SOUTHERN MICHIGAN BANCORP INC
Form 10-Q
August 14, 2002

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended June 30, 2002   Commission file number 2-78178

Southern Michigan Bancorp, Inc.
(Exact name of registrant as specified in its charter)

Michigan	38-2407501
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
51 West Pearl Street, Coldwater, Michigan	49036
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code -- (517) 279-5500

Indicate by check mark whether 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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Common Stock, $2.50 Par Value - 1,866,425 shares at July 31, 2002 (including shares held by ESOP)

PART 1 - FINANCIAL INFORMATION

ITEM 1. Financial Statements.

CONDENSED CONSOLIDATED BALANCE SHEETS

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

ASSETS

Cash and cash equivalents

Securities available for sale

Loans, net of allowance for loan losses of $2,267 (2001 - $2,065)

Premises and equipment, net

Other assets

TOTAL ASSETS

LIABILITIES AND SHAREHOLDERS' EQUITY

Liabilities:

Deposits:

Non-interest bearing

Interest bearing

Accrued expenses and other liabilities

Federal funds purchased

Long-term borrowings

Common stock subject to repurchase obligation in ESOP,
shares outstanding - 101,476 in 2002 (98,549 in 2001)

Shareholders' equity:

Preferred stock, 100,000 shares authorized, none issued or outstanding

Common stock, $2.50 par value:

Authorized--4,000,000 shares

Issued--1,866,435 shares (2001 - 1,920,651)

Outstanding--1,764,959 shares (2001 -1,822,102)

Additional paid-in capital

Retained earnings

Accumulated other comprehensive income, net of tax

Unearned Employee Stock Ownership Plan shares

TOTAL SHAREHOLDERS' EQUITY

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY

(A) The balance sheet at December 31, 2001 has been derived from the audited consolidated financial statements at that date.

See notes to unaudited condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

Three Months Ended
June 30

	2002	2001
	(In thousands, except	
Interest income:		
Loans, including fees	$ 4,190	$ 4,669
Securities:		
Taxable	338	643
Tax exempt	238	194
Other	1	2
Total interest income	4,767	5,508
Interest expense:		
Deposits	1,131	2,175
Other	460	429
Total interest expense	1,591	2,604
NET INTEREST INCOME	3,176	2,904
Provision for loan losses	375	225
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,801	2,679
Non-interest income:		
Service charges on deposit accounts	347	263
Trust fees	143	128
Net gain on sales of securities	--	27
Net gain on sales of loans	143	290
Earnings on life insurance policies	59	54
Loss on viatical settlement contracts	(283)	
Other	169	74
	578	836
Non-interest expense:		
Salaries and employee benefits	1,484	1,257
Occupancy	194	199
Equipment	305	308
Professional and outside services	145	159
Advertising and marketing	38	64
Other	685	651
	2,851	2,638
INCOME BEFORE INCOME TAXES	528	877
Federal income taxes	186	221
NET INCOME	342	656
Other comprehensive income, net of tax:	288	16
COMPREHENSIVE INCOME	$ 630	$ 672
Basic and Diluted Earnings Per Common Share	$ 0.18	$ 0.34
Dividends Declared Per Common Share	$ 0.16	$ 0.15

See notes to unaudited condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

	Six M J 2002
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OPERATING ACTIVITIES	
Net income	$ 905
Adjustments to reconcile net income to net cash from operating activities:	
Provision for loan losses	650
Earnings on life insurance policies	(110)
Loss on viatical settlement contracts	283
Depreciation	449
Amortization of intangible assets	51
Net realized gain on sales of securities	(4)
Net realized loss on disposal of fixed assets	23
Net change in:	
Loans held for sale	1,689
Other assets	442
Accrued expenses and other liabilities	(637)
Reduction of obligation under ESOP	85
Net cash from operating activities	3,826
INVESTING ACTIVITIES	
Proceeds from sales of securities available for sale	254
Proceeds from maturities of securities available for sale	16,927
Purchases of securities available for sale	(4,500)
Net change in loans	(21,103)
Proceeds from sale of premises and equipment	58
Purchase of premises and equipment	(118)
Net cash from investing activities	(8,482)
FINANCING ACTIVITIES	
Net change in deposits	(8,240)
Net change in federal funds purchased	4,000
Proceeds from long-term borrowings	820
Repayments of long-term borrowings	
Common stock repurchased and retired	(856)
Cash dividends paid	(606)
Net cash from financing activities	(4,882)

Net change in cash and cash equivalents	(9,538)
Cash and cash equivalents at beginning of period	23,432
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 13,894

See notes to unaudited condensed consolidated financial statements.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SOUTHERN MICHIGAN BANCORP, INC. AND SUBSIDIARY

June 30, 2002

NOTE A -- BASIS OF PRESENTATION

The accompanying year-end balance sheet data was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2001.

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 share are restated for all stock splits and dividends through the date of issue of the financial statements.

The basic and diluted weighted average common shares outstanding for the three and six month period ended June 30, 2002 and 2001 were:

	For the 3 months ended		For the 6 months ended	
	6/30/02	6/30/01	6/30/02	6/30/01
Basic	1,851,225	1,924,879	1,876,404	1,925,002
Diluted	1,851,432	1,925,008	1,876,765	1,925,063

Reclassifications: Some items in the prior year consolidated financial statements have been reclassified to conform with the current year presentation.

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

FINANCIAL CONDITION

During the first six months of 2002, cash and cash equivalents decreased 40.7% or $9,538,000. In addition, securities available for sale decreased by 20.1% or $12,389,000 during this same time period. These funds were primarily used to fund additional loans.

Gross loans have increased by 8.9% in the first six months of 2002. The increase has occurred primarily in the commercial loan portfolio. Mortgage loans have increased slightly while installment loans continue to decline. There were $174,000 in loans held for sale as of June 30, 2002.

In assessing the adequacy of the allowance for loan losses, management reviews the characteristics of the loan portfolio in order to determine the overall quality and risk profile. Some factors considered by management in determining the level at which the allowance is maintained include a continuing evaluation of those loans identified as being subject to possible problems in collection, results of examinations by regulatory agencies, current economic conditions and historical loan loss experience. The allowance for loan losses is being maintained at a level, which in management's opinion, is adequate to absorb probable incurred loan losses in the loan portfolio as of June 30, 2002.

The allowance for loan losses was $2,267,000 or .98% of gross loans, including loans held for sale, at June 30, 2002. As of December 31, 2001, the allowance for loan losses was $2,065,000 or .97% of gross loans, including loans held for sale. As of June 30, 2002, loans past due 90 days or more or on non-accrual have decreased by a total of $289,000 or 10.7% from December 31, 2001. Despite this decrease, the allowance has remained stable to account for increased volume in the commercial loan area as well as increases in the allowance allocations for specific loan credits.

There were no significant fixed asset commitments as of June 30, 2002.

Total deposits decreased by $8,240,000 or 3.2% during the first six months of 2002. To provide an additional source of funding for loan growth the Company borrowed $4 million of federal funds purchased at June 30, 2002.

During the first six months of 2002, the Company repurchased approximately $856,000 worth of stock and retired it. This resulted in total shareholders' equity decreasing from December 31, 2001.

CAPITAL RESOURCES

The Federal Reserve Board (FRB) has adopted risk-based capital guidelines applicable to the Company. These guidelines require that bank holding companies maintain capital commensurate with both on and off-balance-sheet credit risks of their operations. Under the guidelines, a bank holding company must have a minimum ratio of total capital to risk-weighted assets of 8.0 percent. In addition, a bank holding company must maintain a minimum ratio of Tier 1 capital equal to 4.0 percent of risk-weighted assets. Tier 1 capital includes common shareholders' equity, qualifying perpetual preferred stock and minority interest in equity accounts of consolidated subsidiaries less intangible assets.

As a supplement to the risk-based capital requirements, the FRB has also adopted leverage capital ratio requirements. The leverage ratio requirements establish a minimum ratio of Tier 1 capital to total assets less intangible assets of 3 percent for the most highly rated bank holding companies. All other bank holding companies are required to maintain additional Tier 1 capital yielding a leverage ratio of 4 percent to 5 percent, depending on the particular circumstances and risk profile of the institution.

The following table summarizes the Company's capital ratios as of June 30, 2002 and December 31, 2001:

	June 30, 2002	December 31, 2001
Tier 1 risk-based capital ratio	10.5%	11.1%
Total risk-based capital ratio	11.4%	12.0%
Leverage ratio	8.1%	8.3%

The above table indicates that the Company's capital ratios are above the regulatory minimum requirements.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income increased by 6.4% or $379,000 for the six month period ended June 30, 2002 compared to the same period in 2001. Higher priced deposits matured during the last part of 2001 reducing interest costs which in turn increased the net interest income. This reduction in interest expense offset a 15.5% decrease in gross interest income which declined primarily as a result of the prime rate being lower during the first six months of 2002 as compared to the first six months of 2001.

Provision for Loan Losses

The provision for loan losses is based on an analysis of outstanding loans. In assessing the adequacy of the allowance for loan losses, management reviews the characteristics of the loan portfolio in order to determine the overall quality and risk profile. Some factors considered by management in determining the level at which the allowance is maintained include a continuing evaluation of those loans identified as being subject to possible problems in collection, results of examinations by regulatory agencies, current economic conditions and historical loan loss experience.

Despite lower levels of nonperforming loans and lower net charge-offs, the provision for loan losses for the six months ended June 30, 2002 is $50,000 higher than the provision for the six months ended June 30, 2001. For the three month period ending June 30, 2002, the provision is $150,000 higher than the prior year comparable period. The provision has increased during both of these periods primarily to account for commercial loan growth and to provide for increases in allowance allocations for specific loan credits.

Non-interest Income

Non-interest income decreased $282,000 for the six month period ending June 30, 2002 compared to the same period in 2001. The primary reason for the decrease in non-interest income is the $283,000 loss on viatical settlement contracts during the three months ended June 30, 2002. In mid-July the Company received new information regarding its life insurance investments in eight viatical settlement contracts. A letter was received from the Treasurer of the State of Florida Department of Insurance. The letter stated that the company servicing the Company's viatical settlement contracts has advised the Department that they do not have sufficient funds to pay premiums on policies that are supporting the investments. Management has been in contact with the Florida Department of Insurance as well as legal counsel to do everything possible to protect the Company's investments. For the three months ended June 30, 2002, the Company recorded a $283,000 loss on the $283,000 carrying value of these investments. This loss is based on management's inability at this time to verify continuing value for these investments.

Service charges on deposit accounts increased $87,000 due to the variable nature of the fees assessed, based on customer account balances for business accounts. Offsetting this increase was a $99,000 decrease in the net gain on sales of loans during the same period. Despite rates remaining low, many current homeowners have already taken advantage of the low rate interest environment and have refinanced their mortgages. Thus the level of loan refinancing activity is lower in 2002 as compared to 2001.

Other non-interest income for the three and six months ending June 30, 2002 compared to the same period in 2001 has increased due to increases in ATM income and other miscellaneous income.

Non-interest Expense

Non-interest expenses increased by $590,000 for the six month period ended June 30, 2002 compared to the same period in 2001. During the six months ended June 30, 2002, salaries and employee benefits expense increased $399,000 compared to the same period in 2001. After the first quarter of 2001, the Company hired additional staff in Battle Creek to focus on this targeted market. The Company also hired additional mortgage originators who are paid commissions for work generated. The commissions for the first six months of 2002 have exceeded the commissions for the same time period in 2001 by over $133,000. The cost of employee benefits increased in 2002 as health insurance costs have increased and more employees have participated in the plan. In addition to salaries and employee benefits increasing, the Company saw an increase in legal and other fees related to the resolution of a lawsuit during the first quarter of 2002.

Changes in Management

In December of 2001, the President and CEO of the Company and Southern Michigan Bank & Trust, announced his retirement effective December 31, 2002. An extensive search for a replacement began with a goal to have a replacement in place by mid year. In June of 2002, John Castle was named CEO of both The Company and Southern Michigan Bank & Trust. Since that time, Kurt Miller has been named President of both organizations and Mary Guthrie has been named VP & Senior Trust Officer.

New Accounting Pronouncements

On January 1, 2002, the Company adopted a new accounting standard which addresses accounting for goodwill and intangible assets arising from business combinations. Identifiable intangible assets must be separated from goodwill. Identifiable intangible assets with finite useful lives are amortized under the new standard, whereas goodwill resulting from business combinations, both amounts previously recorded and future amounts purchased, cease being amortized. Annual impairment testing is required for goodwill with impairment being recorded if the carrying amount of goodwill exceeds its implied fair value. The Company's current intangible assets resulted from branch acquisitions. Current interpretations by the Financial Accounting Standards Board (FASB) requires the continued amortization of the core deposit intangibles and the unidentified intangibles resulting from branch acquisitions. However, the FASB is

reconsidering their interpretation and it is possible that in the future there may no longer be a requirement to amortize the unidentified intangibles resulting from branch acquisitions. Adoption of this standard on January 1, 2002 did not have a material effect on the Company's financial statements.

Intangible assets subject to amortization are as follows:

	June 30, 2002		December 31
Description	Gross Amount	Accumulated Amortization	Gross Amount
Core deposit intangibles	$ 559,000	$ 389,000	$ 559,000
Unidentified intangibles	938,000	350,000	938,000
Total	$1,497,000	$ 739,000	$1,497,000

Amortization expense for the first six months of 2002 and 2001 was $51,000 and $59,000. Estimated annual amortization expense for the next five years is:

2002	$102,000
2003	102,000
2004	102,000
2005	102,000
2006	96,000

In August 2001, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations" which will be adopted by the Company on January 1, 2003. The new accounting standard addresses accounting for obligations associated with the retirement of tangible, long-lived assets and requires a liability to be recognized for the fair value of any such obligations. Adoption of this standard on January 1, 2003 is not expected to have a material effect on the Company's consolidated financial position or results of operations.

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This new accounting standard establishes more restrictive requirements for the classification of assets as "held for sale" and also expands the types of dispositions that are to be accounted for as discontinued operations. Adoption of this standard on January 1, 2002 did not have a material effect on the Company's consolidated financial position or results of operations

The FASB recently issued SFAS No. 145 and SFAS No. 146. SFAS No. 145 applies for years beginning after May 14, 2002 and may be adopted sooner. SFAS No. 145 covers extinguishments of debt and leases, and includes some minor technical corrections. Under previous accounting guidance, gains or losses from extinguishments of debt were always treated as extraordinary

items. Under SFAS No. 145 they will no longer be considered extraordinary, except under very limited conditions. Upon adoption of SFAS No. 145, any prior gains and losses from extinguishments of debt must be reclassified as ordinary gains and losses. Under SFAS No. 145, if a capital lease is modified to become an operating lease, it will be accounted for as a sale-leaseback, by following the accounting guidance of SFAS No. 98, instead of being accounted for as a new lease. SFAS No. 146 covers accounting for costs associated with exit or long-lived asset disposal activities, such as restructurings, consolidation or closing of facilities, lease termination costs or employee relocation or severance costs. SFAS No. 146 replaces Emerging Issues Task Force (EITF) 94-3, and is to be applied prospectively to exit or disposal activities initiated after December 31, 2002, and may be adopted sooner. A company may not restate its previously issued financial statements. SFAS No. 146 requires exit or long-lived asset disposal costs to be recognized as an expense when the liability is incurred and can be measured at fair value, rather than at the date of making a commitment to an exit or disposal plan. Management does not expect the effects of the future adoptions of SFAS No. 145 and SFAS No. 146 to be material to the Company's consolidated financial position or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary market risk exposure is interest rate risk and to a lesser extent, liquidity risk. Interest rate risk arises when the maturity or repricing characteristics of assets differ significantly from the maturity or the 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 the Company's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Company's safety and soundness.

The Company measures the impact of changes in interest rates on net interest income through a comprehensive analysis of the Bank's interest rate sensitive assets and liabilities. Interest rate sensitivity varies with different types of interest-earning assets and interest-bearing liabilities. Overnight federal funds and mutual funds on which rates change daily and loans which are tied to the prime rate or a comparable index differ considerably from long-term investment securities and fixed-rate loans. Similarly, certificates of deposit and money market investment accounts are much more interest sensitive than passbook savings accounts. The shorter term interest rate sensitivities are key to measuring the interest sensitivity gap, or excess interest-earning assets over

interest-bearing liabilities. In addition to reviewing the interest sensitivity gap, the Company also analyzes projected changes in market interest rates and the resulting effect on net interest income.

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. Certain portions of the Bank's liabilities may be short-term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the Company seeks to have in place sources of cash to meet short-term demands. These funds can be obtained by increasing deposits, borrowing or selling assets. Also, Federal Home Loan Bank advances and short-term borrowings provide additional sources of liquidity for the Company.

In June of 2002, the Board of directors of the Company approved an issuance of trust preferred securities not to exceed $5,000,000. Management is reviewing alternatives and may close a deal by the end of 2002. Proceeds will be used to provide additional liquidity and capital for the Company.

There have been no significant changes in the distribution of the Company's financial instruments that are sensitive to changes in interest rates during the first six months of 2002.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

None.

ITEM 2. Changes in Securities and Use of Proceeds.

None.

ITEM 3. Defaults Upon Senior Securities.

None.

ITEM 4. Submission of Matters to a Vote of Security Holders.

The annual Meeting of Shareholders of Southern Michigan Bancorp, Inc. was held on April 15, 2002 at Southern Michigan Bank & Trust. The following items were approved by the shareholders at the Annual Meeting:

a. Election of Marcia Albright, James P. Briskey and Nolan E. Hooker as directors.

	Marcia Albright	James Briskey	Nolan Hooker
Number of votes for	1,751,840	1,790,967	1,753,280
Number of votes against	39,127	27,648	37,687
Number of votes abstained	0	0	0
Number of broker nonvotes	128,665	101,017	128,665

H. Kenneth Cole, William E. Galliers, James T. Grohalski, Gregory J. Hull, Thomas E. Kolassa, James J. Morrison and Freeman E. Riddle continued their terms as directors. Jane L. Randall retired from the Board effective April 15, 2002.

b. Ratification of the selection of Crowe, Chizek and Company LLP as Independent Auditors for 2002.

Number of votes for	1,437,173
Number of votes against	18,065
Number of votes abstained	150,003
Number of broker nonvotes	314,391

ITEM 5. Other Information.

None

ITEM 6. Exhibits and Reports on Form 8-K.

None.

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.

(Registrant)

August 14, 2002

Date

/s/ John H. Castle

John H. Castle, Chief Executive Officer

/s/ James T. Grohalski

James T. Grohalski, Chief Financial Officer (Principal Financial and Accounting Officer)