SOUTHERN MICHIGAN BANCORP INC
Form 10-Q
May 15, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2012

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to

Commission File Number: 000-49772

SOUTHERN MICHIGAN BANCORP, INC.

(Exact Name of Registrant as Specified in its Charter)

Michigan **(State or Other Jurisdiction** **of Incorporation or Organization)**	**38-2407501** **(I.R.S. Employer** **Identification No.)**
51 West Pearl Street **Coldwater, Michigan** **(Address of Principal Executive Offices)**	**49036** **(Zip Code)**

(517) 279-5500

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares outstanding of the Registrant s Common Stock, $2.50 par value, as of May 11, 2012, was 2,358,079 shares.

Forward-Looking Statements

This report contains forward-looking statements that are based on management s beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Southern Michigan Bancorp, Inc. Forward-looking statements may be identified by words or phrases such as outlook , plan , or strategy ; that an event or trend may , should , will , is likely , or is probable to continue , has begun or is scheduled or on track or that the Company or its management anticipates , believes , estimates , plans , fore predicts , projects , or expects a particular result, or is committed , confident , optimistic or has an opinion that an event will occur, or oth or phrases such as ongoing , future , judgment , signs , efforts , tend , exploring , appearing , until , near term , going forward , s such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties, which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, statements related to trends in our credit quality metrics, future capital levels, future charge-off levels, real estate valuation, future levels of non-performing assets and costs associated with administration and disposition of non-performing assets, the rate of asset dispositions, dividends, future growth and funding sources, future liquidity levels, the availability of sources of liquidity, future profitability levels, the effects on earnings of changes in interest rates and other revenue sources, the effects of new or changed accounting standards and the effects of existing or new laws or regulations (or interpretations thereof). All statements with references to future time periods are forward-looking. 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 of the information concerning interest rate sensitivity is forward-looking. Management s assumptions regarding pension and other post retirement plans involve judgments that are inherently forward-looking. Our ability to sell other real estate at carrying value or at all, successfully implement new programs and initiatives, increase efficiencies, respond to declines in collateral values and credit quality, maintain our current level of deposits and other sources of funding, and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Southern Michigan Bancorp, Inc., specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions (risk factors) that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update or revise our forward-looking statements to reflect developments that occur or information obtained after the date of this report.

Risk factors include, but are not limited to, the risk factors described in Item 1A - Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2011. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

Part I. Financial Information

Item 1. Financial Statements

SOUTHERN MICHIGAN BANCORP, INC.

UNAUDITED INTERIM FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share data)

		March 31, 2012	December 31, 2011
ASSETS			
Cash and cash equivalents		$ 58,037	$ 42,185
Federal funds sold		261	287
Securities available for sale		84,801	90,344
Loans held for sale		2,650	1,088
Loans, net of allowance for loan losses of $5,525 - 2012 ($5,412 - 2011)		327,344	327,392
Premises and equipment, net		12,451	12,546
Accrued interest receivable		2,067	2,148
Net cash surrender value of life insurance		10,400	10,312
Goodwill		13,422	13,422
Other intangible assets, net		1,585	1,666
Other assets		7,415	7,830
TOTAL ASSETS		$ 520,433	$ 509,220
LIABILITIES			
Deposits:			
Non-interest bearing		$ 69,572	$ 61,930
Interest bearing		364,965	358,581
Total deposits		434,537	420,511
Securities sold under agreements to repurchase and overnight borrowings		14,932	18,074
Accrued expenses and other liabilities		4,234	4,568
Other borrowings		7,600	7,751
Subordinated debentures		5,155	5,155
Common stock subject to repurchase obligation in Employee Stock Ownership Plan, shares outstanding in 2012 (115,170 shares in 2011)	116,711	1,476	1,296
Total liabilities		467,934	457,355
SHAREHOLDERS EQUITY			
Preferred stock, 100,000 shares authorized; none issued or outstanding			
Common stock, $2.50 par value:			
Authorized - 4,000,000 shares			
Issued 2,376,724 shares in 2012 (2,358,599 shares in 2011) Outstanding (other than ESOP shares) shares in 2012 (2,243,429 shares in 2011)	2,260,013	5,650	5,609
Additional paid-in capital		18,104	18,278
Retained earnings		28,410	27,576
Accumulated other comprehensive income, net		472	571

Unearned Employee Stock Ownership Plan shares	(137)	(169)
Total shareholders equity	52,499	51,865
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 520,433	$ 509,220

See accompanying notes to interim consolidated financial statements.

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Southern Michigan Bancorp, Inc.

Consolidated Statements of Income (Unaudited)

(In thousands, except per share data)

	Three Months Ended March 31, 2012	2011
Interest income:		
Loans, including fees	$ 4,511	$ 4,370
Securities:		
Taxable	156	138
Tax-exempt	242	216
Other	26	51
Total interest income	4,935	4,775
Interest expense:		
Deposits	661	844
Other	133	159
Total interest expense	794	1,003
Net interest income	4,141	3,772
Provision for loan losses	225	125
Net interest income after provision for loan losses	3,916	3,647
Non-interest income:		
Service charges on deposit accounts	394	511
Trust fees	298	275
Net gains on security calls	3	2
Net gains on loan sales	402	317
Earnings on life insurance assets	88	80
ATM and debit card fee income	272	235
Brokerage income	54	46
Other	154	189
Total non-interest income	1,665	1,655
Non-interest expense:		
Salaries and employee benefits	2,421	2,447
Occupancy, net	283	373
Equipment	192	203
Printing, postage and supplies	139	141
Telecommunication expenses	96	99
Professional and outside services	256	221
Software maintenance	111	105
FDIC assessments	100	165
Amortization of other intangibles	81	85
Expenses relating to OREO property	128	45
ATM expense	101	82
Other	374	399
Total non-interest expense	4,282	4,365
INCOME BEFORE INCOME TAXES	1,299	937
Federal income tax provision	297	189

NET INCOME	$	1,002	$	748
Basic Earnings Per Common Share	$	0.43	$	0.32
Diluted Earnings Per Common Share	$	0.42	$	0.32
Dividends Declared Per Common Share	$	0.07	$	0.05

See accompanying notes to interim consolidated financial statements.

Southern Michigan Bancorp, Inc.

Consolidated Statements of Comprehensive Income (Unaudited)

(In thousands, except per share data)

	Three Months Ended March 31, 2012	2011
NET INCOME	$ 1,002	$ 748
OTHER COMPREHENSIVE INCOME (LOSS)		
Unrealized gain (loss) on available for sale securities	(148)	200
Reclassification adjustments for net realized gains included in net income	(3)	(2)
	(151)	198
Income tax effect	(52)	67
Other comprehensive income (loss)	(99)	131
TOTAL COMPREHENSIVE INCOME	$ 903	$ 879

See accompanying notes to interim consolidated financial statements.

Southern Michigan Bancorp, Inc.

Consolidated Statements of Changes in Shareholders Equity

(In thousands, except number of shares and per share data)

For the Three Months Ended March 31, 2012 and 2011

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Unearned ESOP Shares	Total
Balance at January 1, 2011	$ 5,583	$ 18,033	$ 24,692	$ (168)	$ (297)	$ 47,843
Net income			748			748
Net change in other comprehensive income items				131		131
Cash dividends declared - $.05 per share			(117)			(117)
Vesting of restricted stock		20				20
Forfeiture of restricted stock (378 shares)	(2)	2				
Change in common stock subject to repurchase	(2)	95				93
Reduction of ESOP obligation					32	32
Stock option expense		15				15
Balance at March 31, 2011	$ 5,579	$ 18,165	$ 25,323	$ (37)	$ (265)	$ 48,765
Balance at January 1, 2012	$ 5,609	$ 18,278	$ 27,576	$ 571	$ (169)	$ 51,865
Net income			1,002			1,002
Net change in other comprehensive income items				(99)		(99)
Cash dividends declared - $.07 per share			(168)			(168)
Vesting of restricted stock		39				39
Change in common stock subject to repurchase	(4)	(176)				(180)
Issuance of restricted stock (18,125 shares of common stock at $11.20)	45	(45)				
Reduction of ESOP obligation					32	32
Stock option expense		8				8
Balance at March 31, 2012	$ 5,650	$ 18,104	$ 28,410	$ 472	$ (137)	$ 52,499

See accompanying notes to interim consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Operating Activities		
Net income	$ 1,002	$ 748
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	225	125
Depreciation	232	222
Net amortization (accretion) of investment securities	(50)	215
Loans originated for sale	(16,267)	(9,576)
Proceeds on loans sold	15,107	12,263
Net gains on loan sales	(402)	(317)
Stock option and restricted stock grant compensation expense	47	35
Net gains on security calls	(3)	(2)
Net loss on other real estate owned sales	74	28
Amortization of other intangible assets	81	85
Net gain on disposal of equipment		(7)
Net change in obligation under ESOP	32	32
Net change in:		
Accrued interest receivable	81	(120)
Cash surrender value of life insurance	(88)	(80)
Other assets	(176)	187
Accrued expenses and other liabilities	(335)	(363)
Net cash from operating activities	(440)	3,475
Investing Activities		
Activity in available for sale securities:		
Proceeds from maturities and calls	14,696	6,144
Purchases	(9,251)	(28,001)
Net change in federal funds sold	26	26
Loan originations and payments, net	(434)	3,409
Proceeds on other real estate owned sales	826	323
Proceeds from sale of equipment		26
Additions to premises and equipment	(137)	(241)
Net cash from investing activities	5,726	(18,314)
Financing Activities		
Net change in deposits	14,026	7,694
Net change in securities sold under agreements to repurchase and overnight borrowings	(3,142)	1,594
Repayments of other borrowings	(151)	(1,225)
Cash dividends paid	(167)	(116)
Net cash from financing activities	10,566	7,947
Net change in cash and cash equivalents	15,852	(6,892)
Beginning cash and cash equivalents	42,185	78,833
Ending cash and cash equivalents	$ 58,037	$ 71,941

Cash paid for interest	$ 798	$ 1,002
Cash paid for income taxes	647	50
Transfers from loans to other real estate owned	257	78

See accompanying notes to interim consolidated financial statements.

SOUTHERN MICHIGAN BANCORP, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments considered necessary in order to make the financial statements not misleading have been included. Operating results for the three months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and related footnotes of the Company for December 31, 2011 included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, filed with the Securities and Exchange Commission on March 30, 2012.

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.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Estimating the risk of loss and the amount of loss on any loan is necessarily subjective. Accordingly, management estimates the allowance balance based on past loan loss experience, nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, information in regulatory examination reports, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management s judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired.

Consumer loans are typically charged-off no later than 120 days past due. Real estate mortgage loans in the process of collection are charged-off on or before they become 365 days past due. Commercial loans are charged-off promptly upon the determination that all or a portion of any loan balance is uncollectible. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Impaired Loans: Loan impairment is reported when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage and consumer loans and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan s effective interest rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans are evaluated for impairment when payments are delayed, typically 90 days or more, or when it is probable that all principal and interest amounts will not be collected according to the contractual terms of the loan. Loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. All nonaccrual loans have also been determined by the Company to meet the definition of an impaired loan.

Reclassifications

Certain 2011 items have been reclassified to conform to the 2012 presentation.

NOTE B NEW ACCOUNTING PRONOUNCEMENTS

Adoption of New Accounting Standards:

In May 2011, the Financial Accounting Standards Board (FASB) issued ASU No. 2011-04 *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in ASU 2011-04 generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. ASU 2011-04 results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRSs. The amendments in ASU 2011-04 are to be applied prospectively. ASU 2011-04 was adopted effective January 1, 2012, but did not have any impact on the Company s financial position or results of operations.

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

The amendments in ASU 2011-05 should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted ASU 2011-05 for the first quarter of 2012 and has elected to present the components of other comprehensive income in a separate statement. The adoption of ASU 2011-05 did not have any impact on the Company s financial condition or results of operations.

In September 2011, FASB issued ASU 2011-08, *Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment*. The amendments in ASU 2011-08 gives the entity the option of first assessing qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after the assessment, the entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. The amendments in ASU 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company will consider the provisions of ASU 2011-08 when performing annual goodwill and other intangible asset impairment testing later in 2012.

In December 2011, FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, amending ASC Topic 210 requiring an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effects of those arrangements on its financial position. ASU 2011-11 is effective for annual and interim periods beginning on or after January 1, 2013. The Company has not yet determined what, if any, financial statement impact the adoption of ASU 2011-11 will have.

NOTE C EARNINGS PER SHARE

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. ESOP shares are considered outstanding for this calculation unless unearned. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per common share are restated for all stock splits and stock dividends through the date of issue of the financial statements.

A reconciliation of the numerators and denominators of basic and diluted earnings per share for the three month periods ended March 31, 2012 and 2011 is as follows (dollars in thousands, except per share data):

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Basic earnings per share:		
Net income	$ 1,002	$ 748
Weighted average common shares outstanding	2,372,193	2,340,434
Less unallocated ESOP shares	15,017	23,844
Weighted average common shares outstanding for basic earnings per share	2,357,176	2,316,590
Basic earnings per share	$ 0.43	$ 0.32
Diluted earnings per share:		
Net income	$ 1,002	$ 748
Weighted average common shares outstanding for basic earnings per share	2,357,176	2,316,590
Add: Dilutive effect of assumed exercise of stock options	4,379	4,729
Weighted average common and dilutive potential common shares outstanding	2,361,555	2,321,319
Diluted earnings per share	$ 0.42	$ 0.32

Stock option awards that were anti-dilutive, and therefore not included in the computation of diluted earnings per share, were as follows: 199,961 and 196,787 as of March 31, 2012 and 2011, respectively.

NOTE D   LOANS AND ALLOWANCE FOR LOAN LOSSES

Credit Risk Elements:

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

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

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

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

In evaluating the allowance for loan losses, loans are analyzed based on the department originating the loan (commercial, mortgage or consumer), which in some instances may be different than how the loans are categorized for regulatory reporting purposes. Consequently, loan groupings for impaired loans for purposes of calculating the allowance for loan losses by portfolio segment may differ from impaired loan groupings for regulatory reporting purposes.

The following is an analysis of the allowance for loan losses by portfolio segment and based on impairment method as of and for the three month periods ended March 31, 2012 and 2011 (in thousands):

	Commercial including Commercial Real Estate	Consumer	Real Estate Mortgage 1st Lien	Real Estate Mortgage Junior Lien	Total
March 31, 2012:					
Balance at January 1	$ 4,039	$ 68	$ 1,155	$ 150	$ 5,412
Provision for loan losses	60	3	155	7	225
Loans charged off	(48)	(8)	(124)	(11)	(191)
Recoveries	63	6	2	8	79
Balance at March 31	$ 4,114	$ 69	$ 1,188	$ 154	$ 5,525
Ending balance individually evaluated for impairment	$ 895		$ 243	$ 5	$ 1,143
Ending balance collectively evaluated for impairment	3,219	69	945	149	4,382
Total	$ 4,114	$ 69	$ 1,188	$ 154	$ 5,525
March 31, 2011:					
Balance at January 1	$ 4,239	$ 86	$ 1,211	$ 158	$ 5,694
Provision for loan losses	(202)	47	146	134	125
Loans charged off	(100)	(35)	(120)	(64)	(319)
Recoveries	66	3	6	1	76
Balance at March 31	$ 4,003	$ 101	$ 1,243	$ 229	$ 5,576
Ending balance individually evaluated for impairment	$ 842		$ 309	$ 15	$ 1,166
Ending balance collectively evaluated for impairment	3,161	101	934	214	4,410
Total	$ 4,003	$ 101	$ 1,243	$ 229	$ 5,576

Commercial loans also include demand deposit loan account charge-offs and recoveries amounting to $43,000 and $39,000, respectively, for the three months ended March 31, 2012 and $37,000 and $23,000, respectively, for the three months ended March 31, 2011.

The following is a summary of the recorded investment in loans, by portfolio segment and based on impairment method, as of March 31, 2012 and December 31, 2011 (in thousands):

	Commercial including Commercial Real Estate	Consumer	Real Estate Mortgage 1st Lien	Real Estate Mortgage Junior Lien	Total
March 31, 2012:					
Ending balance individually evaluated for impairment	$ 6,961	$ 26	$ 3,042	$ 84	$ 10,113
Ending balance collectively evaluated for impairment	238,325	7,871	63,947	12,613	322,756
Total loans	$ 245,286	$ 7,897	$ 66,989	$ 12,697	$ 332,869
December 31, 2011:					
Ending balance individually evaluated for impairment	$ 6,440	$ 29	$ 3,326	$ 86	$ 9,881
Ending balance collectively evaluated for impairment	237,263	7,800	64,927	12,933	322,923
Total loans	$ 243,703	$ 7,829	$ 68,253	$ 13,019	$ 332,804

The following tables present loans individually evaluated for impairment by class of loans as of March 31, 2012 and December 31, 2011 (in thousands):

	Unpaid Principal Balance	Allowance for Loan Losses Allocated
March 31, 2012:		
With no related allowance recorded:		
Commercial	$ 358	$
Real estate - commercial	3,058	
Real estate - construction	221	
Consumer	26	
Real estate mortgage	2,305	
With an allowance recorded:		
Commercial	534	50
Real estate - commercial	1,424	588
Real estate - construction	36	5
Consumer		
Real estate mortgage	2,151	500
Total	$ 10,113	$ 1,143

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

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of March 31, 2012 and December 31, 2011 by class of loans (in thousands):

	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
March 31, 2012:							
Commercial	$ 13	$	$ 117	$ 130	$ 367	$ 69,406	$ 69,903
Real estate - commercial	97	53		150	3,412	148,258	151,820
Real estate - construction					234	12,396	12,630
Consumer	61	22	6	89	26	8,090	8,205
Real estate mortgage	721	358		1,079	1,986	87,246	90,311
Total	$ 892	$ 433	$ 123	$ 1,448	$ 6,025	$ 325,396	$ 332,869
December 31, 2011:							
Commercial	$ 182	$ 120	$ 6	$ 308	$ 413	$ 69,335	$ 70,056
Real estate - commercial	538	144		682	2,982	147,165	150,829
Real estate - construction					231	12,248	12,479
Consumer	22	4		26	29	8,112	8,167
Real estate mortgage	1,476	780		2,256	2,048	86,969	91,273
Total	$ 2,218	$ 1,048	$ 6	$ 3,272	$ 5,703	$ 323,829	$ 332,804

Modifications:

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

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

The following table summarizes the number and volume of TDRs the Company has recorded in its loan portfolio as of March 31, 2012 and the amount of specific reserves in the allowance for loan losses relating to the TDRs (in thousands):

	Number of Loans	Amount	Specific Reserves Allocated
March 31, 2012			
Commercial	5	$ 716	$ 18
Real estate - commercial	5	1,613	12
Real estate - construction			
Real estate - mortgage	17	1,609	169
Consumer			
Total	27	$ 3,938	$ 199

No additional loans were classified as TDRs during the first quarter of 2012.

Credit Quality Indicators:

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

Special Mention: Loans classified as special mention have a potential weakness that deserves management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company s credit position at some future date.

Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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

As of March 31, 2012 and December 31, 2011, based on the most recent analysis performed, the risk category of loans by class of loans was as follows (in thousands):

	Pass	Special Mention	Substandard	Doubtful	Not Risk Rated	Total
March 31, 2012						
Commercial	$ 59,128	$ 6,163	$ 4,612	$	$	$ 69,903
Real estate - commercial	129,856	14,111	7,561		292	151,820
Real estate - construction	6,092	2,341	538		3,659	12,630
Real estate - mortgage	7,377	3,258	2,990		76,686	90,311
Consumer					8,205	8,205
Total	$ 202,453	$ 25,873	$ 15,701	$	$ 88,842	$ 332,869
December 31, 2011						
Commercial	$ 59,492	$ 5,855	$ 4,709	$	$	$ 70,056
Real estate - commercial	128,405	14,681	7,437		306	150,829
Real estate - construction	5,547	2,542	520		3,870	12,479
Real estate - mortgage	7,399	3,177	2,743		77,954	91,273
Consumer					8,167	8,167
Total	$ 200,843	$ 26,255	$ 15,409	$	$ 90,297	$ 332,804

NOTE E STOCK OPTIONS

Shareholders of the Company approved a stock option plan in April 2000 and a stock incentive plan in June 2005. The plans authorized the Company to issue up to 115,500 and 157,500 shares, respectively. In May 2008, shareholders of the Company ratified amendments to the Stock Incentive Plan of 2005, which among other things increased the authorized shares for issuance from 157,500 to 300,000. On March 20, 2010, the April 2000 stock option plan terminated. As of March 31, 2012, there were 54,482 shares available for future issuance under the 2005 plan.

A summary of stock option activity is as follows for the three months ended March 31, 2012:

	Shares	Weighted Average Price
Outstanding at beginning of year	221,026	$ 21.06
Granted	7,875	11.20
Exercised		
Forfeited		
Outstanding at March 31, 2012	228,901	$ 20.72
Options exercisable at March 31, 2012	148,951	$ 21.40

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 assumption is based on the Company s history and expected dividend payouts. Following are the assumptions used in calculating the fair value of the options issued during the three months ended March 31, 2012:

Dividend yield	2.93%
Expected life	8 years

Expected volatility	22.84%
Risk-free interest rate	0.26%
Weighted average fair value of options granted during 2012	$ 1.59

The Company recorded compensation expense of $8,000 and $15,000, respectively, related to stock options during the three month periods ended March 31, 2012 and 2011.

Restricted Stock Shares of restricted stock may also be granted under the Stock Incentive Plan of 2005. Compensation expense is recognized over the vesting period of the shares based on the market value of the shares on the grant date. All shares of restricted stock issued and outstanding vest 20% per year over five years. Compensation expense related to the award of shares of restricted stock was $39,000 and $15,000, respectively, during the three months ended March 31, 2012 and 2011. As of March 31, 2012, there was $540,000 of total unrecognized compensation expense related to non-vested shares of restricted stock granted under the plan, which is expected to be recognized over a weighted average period of 3.8 years.

A summary of restricted stock activity is as follows for the three months ended March 31, 2012:

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2012	41,309	$ 11.33
Granted	18,125	11.20
Vested	(6,231)	10.35
Forfeited		
Nonvested at March 31, 2012	53,203	$ 11.40

NOTE F FAIR VALUE INFORMATION

The following methods and assumptions were used by the Company in estimating fair values for financial instruments:

Cash and cash equivalents and federal funds sold: The carrying amount reported in the balance sheet approximates fair value.

Securities available for sale: Fair values for securities available for sale are based on quoted market prices, where available. For all other securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the securities terms and conditions, among other things.

Loans and loans held for sale, net: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans are estimated using discounted cash flows analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of discount for credit quality concerns.

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

Off-balance-sheet financial instruments: The estimated fair value of off-balance-sheet financial instruments is based on current fees or costs that would be charged to enter or terminate the arrangements. The estimated fair value is not considered to be significant for this presentation.

Deposits: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of expected monthly maturities on time deposits.

Securities sold under agreements to repurchase and overnight borrowings: The carrying amount reported in the balance sheet approximates fair value.

Other borrowings: The fair value of other borrowings is estimated using discounted cash flows analysis based on the current incremental borrowing rate for similar types of borrowing arrangements.

Subordinated debentures: The carrying amount reported in the balance sheet approximates fair value of the variable-rate subordinated debentures.

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

While these estimates of fair value are based on management s judgment of appropriate factors, there is no assurance that if the Company had disposed of such items at March 31, 2012 or December 31, 2011, the estimated fair values would have been realized. Market values may differ depending on various circumstances not taken into consideration in this methodology. The estimated fair values at March 31, 2012 and December 31, 2011, should not be considered to apply at subsequent dates.

In addition, other assets and liabilities that are not defined as financial instruments are not included in the following disclosures, such as property and equipment. Also, non-financial instruments typically not recognized in financial statements may have value but are not included in the following disclosures. These include, among other items, the estimated earnings power of core deposit accounts, trained work force, customer goodwill and similar items.

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

	March 31, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 58,037	$ 58,037	$ 42,185	$ 42,185
Federal funds sold	261	261	287	287
Securities available for sale	84,801	84,801	90,344	90,344
Loans held for sale	2,650	2,650	1,088	1,088
Loans, net of allowance for loan losses	327,344	332,826	327,392	333,283
Accrued interest receivable	2,067	2,067	2,148	2,148
Financial liabilities:				
Deposits	$ (434,537)	$ (436,245)	$ (420,511)	$ (422,493)
Securities sold under agreements to repurchase and overnight borrowings	(14,932)	(14,932)	(18,074)	(18,074)
Other borrowings	(7,600)	(7,675)	(7,751)	(7,860)
Subordinated debentures	(5,155)	(5,155)	(5,155)	(5,155)
Accrued interest payable	(127)	(127)	(131)	(131)

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

The Company also has unrecognized financial instruments, which include commitments to extend credit and standby letters of credit. The estimated fair value of such instruments is considered to be their contract amount.

NOTE G FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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

Securities available for sale classified as Level 3 inputs represent non-publicly traded municipal issues with limited trading activity from entities within the Company s market area. The fair value of these investments is determined using Level 3 valuation techniques, as there is no market available to price these investments. The method used for determining the fair value for these investments includes 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 investments.

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

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

The following table summarizes financial and nonfinancial assets (there were no financial or nonfinancial liabilities) measured at fair value as of March 31, 2012 and December 31, 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

	Level 1 Inputs	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
March 31, 2012				
Recurring:				
Securities available for sale:				
Federal agencies	$ 27,328	$	$	$ 27,328
U.S. government sponsored entities and agencies	16,923			16,923
States and political subdivisions		31,719	2,041	33,760
Asset-backed securities	66			66
Collateralized mortgage obligations	6,244			6,244
Mortgage-backed securities		480		480
Total available for sale	$ 50,561	$ 32,199	$ 2,041	$ 84,801
Nonrecurring:				
Impaired loans	$	$	$ 8,970	$ 8,970
Other real estate owned	$	$	$ 870	$ 870

Impaired loans are reported net of a $1,143,000 allowance for loan losses.

	Level 1 Inputs	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
December 31, 2011				
Recurring:				
Securities available for sale:				
Federal agencies	$ 28,435	$	$	$ 28,435
U.S. government sponsored entities and agencies	22,956			22,956
States and political subdivisions		31,213	2,232	33,445
Asset-backed securities	2,476			2,476
Mortgage-backed securities		3,032		3,032
Total available for sale	$ 53,867	$ 34,245	$ 2,232	$ 90,344
Nonrecurring:				
Impaired loans	$	$	$ 8,897	$ 8,897
Other real estate owned	$	$	$ 1,530	$ 1,530

Impaired loans are reported net of a $984,000 allowance for loan losses.

The following is a summary of activity of securities available for sale which are measured at fair value on a recurring basis using significant unobservable (Level 3) inputs during the three month period ended March 31, 2012 (in thousands):

Balance at January 1, 2012	$ 2,232
Net maturities and calls	(165)
Net unrealized losses included in other comprehensive income (loss)	(26)
Balance at March 31, 2012	$ 2,041

NOTE H SUBSEQUENT EVENTS

Management evaluated subsequent events through the date the financial statements were issued. Events or transactions occurring after March 31, 2012, but prior to when the financial statements were issued, that provided additional evidence about conditions that existed at March 31, 2012, have been recognized in the financial statements for the nine month period ended March 31, 2012. Events or transactions that provided evidence about conditions that did not exist at March 31, 2012, but arose before the financial statements were issued, have not been recognized in the financial statements for the three month period ended March 31, 2012.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides information about the consolidated financial condition and results of operations of the Company and its subsidiary, Southern Michigan Bank & Trust (SMB&T) as of March 31, 2012 and December 31, 2011, and for the three month periods ended March 31, 2012 and 2011. You should review the discussion in conjunction with the Company s consolidated financial statements and related notes.

Executive Summary

Net income for the three month period ended March 31, 2012 was $1,002,000 compared to $748,000 for the same period in 2011. Earnings per share was $0.43 for the three month period ended March 31, 2012 compared to $0.32 for the same period in 2011. Return on average assets was 0.77% for the first three months of 2012 compared to 0.60% for the first three months of 2011. Return on average shareholders equity was 7.63% for the first three months of 2012 compared to 6.19% for the same period in 2011.

Total consolidated assets at March 31, 2012 were $520.4 million compared to $509.2 million at December 31, 2011. Total deposits at March 31, 2012 were $434.5 million compared to $420.5 million at December 31, 2011. Total shareholders equity was $52.5 million at March 31, 2012 compared to $51.9 million at December 31, 2011.

Results of Operations

Net Interest Income

The Company derives the greatest portion of its income from net interest income. Net interest margin for the three month period ended March 31, 2012 was 3.68% compared to 3.49% for the same period of 2011, an increase of 19 basis points. Average loan balances for the first three months of 2012 increased $24.2 million compared to the same period of 2011, while the average balance in the lower yielding federal funds sold and other decreased $20.3 million. Comparing the first quarter of 2012 to the first quarter of 2011, loan volume was up, resulting in higher interest income, while asset yields were down. This reduction in asset yields was offset as the Company was able to lower its cost of funds by 24 basis points during the three month period ended March 31, 2012 compared to the same period of 2011.

The following tables provide information regarding interest income and expense for the three-month periods ended March 31, 2012 and 2011, respectively. Table 1 shows the year-to-date daily average balances for interest earning assets and interest bearing liabilities, interest earned or paid, and the annualized effective rate. Table 2 shows the effect on interest income and expense of changes in volume and interest rates on a tax equivalent basis.

Table 1 Average Balances and Tax Equivalent Interest Rates

(Dollars in Thousands):

	March 31, 2012			March 31, 2011		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS						
Interest earning assets:						
Loans(1)(2)(3)	$ 333,406	$ 4,527	5.43%	$ 309,173	$ 4,374	5.66%
Federal funds sold and other(6)	44,777	26	.23	65,116	51	.31
Taxable investment securities(4)	56,497	156	1.10	46,966	138	1.18
Tax-exempt investment securities(1)	31,082	368	4.74	23,962	327	5.46
Total interest earning assets	465,762	5,077	4.36	445,217	4,890	4.39
Non-interest earning assets:						
Cash and due from banks	11,535			12,407		
Other assets(5)	48,489			48,446		
Less allowance for loan losses	(5,356)			(5,584)		
Total assets	$ 520,430			$ 500,486		
Interest bearing liabilities:						
Demand deposits	$ 193,190	135	.28%	$ 167,862	123	.29%
Savings deposits	54,409	6	.04	50,141	12	.10
Time deposits	118,874	520	1.75	136,530	709	2.08
Securities sold under agreements to repurchase and federal funds purchased	16,929	9	.21	16,588	12	.29
Other borrowings	7,696	82	4.26	9,892	109	4.41
Subordinated debentures	5,155	42	3.26	5,155	38	2.95
Total interest bearing liabilities	396,253	794	.80	386,168	1,003	1.04
Non-interest bearing liabilities:						
Demand deposits	66,106			61,209		
Other	4,182			3,383		
Common stock subject to repurchase obligation	1,386			1,353		
Shareholders equity	52,503			48,373		
Total liabilities and shareholders equity	$ 520,430			$ 500,486		
Net interest income		$ 4,283			$ 3,887	
Interest rate spread			3.56%			3.35%
Net yield on interest earning assets			3.68%			3.49%

(1) Includes tax equivalent adjustment of interest (assuming a 34% tax rate) for securities and loans of $125,000 and $16,000, respectively, for 2012 and $111,000 and $4,000, respectively, for 2011.
(2) Average balance includes average non-accrual loan balances of $5,922,000 in 2012 and $5,617,000 in 2011.
(3) Interest income includes loan fees of $59,000 in 2012 and $36,000 in 2011.
(4) Average balance includes average unrealized gain of $1,404,000 in 2012 and $170,000 in 2011 on available for sale securities.
(5) Includes $15,058,000 in 2012 and $15,394,000 in 2011 relating to goodwill and other intangible assets.

(6) Includes $44,521,000 in 2012 and $61,851,000 in 2011 of federal reserve deposit accounts.

Table 2 Changes in Tax-Equivalent Net Interest Income

(Dollars in Thousands)

	Three Months Ended March 31 2012 Over 2011 Increase (Decrease) Due To			Three Months Ended March 31 2011 Over 2010 Increase (Decrease) Due To		
	Rate	Volume	Net	Rate	Volume	Net
Interest income on:						
Loans	$ (181)	$ 334	$ 153	$ (79)	$ (284)	$ (363)
Taxable securities	(9)	27	18	(99)	56	(43)
Tax-exempt securities	(47)	88	41	(10)	28	18
Federal funds sold	(11)	(14)	(25)	(3)	31	28
Total interest earning assets	$ (248)	$ 435	$ 187	$ (191)	$ (169)	$ (360)
Interest expense on:						
Demand deposits	$ (6)	$ 18	$ 12	$ (27)	$ 19	$ (8)
Savings deposits	(7)	1	(6)	(12)	2	(10)
Time deposits	(105)	(85)	(190)	(158)	20	(138)
Securities sold under agreements to repurchase and federal funds purchased	(3)		(3)	1	1	2
Other borrowings	(3)	(23)	(26)	30	(42)	(12)
Subordinated debentures	4		4			
Total interest bearing liabilities	$ (120)	$ (89)	$ (209)	$ (166)	$	$ (166)
Net interest income	$ (128)	$ 524	$ 396	$ (25)	$ (169)	$ (194)

Tax equivalent net interest income increased $396,000, or 10.2%, in the first three months of 2012 compared to the same period in 2011. This was a result of a $524,000 net increase due to volume changes comparing the first three months of 2012 with the first three months of 2011 on a tax equivalent basis and a $128,000 net decrease due to rate changes for the comparable periods.

The presentation of net interest income on a tax equivalent 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 net interest income on a tax equivalent basis were $141,000 and $115,000, respectively, for the three months ended March 31, 2012 and 2011. These adjustments were computed using a 34% federal income tax rate.

Provision for Loan Losses

The provision for loan losses is based on an analysis of additions to the allowance for loan losses believed to be appropriate. The provision is charged to income to bring the allowance for loan losses to a level believed adequate by management to absorb probable incurred losses in the loan portfolio. Some factors considered by management in determining the level at which the allowance is maintained include specific credit reviews, historical loan loss experience, current economic conditions and trends, results of examinations by regulatory agencies and the volume, growth and composition of the loan portfolio. The provision is adjusted quarterly, if necessary, to reflect changes in the factors above, and actual charge-off experience and any known losses.

The provision for loan losses for the three month period ended March 31, 2012 was $225,000 compared to a provision for loan losses for the same period of 2011 of $125,000.

The allowance for loan losses was 1.66% of total loans at March 31, 2012 compared to 1.63% at December 31, 2011 and 1.82% at March 31, 2011.

Charge-offs and recoveries for respective loan categories for the three months ended March 31, 2012 and 2011 were as follows (in thousands):

	March 31, 2012		March 31, 2011	
	Charge-offs	Recoveries	Charge-offs	Recoveries
Commercial	$ 5	$ 23	$ 62	$ 43
Residential real estate	135	10	184	7
Consumer	51	46	73	26
Total	$ 191	$ 79	$ 319	$ 76

Net charge-offs in the first three months of 2012 were $112,000, or 0.14%, of loans on an annualized basis. Net charge-offs in the first three months of 2011 were $243,000, or 0.32%, of loans on an annualized basis.

The Company had specific allowance reserves on impaired loans of $1,143,000 as of March 31, 2012 compared to $984,000 as of December 31, 2011 and $1,166,000 at March 31, 2011. Specific allowance reserves have been allocated where the fair values of loans were considered to be less than their carrying values. The Company obtains valuations on collateral dependent loans when the loan is considered by management to be impaired and uses the valuation amounts in the determination of fair value. Management believes the specific reserves allocated to impaired loans as of March 31, 2012 were reasonable based on the circumstances surrounding each particular borrower.

Non-interest income

Non-interest income for the three month periods ended March 31, 2012 and 2011 was $1,665,000 and $1,655,000, respectively.

Service charges on deposit accounts decreased 22.9%, or $117,000, in the first quarter of 2012 compared to the first quarter of 2011. The Company continues to experience lower volume of non-sufficient fund items as a result of changes made to its overdraft protection program in July 2010 and June 2011 to comply with regulatory guidance that became effective in August 2010 and July 2011, respectively. These changes have resulted in lower fee income.

Net gains on loan sales increased 26.8%, or $85,000, in the first quarter of 2012 compared to the first quarter of 2011. Fixed rate long term residential mortgages are generally sold in the secondary market, while adjustable rate mortgage loans are retained in the loan portfolio. Continued favorable mortgage rates contributed to the increase in net gains on loan sales.

ATM and debit card fee income increased 15.7%, or $37,000, in the first quarter of 2012 compared to the first quarter of 2011. Increases are primarily due to increased volumes of approved transactions.

Non-interest expense

Non-interest expense for the three month period ended March 31, 2012 was $4,282,000 compared to $4,365,000 for the same period in 2011, a decrease of 1.9% or $83,000.

Occupancy costs decreased $90,000, or 24.1%, in the first quarter of 2012 as compared to 2011. The Bank closed two branches in the second quarter of 2011 reducing occupancy costs.

FDIC assessment expense decreased $65,000 for the three month period ended March 31, 2012 compared to the same period in 2011 due to changes effective April 1, 2011.

Expenses relating to OREO property were $128,000 for the first quarter of 2012 compared to $45,000 for the first quarter of 2011. OREO expenses include costs to carry OREO, such as property taxes, insurance and maintenance costs, fair value write-downs after the property is transferred to OREO and net gains/losses from the disposition of OREO. Write-downs and net gains/losses from dispositions of OREO totaled $74,000 for the first quarter of 2012 compared to $27,000 for the first quarter of 2011.

Federal income taxes

The Company had an income tax provision of $297,000 for the three months ended March 31, 2012 compared to $189,000 for the comparable period of 2011. The effective tax rate for the three month period ended March 31, 2012 was 22.9% compared to 20.2% for the comparable 2011 period. Tax-exempt income continues to have a positive impact on the Company s tax provision and effective tax rate. The benefit offsetting lower coupon rates on municipal instruments is the nontaxable feature of the income earned on such investments. This resulted in a lower effective tax rate and reduced the federal income tax provision.

Financial Condition

Assets

Total assets at March 31, 2012 were $520.4 million, an increase of $11.2 million compared to December 31, 2011. Securities available-for-sale totaled $84.8 million at March 31, 2012, a decrease of $5.5 million, or 6.1%, compared to December 31, 2011. Cash and cash equivalents increased $15.9 million, or 37.6%, at March 31, 2012 compared to December 31, 2011. Maturities of securities and cash increases from higher deposit balances were retained in cash and cash equivalents to fund anticipated 2012 second quarter loan growth.

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 foreclosure and in lieu of foreclosure.

A loan generally is classified as nonaccrual 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, the Company may choose to restructure the contractual terms of certain loans. The Company 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 the Company 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, the Company 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:

(Dollars in thousands)

	3/31/12	12/31/11	3/31/11
Nonaccrual loans:			
Commercial and commercial real estate	$ 4,013	$ 3,626	$ 4,180
Real estate mortgage	1,986	2,048	1,562
Consumer	26	29	28
	6,025	5,703	5,770
Loans contractually past due 90 days or more and still on accrual:			
Commercial and commercial real estate	117	6	372
Real estate mortgage			
Consumer	6		
	123	6	372
Accruing loans modified under troubled debt restructurings:			
Commercial and commercial real estate	1,879	1,933	1,589
Real estate mortgage	1,426	1,607	1,149
Consumer			
	3,305	3,540	2,738
Total nonperforming loans	9,453	9,249	8,880
Other real estate	870	1,530	983
Total nonperforming assets	$ 10,323	$ 10,779	$ 9,863
Nonperforming loans to total loans	2.84%	2.78%	2.90%
Nonperforming assets to total assets	1.98%	2.12%	1.96%

The balance of TDR loans included in nonaccrual loans was $633,000 at March 31, 2012, $694,000 at December 31, 2011 and $1,475,000 at March 31, 2011.

Nonperforming loans are subject to continuous monitoring by management and estimated losses are specifically allocated for in the allowance for loan losses where appropriate. At March 31, 2012, December 31, 2011 and March 31, 2011, the Company had loans of $10.1 million, $9.9 million and $10.2 million, respectively, which were considered impaired.

In management s evaluation of the loan portfolio risks, any significant future increases in nonperforming loans is dependent to a large extent on the economic environment. In a deteriorating or uncertain economy, management applies more conservative assumptions when assessing the future prospects of borrowers and when estimating collateral values.

<u>Liabilities</u>

Deposits totaled $434.5 million at March 31, 2012, an increase of $14.0 million, or 3.3%, from December 31, 2011. The majority of deposits are derived from core client sources, relating to long term relationships with local individuals, businesses and public clients. A small amount of brokered deposits are maintained, but are not used to support growth.

Increases in the first quarter were due to retail deposit account balance increases and cyclical increases in balances for municipalities collecting property taxes and school systems receiving funds from the state. These cyclical balance increases are expected to return to more normal levels as the money is distributed and expended.

Shareholders equity

Total shareholders equity amounted to $52.5 million at March 31, 2012, an increase of $634,000 from December 31, 2011. The increase was primarily attributable to net income for the period, less dividends to shareholders.

The following table summarizes the Company s consolidated regulatory capital ratios, as well as SMB&T s, as of March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011	Minimum Required for Capital Adequacy Purposes	Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations
Total risk-based capital ratio				
Consolidated	14.0%	13.7%	8.0%	N/A
SMBT	14.0	13.7	8.0	10.0%
Tier 1 capital ratio				
Consolidated	12.8	12.4	4.0	N/A
SMBT	12.7	12.4	4.0	6.0
Leverage ratio				
Consolidated	8.6	8.6	4.0	N/A
SMBT	8.6	8.6	4.0	5.0

At March 31, 2012, SMB&T was categorized as well capitalized under applicable regulatory guidelines.

Liquidity

Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. SMB&T maintains certain levels of liquid assets (the most liquid of which are cash and cash equivalents, federal funds sold and investment securities) in order to meet these demands. Maturing loans and investment securities are the principal sources of asset liquidity. Liquidity is monitored and closely managed by the Asset/Liability Management Committee (ALCO), whose members are comprised of senior management.

SMB&T maintains correspondent accounts with other banks for various purposes. At times, SMB&T is a participant in the federal funds market, either as a borrower or a seller. SMB&T has a $3 million federal funds line available from a correspondent bank. In addition, SMB&T has the ability to borrow $27.9 million from the Federal Home Loan Bank based on collateral pledged, and also has the ability to borrow at the discount window of the Federal Reserve Bank as an additional short term funding source.

The Company s balances in federal funds sold and short term interest bearing balances with banks aggregated $46.4 million at March 31, 2012, compared to $29.9 million at December 31, 2011 and $61.8 million at March 31, 2011. The Company continues to maintain high levels of liquidity, with investments, federal funds and cash equivalents held to improve the liquidity of the balance sheet during this period of economic uncertainty. The Company expects to maintain higher than normal levels of liquidity until economic conditions improve and more attractive investment opportunities emerge.

The Company s principal source of funds to pay cash dividends is the earnings and dividends paid by SMB&T. The payment of dividends by SMB&T is subject to legal and regulatory restrictions. At March 31, 2012, using the most restrictive of these restrictions, the aggregate cash dividends that SMB&T could pay the Company without prior regulatory approval was approximately $8 million.

Impact of Inflation and Changing Prices

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

Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 15d 15(e) under the Exchange Act) as of March 31, 2012. Based on and as of the time of that evaluation, the Company s management, including the Chief Executive Officer and Chief Financial Officer, concluded that as of the end of the period covered by this report the Company s disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms and is accumulated and communicated to the Company s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in the Company s internal control over financial reporting that occurred during the three months ended March 31, 2012 that has materially affected, or that is reasonably likely to materially affect, the Company s internal control over financial reporting.

Part II. Other Information

Item 6. Exhibits

Exhibits. The following exhibits are filed as part of this report on Form 10-Q:

Exhibit Number	Document
3.1	Articles of Incorporation of Southern Michigan Bancorp, Inc., as amended. Previously filed with the Commission on July 13, 2007 in Southern Michigan Bancorp Inc. s Form S-4 Registration Statement, Exhibit 3.1. Here incorporated by reference.
3.2	Amended and Restated Bylaws of Southern Michigan Bancorp, Inc., as amended. Previously filed with the Commission on July 13, 2007 in Southern Michigan Bancorp Inc. s Form S-4 Registration Statement, Exhibit 3.2. Here incorporated by reference.
4.1	Articles of Incorporation of Southern Michigan Bancorp, Inc., as amended. Exhibit 3.1 is here incorporated by reference.
4.2	Amended and Restated Bylaws of Southern Michigan Bancorp, Inc., as amended. Exhibit 3.2 is here incorporated by reference.
4.3	Long-Term Debt. The registrant has outstanding long-term debt which at the time of this report does not exceed 10% of the registrant s total consolidated assets. The registrant agrees to furnish copies of the agreements defining the rights of holders of such long-term debt to the Securities and Exchange Commission upon request.
31.1	Certification of Chairman of the Board and Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Senior Vice President, Chief Financial Officer, Secretary and Treasurer under Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification pursuant to 18 U.S.C. § 1350.
101.INS	XBRL Instance Document (1)
101.SCH	XBRL Taxonomy Extension Schema Document (1)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (1)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)
101.DEF	XBRL Taxonomy Extension Definitions Linkbase Document (1)

(1) As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	SOUTHERN MICHIGAN BANCORP, INC.
Date: May 15, 2012	By: /s/ John H. Castle John H. Castle Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
Date: May 15, 2012	By: /s/ Danice L. Chartrand Danice L. Chartrand Senior Vice President, Chief Financial Officer, Secretary and Treasurer (Principal Financial and Accounting Officer)