,195	$ 20,320
Net interest income	25,284	22,583	20,217	19,568	18,707
Provision for loan losses	250	175	100	250	400
Net income	8,125	5,421	6,097	5,806	4,792
Per share data:					
Basic earnings per share	3.52	2.30	2.54	2.42	1.99
Cash dividends declared	0.87	0.83	0.76	0.63	0.58
Balance sheet data:					
Gross loans	531,974	523,447	449,815	421,989	410,112
Deposits	605,893	577,144	535,845	477,485	444,270
Other borrowings	28,500	39,500	10,200	10,000	10,000
Equity	75,527	70,037	70,131	67,769	63,160
Total assets	738,831	712,345	641,532	582,771	543,345
Return on average assets	1.11%	0.80%	1.00%	1.02%	0.87%
Return on average equity (1)	11.21	7.64	8.69	8.82	7.79
Dividend payout ratio (2)	24.87	36.08	30.26	26.15	29.15
Average equity to average assets (1)	9.92	10.52	11.49	11.52	11.18

(1) Average equity 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 11, 2019, there were 2,321,678 shares of Southern common stock, issued and outstanding, held by 308 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:

	2018			2017		
	Closing Price		Cash Dividends Declared	Closing Price		Cash Dividends Declared
Quarter Ended	High	Low		High	Low	
March 31	$ 44.00	$ 35.60	$ 0.21	$ 35.00	$ 29.50	$ 0.20
June 30	38.00	35.50	0.22	35.00	32.01	0.21
September 30	47.00	36.22	0.22	34.60	32.01	0.21
December 31	41.90	38.10	0.22	38.00	33.15	0.21

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.

View from the front of Southern's Marshall Branch.

Southern Michigan
BANCORP, INC.