March 28, 2007

To My Fellow Shareholders,

On behalf of the Directors and employees of Sturgis Bancorp, Inc. and Sturgis Bank & Trust Company, I am pleased to provide a copy of our 2006 Annual Report. In this Annual Report you will find many key ratios and measures of performance. I encourage you to study this information and participate as a shareholder. If you do not understand information contained in this report, or have suggestions, do not hesitate to contact me at (269) 651-9345.

Our net income for 2006 was $3,151,000, or $1.29 per share, basic and diluted, compared with net income of $2,702,000 or $1.06 per share, basic and diluted, for 2005. This represents a 16.6% increase and a record year for the Bank as measured on a per share basis. The primary driver of this increase was the improvement of our net interest income. Management stayed true to its strategy of maintaining a positive interest margin over the last, historically low, interest rate cycle. The benefits of this strategy are demonstrated in the results for 2006. Net interest income was up 15.0% to $11.2 million, from $9.7 million for the year ended December 31, 2005.

Management also focused on diversifying the sources of noninterest income in an effort to reduce our reliance on mortgage banking activities. While mortgage banking activities continues to be an important component of noninterest income, we have reduced this component on a percentage basis. This has been accomplished with the addition of a full service Trust Department and Investment Services subsidiary. Noninterest income was $4.4 million for 2006, unchanged from 2005. This result is despite an industry wide fall-off of mortgage refinancing activity and slower home sales in our region. The decrease in income from mortgage banking activities was offset by higher commission income. This year's performance demonstrates Management's success in diversifying sources of non-interest income.

Total assets as of December 31, 2006 were $320,858,000. This was an increase of $13.3 million, or approximately 4.0 % from December 31, 2005. This increase was primarily in securities, interest-bearing deposits and loans. Loans and deposits as of December 31, 2006 were $242 million and $216 million respectively. Over the last twelve months, Management has focused on continued asset quality measures and balance sheet composition. Asset quality is stable despite a weak Michigan economy. The Bank continues to focus on commercial banking relationships and increasing the number of checking accounts. Commercial deposit accounts and consumer checking accounts typically generate higher fee income and are a lower cost source of funding. This focus will continue in 2007.

Within this 2006 Annual Report, you will find a graph titled "Gross Assets Managed". The purpose of this graph is to help you understand we are more than a simple $320.0

million Bank. The Bank also has loans it services for others totaling $206.0 million. These are loans the Bank originated and sold, but retained the customer relationship. The bank has $144.0 million in trust assets under administration and has been very successful with its wholly owned brokerage service Oakleaf Financial Services. Oakleaf has approximately $250.0 million in assets under management and contributed approximately $360,000 to the bottom line in 2006. The final component reflected in the graph represents commercial deposit accounts swept to an outside money market fund. The Bank retains a moderate margin in these accounts and swept balances were approximately $17.8 million at year end 2006.

Equity management is also an important focus for Management. During the year ended December 31, 2006, Sturgis Bancorp, Inc. redeemed $1.0 million in stock and paid cash dividends of $0.45 per common share. The Bank plans to maintain its "well capitalized" position while continuing to be focused on growth and repurchase opportunities. Book value per share increased to $11.40 at December 31, 2006 from $10.65 per share at December 31, 2005. In addition to the regular dividends paid in 2006, the Board of Directors authorized and paid a special dividend of $0.05 per share. This was done to reward shareholders for an excellent year.

The Board of Directors raised the regular dividend to $0.12 per share for shareholders of record February 15, 2007. This represented a 20% increase over the prior quarter and was the second increase in 18 months.

While the economic forecasts for Michigan and the real estate markets remain pessimistic for 2007, Management is committed to holding its course. We are positive on the adjustments we have made over the last few years and believe we are gaining momentum. Our primary market is not as dependent on the automotive industry as many of the markets on the Eastern side of our State. We benefit from a diversified business environment across the markets we serve. We are well diversified in our loan portfolio and focused on continuing our emphasis on credit quality.

Our Directors, Officers and Employees are involved in numerous community groups and boards. The Bank is a generous supporter of many philanthropic causes. In addition, the Bank is a major player in the economic development of the communities we serve. We believe these activities are part of our mission. We also believe it affords us a competitive edge when seeking new business opportunities. It differentiates us from the large regional banks in our market. It also works as a retention tool for our employees. Our employees are proud to be part of an organization that is committed to the community we serve. Although we recognize financial performance provides us our independence, we will continue our commitment to the betterment of our communities. This is a hallmark of our past and the beacon to our future.

In 2006 we experienced both a sad and happy event. Raymond Dresser, Jr. retired from our Board after 39 years of service. Mr. Dresser was appointed to the Board in 1968, after many years of service as a Director by his father. His retirement was due to a provision in the Bancorp bylaws mandating that directors cannot serve past their 75th birthday. Mr. Dresser will be missed by me and his fellow board members. His depth of knowledge and years of faithful service have been invaluable. Mr. Dresser was instrumental in several key decisions made by the Bank during his leadership. The happy part of this event is that John R. Dresser has been appointed to fill the vacant seat. The Board unanimously appointed him to fill this vacancy and John has been nominated for election at the 2007 Annual Meeting. I hope you will support the Board's nomination, by voting in favor of John. He has several years of knowledge, gained from his father and in his role as the Bank's Legal Counsel. John is very involved in the community, understands and supports the concept of community banking. His depth of banking knowledge makes him very well qualified for your support.

We expect 2007 will be a challenging year for the banking industry. We do not believe our Bank will be an exception. We understand the challenges in our markets and Management is prepared to address those challenges. Management is confident we have implemented a strong strategic plan and is committed to long-term financial performance. The Bank is staffed with a very strong branch team and experienced lending staff. We continue to evaluate possible branch acquisitions and de novo opportunities that make good business sense. Management is also investigating strategic partnerships that may reduce operating expenses or enhance revenue streams.

In summary, our Bank continues to produce sound core earnings and we are focused on growing shareholder value, being a responsible corporate citizen and providing a work environment based on integrity and service. We look forward to our continuing role as the leading financial institution in St. Joseph County, Michigan and growing our presence in the Van Buren and Branch County markets.

I wish to thank the members of our Board of Directors for their guidance and counsel. I also wish to recognize the talented staff of Sturgis Bank & Trust Company for their hard work and dedication to you, our shareholders.

I wish to close by asking each of you to consider our products and services when choosing your financial service provider. After all, you are contributing to your own success, while receiving top-notch service, when you do business with your community Bank. Thank you for your continuing support and investment in Sturgis Bancorp, Inc.

Sincerely,

STURGIS BANCORP, INC

Eric L. Eishen
President/CEO

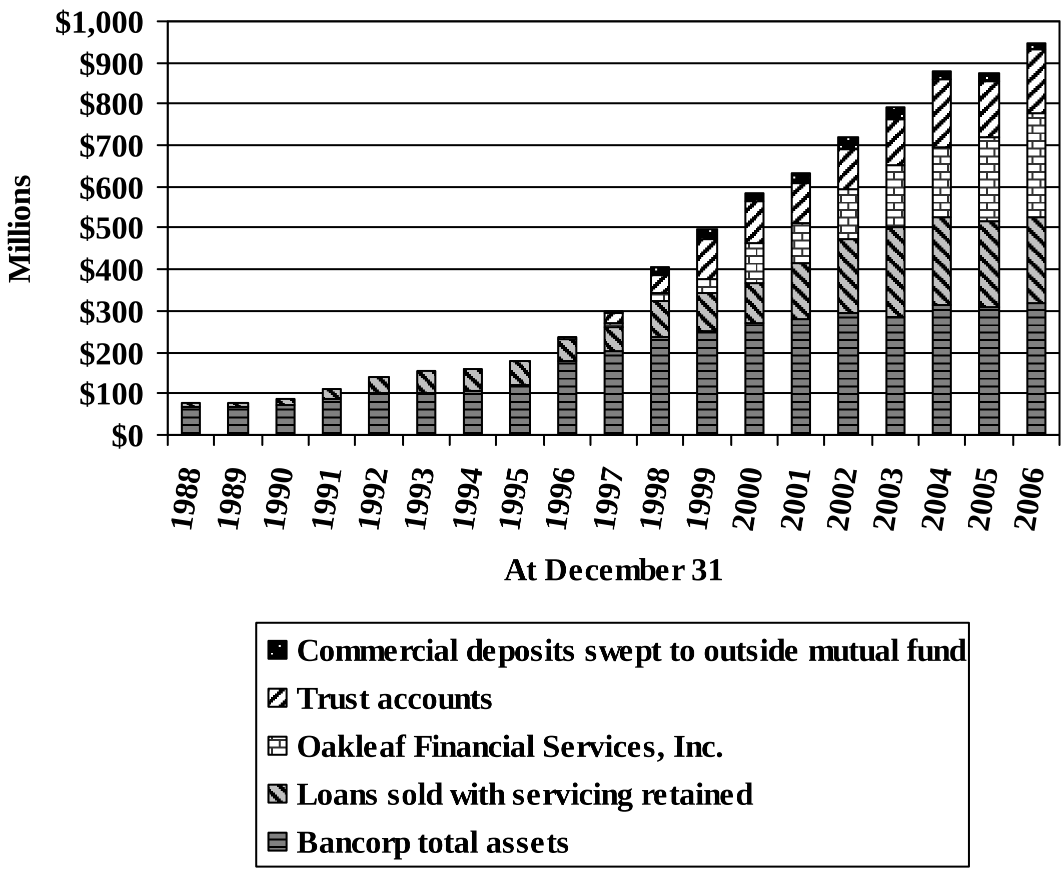
CONTENTS

SELECTED FINANCIAL DATA

	At December 31,				
	2006	2005	2004	2003	2002
Total assets	$320,858	$307,515	$313,561	$287,338	$296,684
Cash and investment securities	29,463	22,085	25,628	29,079	39,768
Loans and loans held for sale	241,751	236,749	236,496	216,849	219,481
Mortgage -backed securities	19,590	18,337	22,685	11,720	8,913
Allowance for loan losses	2,523	2,287	2,616	2,294	1,920
Deposits	216,134	213,593	211,164	199,920	202,564
Short-term borrowings	-	-	9,259	5,876	6,672
Long-term borrowings	61,000	51,000	46,903	49,929	57,709
Stockholders' equity	27,549	26,608	28,663	29,158	27,453
Book Value per share	11.40	10.65	10.53	10.38	9.81
Shares outstanding (actual number)	2,416,511	2,498,064	2,723,260	2,808,535	2,799,535

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Interest income	$19,610	$16,904	$14,896	$15,246	$17,411
Interest expense	8,425	7,181	6,338	7,017	8,414
Provision for loan losses	493	371	812	820	1,495
Noninterest income	4,438	4,394	4,283	5,750	5,393
Noninterest expense	10,599	9,907	9,450	9,578	8,986
Federal income tax	1,380	1,137	865	976	1,118
Net income	3,151	2,702	1,715	2,605	2,790
Earnings per share (basic)	1.29	1.06	0.62	0.93	0.95
Earnings per share (diluted)	1.29	1.06	0.62	0.93	0.95
Cash dividends per share	0.45	0.38	0.36	0.35	0.28
Dividend payout ratio	34.93%	35.39%	58.06%	37.73%	29.47%
Equity/Assets ratio	8.59%	8.65%	9.14%	10.15%	9.25%
Return on assets	1.02%	0.86%	0.56%	0.89%	0.95%
Return on equity	11.66%	10.16%	5.93%	9.16%	9.96%
Weighted average shares					
outstanding (actual number):					
Basic	2,466,823	2,546,648	2,762,294	2,808,461	2,949,874
Diluted	2,449,643	2,550,030	2,767,603	2,811,468	2,952,239

Gross Assets Managed



This graph illustrates the growth of relationships for the Company since 1988. Each of these relationships indicates a point of contact with customers.

Branch acquisitions with related deposits assumed are shown below:

Seller Name	Year	Branch Locations	Total Deposits
First Federal of Michigan	March 12, 1988	Three Rivers	$10,354,773
Fidelity Federal	June 29, 1990	Three Rivers	3,068,392
Standard Federal Bank	July 6, 1991	Sturgis	9,755,357
Great Lakes Bancorp	March 15, 1996	Coldwater and South Haven	24,016,569
KeyBank	December 8, 1997	Bronson and Constantine	16,883,609
First of America Bank	September 11, 1998	Centreville, Climax, Covert, and South Haven	45,140,000

The graph shows growth, even after the most recent branch acquisitions in 1998, to over 200% of the 1998 sum.

CORPORATE YEAR IN REVIEW

On December 11, 2001, the shareholders of Sturgis Bank & Trust Company (the “Bank”) approved the reorganization of the Bank to become a wholly owned subsidiary of Sturgis Bancorp, Inc. (the “Bancorp”), a financial holding company. The Bancorp is a financial holding company under the Bank Holding Company Act of 1956, as amended. This reorganization was effective January 1, 2002. As a result, historical information in this Annual Report for periods before the January 1, 2002 effective date relate to the Bank. Throughout this Annual Report Sturgis Bancorp, Inc. will be referred to as Bancorp and Sturgis Bank & Trust Company will be referred to as the Bank.

The Bank, a Michigan savings bank, was founded in 1905 as a state chartered mutual building and loan. The original mission of the Bank was to promote personal savings and provide financing for the purchase of homes. Today we remain committed to the same objectives by offering consumer, educational, and property improvement loans, along with a large selection of investment opportunities to our community.

Although the Bank's primary business has historically been and will continue to be the origination of first mortgage loans on 1-4 family unit homes, it has implemented strategies in the last few years that have increased commercial real estate and small business loans within its primary market area. Commercial loan growth remained strong during 2006. The small reduction in residential mortgages was offset by growth in consumer loans.

In 2006, the Bank purchased land in South Haven to expand services at an additional branch location.

The Bank has its main office in Sturgis and branch offices in Bronson, Centreville, Climax, Coldwater, Colon, South Haven, Sturgis, Three Rivers and White Pigeon, Michigan. The Bank's market area includes all of St. Joseph County and parts of Cass, Branch, Calhoun, Van Buren, Allegan, Hillsdale and Kalamazoo Counties in Michigan.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward Looking Statements

This report contains statements that constitute forward-looking statements. These statements appear in several places in this report and include statements regarding intent, belief, outlook, objectives, efforts, estimates or expectations of Bancorp, primarily with respect to future events and the future financial performance of Bancorp. Any such forward-looking statements are not guarantees of future events or performance and involve risks and uncertainties, and actual results may differ materially from those in the forward-looking statement. Factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement include, but are not limited to, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking laws and regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; government and regulatory policy changes; the outcome of any pending and future litigation and contingencies; trends in consumer behavior and ability to repay loans; and changes of the world, national and local economies. Bancorp undertakes no obligation to update, amend or clarify forward-looking statements as a result of new information, future events, or otherwise.

Critical Accounting Policies

The banking industry is highly regulated. Furthermore, the nature of the banking industry is such that, other than described below, the use of estimates and management judgment are not likely to present a material risk to the financial statements. In cases where estimates or management judgment are required, internal controls and processes are established to provide assurance that such estimates and management judgments are materially correct to the best of management's knowledge.

Allowance for loan losses - Accounting for loan classifications, accrual status, and determination of the allowance for loan losses is based on regulatory guidance. This guidance includes, but is not limited to, generally accepted accounting principles, the uniform retail credit classification and account management policy issued by the Federal Financial Institutions Examination Council ("FFIEC"), and the joint policy statement on the allowance for loan losses methodologies issued by the FFIEC. Accordingly, the allowance for loan losses includes a reserve calculation based on an evaluation of loans determined to be impaired, risk ratings, historical losses, loans past due, and other subjective factors. However, there is still a degree of subjectivity when formulating the level of the allowance for loan losses and historical trends may not be indicative of future levels provided to the reserve account.

Commercial loan rating system and identification of impaired loans – Bancorp has a defined risk rating system that is designed to assess the risk of individual loans and overall risk of the commercial loan portfolio. The system assigns a risk weighting to factors such as cash flow, collateral, financial condition, operating performance, repayment history, management, and strength of the customer's industry. An assessment of risk is performed as a part of the loan approval process as well as periodic updates based on the circumstances of the individual loan. Bancorp employs both internal and external loan review services to assess risk ratings.

Originated mortgage servicing rights ("OMSR") - Bancorp records the original "OMSR" based on market data. The OMSR is amortized into non-interest income in proportion to the period of the estimated future net servicing income of the underlying financial asset. Additionally, an independent third party valuation is performed to determine potential impairment of the OMSR as a result of changes in interest rates and expected future loan prepayment speeds. Significant changes in interest rates or prepayment speeds could have a significant impact on the carrying value of mortgage servicing assets.

Deferred income tax assets –Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

Goodwill and Intangible Assets – Bancorp had $5.1 million of goodwill at December 31, 2006 and 2005. Effective January 1, 2002, Bancorp adopted Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Other Intangible Assets, which changes Bancorp's accounting for goodwill and other intangible assets. Generally intangible assets that meet certain criteria are recognized and subsequently amortized over their estimated useful lives. Goodwill and intangible assets with indefinite lives, such as Bancorp's goodwill, are not amortized. However, such assets are tested for impairment annually after adoption of SFAS 142.

Results of Operations

Bancorp reported net income of $3.2 million and $2.7 million for the years ended December 31, 2006 and 2005, respectively. Diluted earnings per share were $1.29, and $1.06 for the years ended December 31, 2006 and 2005, respectively. The increase in net interest income to 2006 from 2005 is the primary component of the increase in net income. Noninterest income categories of service fees and charges, investment brokerage income and other income offset decreases in trust fee income and mortgage banking income. The increase in noninterest expense to $10.6 million in 2006 from $9.9 million in 2005 includes $327,000 of realized loss on sale of available-for-sale securities.

Interest Income

Interest income increased $2.7 million to $19.6 million from $16.9 million. This increase is primarily due to the increases in average interest rates. The average interest rate earned on loans increased to 7.55% in 2006 from 6.57% in 2005. This increase in the average interest rate earned is primarily due to adjustable rate loans repricing higher through 2006. Average interest-earning assets decreased to $272.7 million in 2006 from $274.4 million in 2005. Management believes the expansion of commercial lending has been a primary cause of the improved interest income, as rates increased during the period. Most commercial credits are priced on a variable basis and the expansion of non-interest bearing commercial deposit accounts will help to reduce the average funding costs. The average yield on interest-earning assets increased to 7.19% in 2006 from 6.16% in 2005.

Interest Expense

Interest expense increased $1.2 million to $8.4 million in 2006 from $7.2 million in 2005. This was primarily due to the increase in average interest rates on interest-bearing liabilities to 3.28% in 2006 from 2.73% in 2005. The average rate paid on interest-bearing deposits was 2.74% in 2006, compared to 2.09% in 2005. The average rate paid on borrowed funds increased to 4.76% in 2006 from 4.69% in 2005.

Net Interest Income

Net interest income for the year ended December 31, 2006 was $11.2 million compared to $9.7 million for the year ended December 31, 2005, an increase of $1.5 million or 15.0%. This increase was caused primarily by an increase in net interest margin to 4.10% in 2006 from 3.54% in 2005. Growth in market rates through 2006, relative to 2005, increased the margin, due to the asset sensitivity of the loan portfolio. The Bank has positioned itself for net interest income to increase with rising interest rates.

Average Balances, Interest Rates and Yields. Net interest income is affected by the difference ("interest rate spread") between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities and the relative amounts of interest-bearing liabilities and interest-earning assets. When the total of interest-earning assets approximates or exceeds the total of interest-bearing liabilities, any positive interest rate spread will generate net interest income. Financial institutions have traditionally used interest rate spreads as a measure of net interest income. Another indication of an institution's net interest income is its "net yield on interest-earning assets" or "net interest margin," which is net interest income divided by average interest-earning assets. The Bank's net interest margin for 2006 and 2005 was, 4.10% and 3.54% respectively. This increase in 2006, relative to 2005, demonstrates the effect of the Bank's positive gap position. A positive gap means that interest-bearing assets are repricing at a faster pace than interest-bearing liabilities. The most significant risk to this positive gap strategy is that rate increases are reversed. Management does not believe this scenario is likely in the short-term.

Average Balances and Interest Rates
Year Ended December 31,

	2006			2005		
	Average Outstanding Balance	**Interest Earned/ Paid**	**Yield/ Rate**	**Average Outstanding Balance**	**Interest Earned/ Paid**	**Yield/ Rate**
Interest-Earning Assets:						
Loans (1)	$238,284	$17,982	7.55%	$235,299	$15,453	6.57%
Mortgage-backed securities	18,297	834	4.55%	21,687	733	3.38%
Investment securities (2)	7,351	374	5.09%	7,623	349	4.57%
Interest-bearing deposits	8,814	420	4.77%	9,807	369	3.77%
Total interest-earning assets	$272,746	$19,610	7.19%	$274,416	$16,904	6.16%
Interest-Bearing Liabilities:						
Deposits	$196,024	$5,372	2.74%	$196,566	$4,104	2.09%
FHLB advances and repurchase agreements	64,091	3,053	4.76%	65,574	3,077	4.69%
Total interest-bearing liabilities	$260,115	$8,425	3.24%	$262,140	$7,181	2.73%
Net interest income		$11,185			$9,723	
Interest rate spread			3.95%			3.43%
Net interest-earning assets	$12,631			$12,276		
Net interest margin			4.10%			3.54%

(1) Interest on loans includes fees. Nonaccrual loans and loans held for sale have been included in the average balances of loans.
(2) Yield on investment securities is reported on an actual and not a tax equivalent basis

The following table presents information regarding the weighted average yields received on loans and other assets and the weighted average rates paid on deposits and borrowings on the last day of the years indicated. Non-accruing loans have been included in the table as loans carrying a zero yield.

	December 31,	
	2006	**2005**
Weighted average rate:		
Loans	7.70%	6.98%
Mortgage-backed securities	5.61%	4.66%
Investments(1)	5.03%	4.60%
Interest-bearing deposits	5.59%	3.48%
All interest-earning assets	7.41%	6.68%
Weighted average cost:		
Deposits (interest-bearing)	2.66%	2.10%
FHLB advances & repo	4.83%	4.56%
All interest-bearing liabilities	3.22%	2.67%
Interest rate spread	4.19%	4.01%

(1) Yield on investment securities is reported on an actual and not a tax equivalent basis.

Rate/Volume Analysis. The following table sets forth certain information regarding changes in interest income and interest expense of Bancorp for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to: (i) changes in volume (change in volume multiplied by the prior year rate) and (ii) changes in rate (change in rate multiplied by the prior year volume). Rate/volume variances have been allocated proportionately to the change due to rate and the change due to volume.

	Year Ended December 31, 2006 vs 2005 Increase (Decrease) Due To:			Year Ended December 31, 2005 vs 2004 Increase (Decrease) Due To:		
Interest Income:	Volume	Rate	Total	Volume	Rate	Total
Loans	$198	$2,331	$2,529	$482	$1,667	$2,149
Mortgage-backed securities	(127)	228	101	102	(316)	(214)
Investment securities	(13)	38	25	13	(47)	(34)
Interest-bearing deposits	(40)	91	51	(91)	197	106
Total interest-earning assets	18	2,688	2,706	506	1,501	2,007
Interest Expense:						
Deposits	(11)	1,279	1,268	60	448	508
FHLB advances	(70)	46	(24)	145	190	335
Total interest-bearing liabilities	(81)	1,325	1,244	205	638	843
Net Interest Income	$99	$1,363	$1,462	$301	$863	$1,164

Provision for Loan Losses

The provision for loan losses was $493,000 for the year ended December 31, 2006 and $371,000 for the year ended December 31, 2005, an increase of $122,000. The provision for loan losses was based upon management's assessment of relevant factors, including types and amounts of non-performing loans, historical and anticipated loss experience on such types of loans, and economic conditions. Loans charged off during 2006, net of recoveries, were $257,000, compared to $700,000 during 2005. The higher net loans charged off in 2005 included amounts provided in 2004.

Nonperforming loans increased to $2.5 million at December 31, 2006 from $2.3 million at December 31, 2005. This increase in nonperforming loans is primarily comprised of residential mortgages.

The allowance for loan losses as a percentage of total loans increased to 1.00% in 2006 from 0.95% in 2005. This increase is primarily due to the a change in the mix of the Bank's loan portfolio Management monitors the increasing exposure to commercial lending and economic developments the Bank's market area, among other factors, in determining appropriate provisions to the allowance for loan losses.

Noninterest Income

Noninterest income was $4.4 million in 2006 and 2005. Service charges and other fees increased by $118,000 and brokerage commissions increased by $126,000. Trust fee income decreased to $337,000 in 2006 from $528,000 in 2005, partially due to one-time fee income in 2005 from transferring a large trust relationship to a brokerage relationship. Brokerage activities continue to grow at the Company. Brokerage income, which is influenced by the U.S. economy and stock market values, was 29.5% of non-interest income for 2006 and will continue to be a large component of noninterest income. During 2006 and 2005, mortgage banking activity was dominated more by purchases and sales, rather than refinances. Proceeds from sale of loans decreased to $21.5 million in 2006 from $32.0 million in 2005. The decrease is due to higher market interest rates in 2006.

Noninterest Expense

Noninterest expense was $10.6 million in 2006, compared to $9.9 million in 2005, an increase of $692,000. The largest component of the increase was compensation and related expenses, which increased $621,000 to $6.4 million in 2006 from $5.8 million in 2005. Average loan costs deferred, a contra-expense item to compensation and related expenses, decreased by $39,000. Increased pension expenses and annual salary adjustments also contributed to the increase in compensation. Professional services decreased $108,000 due to Bancorp's private company status. During 2006, Bancorp realized $327,000 loss on sale of $11.9 million of available-for-sale securities, with the proceeds reinvested at market rates. At December 31, 2006, goodwill was not impaired. Management actively minimizes noninterest expense, although certain noninterest expenses are outside of Management's direct control. Management expects salaries and employee benefits to increase by 3-5% annually.

The effective federal income tax rate was 30.5% in 2006 and 29.6% in 2005.

Financial Condition

General. Bancorp's total assets at December 31, 2006 were $320.9 million compared to $307.5 million at December 31, 2005, an increase of $13.3 million or 4.3%. Most of the increase in total assets was in loans and interest-bearing deposits in banks. Bancorp continued to sell long-term, fixed rate, residential mortgage loans.

Loans. Net loans increased to $241.6 million at December 31, 2006 from 235.6 million at December 31, 2005. This increase was primarily due to a $6.7 million increase in commercial loans, which offset the decrease in residential mortgages. The Bank sells long-term, fixed rate, residential mortgages in the secondary market. The major buyers of these loans are Federal Home Loan Mortgage Corporation (FHLMC) and FHLB. Commercial mortgage loans, including net commercial construction loans, increased to $96.4 million, or 38.3% of gross loans at December 31, 2006 from $91.6 million, or 38.1% of gross loans, at December 31, 2005. The proceeds from sales of loans (primarily fixed-rate, residential mortgages) were $21.5 million and $32.0 million for the years ended December 31, 2006 and 2005, respectively. The mortgage loans originated for sale ($20.3 million in 2006 and $29.4 million in 2005) were primarily funded by the secondary mortgage market sales. The decision to sell fixed-rate mortgages with original maturities of 10-years or greater protects the Bank from the interest rate risk inherent in holding these longer term, fixed-rate loans and provides a source of liquidity to fund loan demand. Any increase in market interest rates will continue to decelerate the pace of refinance activity in the residential loan portfolio, as the Bank intends to continue focusing its efforts on growing commercial loans.

At December 31, 2006, outstanding loan commitments were $5.5 million and $47.7 million on fixed and variable-rate loans, respectively. Of these loan commitments, Management expects $9.1 million to be disbursed for new loans during the first half of 2007. The additional loan commitments are unused lines of credit, which may be drawn at any time by the borrower. These loan commitments will be funded by interest-bearing deposits, maturing assets, and additional FHLB borrowings, if needed.

Loans serviced for others decreased by $3.0 million to $205.8 million at December 31, 2006 from $208.8 million at December 31, 2005. This servicing portfolio consists of loans originated by the Bank and sold in the secondary mortgage market with servicing retained by the Bank. Management believes this provides the Bank with a competitive advantage in its market. The retention of servicing requires the Bank to keep a higher staffing level than if the servicing is sold. But many consumers have discovered the difficulties encountered when loan servicing is sold. The retention of servicing also allows the Bank to cross-sell other banking products and services to these customers. The value of the right to service is appraised quarterly and any temporary impairment of the value of servicing rights is recognized quarterly. The originated mortgage servicing rights asset required a valuation allowance of $39,000 at December 31, 2006. The Bank will continue to monitor the valuation of the servicing rights asset. If subsequent analysis shows changes in the appraised impairment, the valuation allowance will be adjusted to match the impairment.

Bancorp has no purchased mortgage servicing portfolio.

The following table provides an analysis of the allowance for loan losses:

	Year Ended December 31, 2006	2005
Balance at the beginning of the period	$ 2,287	$ 2,616
Charge-offs:		
Residential mortgages	148	205
Commercial mortgages	57	205
Commercial nonmortgage loans	62	327
Other consumer and installment loans	61	115
Total charge-offs	328	852
Recoveries		
Residential mortgages	-	14
Commercial mortgages	40	83
Commercial nonmortgage loans	2	1
Other consumer and installment loans	29	54
Total recoveries	71	152
Net charge-offs	257	700
Provision for loan losses	493	371
Balance at the end of the period	$ 2,523	$ 2,287
Ratio of net charge-offs during the period to average loans outstanding during the period	0.11%	0.30%
Allowance for loan losses to total loans	1.00%	0.95%
Nonperforming assets to total assets	1.07%	1.07%
Allowance for loan losses to nonperforming assets	73.48%	69.71%

The following table shows the allocation of the allowance for loan losses at the dates indicated by loan type:

	As of December 31,			
	2006		2005	
	Amount	Percent of Loans in Each Category To Total Loans	Amount	Percent of Loans in Each Category To Total Loans
Residential mortgages	$1,253	50.44%	$ 387	50.13%
Commercial mortgages	733	36.12%	1,498	36.86%
Construction loans – residential	37	1.77%	9	2.76%
Construction loans – commercial	32	2.25%	37	1.42%
Commercial nonmortgage loans	367	6.06%	271	5.32%
Loans secured by deposits	-	0.29%	-	0.38%
Other consumer and installment	101	3.07%	85	3.13%
Total allowance for loan losses	$2,523	100.00%	$ 2,287	100.00%

Loans in nonaccrual status at December 31, 2006 were $1.9 million, up from $1.7 million at December 31, 2005. The increase in nonaccrual loans was primarily residential mortgages. The following table presents the aggregate amount of troubled asset categories as of the dates indicated:

	December 31,	
	2006	2005
Past due – 90 days or greater	$ 621	$ 529
Nonaccrual loans	1,854	1,731
Real estate owned	958	1,021
Total nonperforming assets	3,433	3,281
Restructured assets	624	642
Total troubled assets	$4,057	$3,923
Ratio of troubled assets to total loans	1.61%	1.63%
Ratio of troubled assets to total assets	1.26%	1.27%

Interest-bearing Deposits in Banks. Interest-bearing deposits in banks were $8.9 million at December 31, 2006, compared to $3.4 million at December 31, 2005, an increase of $5.5 million. This increase was funded with advances from FHLBI.

Securities – Available for sale. Investment securities available for sale of $16.7 million at December 31, 2006 and $14.8 million at December 31, 2005 consisted of mortgage-backed securities issued by the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation. The Bank's investment strategy has historically been to carry its mortgage-backed securities in the held-to-maturity portfolio. Management has changed this strategic decision, so that a balanced investment portfolio can more directly contribute to future liquidity needs, by being carried as available-for-sale. During 2006, the Bank sold $11.9 million of its available-for-sale securities at a loss of $327,000. Proceeds of the sale were reinvested in available-for-sale securities at market rates.

Securities – Held-to-maturity. Investment securities held-to-maturity consist of U.S agency mortgage-backed securities, municipal obligations, and a trust preferred security. The investment securities held-to-maturity were $5.8 million at December 31, 2006 compared to $6.6 million at December 31, 2005, a decrease of $0.8 million. The decrease was due to matured municipal obligations and principal payments on mortgage-backed securities. There were no investment securities held-to-maturity purchased during 2006.

Deposits and Borrowed Funds. Deposits were $216.1 million at December 31, 2006 compared to $213.6 million at December 31, 2005, an increase of $2.5 million or 1.2%. Interest-bearing deposits increased to $195.1 million at December 31, 2006 from $195.0 million at December 31, 2005. Certificates of deposit with balances greater than or equal to $100,000 (commonly referred to as Jumbo Certificates), which carry greater interest rate sensitivity, increased by $4.7 million to $55.2 million at December 31, 2006 from $50.5 at December 31, 2005. The Bank views Jumbo Certificates of deposit as a source of liquidity. Other certificates of deposit decreased to $48.0 million at December 31, 2006 from $48.6 million at December 31, 2005. Transaction savings accounts and checking accounts decreased $4.0 million, or 4.1%, from December 31, 2005 to December 31, 2006. Transaction savings accounts and checking accounts represent 42.53% of deposits at December 31, 2006, compared to 44.89% of deposits at December 31, 2005. Bank management is actively attempting to increase these core deposit account relationships. Transaction savings accounts and checking accounts provide relatively inexpensive funding for future growth, compared to alternative certificates of deposit and borrowed funds at higher interest rates. The Bank offers competitive rates on its time deposits and uses jumbo certificates or borrowed funds, when that strategy enhances net interest income.

The Bank has an available line of credit with FHLB which provides for advances up to $8.0 million and matures annually in March. The Bank anticipates renewal of the line of credit at maturity in March 2007. All borrowings from FHLB are collateralized by substantially all mortgage loans and securities backed by the US Government.

Long-term advances were $61.0 million at December 31, 2006 compared to $51.0 million at December 31, 2005, an increase of $10.0 million. No short-term advances were outstanding at December 31, 2006 or 2005. Management anticipates increasing FHLB advances, as demand for portfolio loans increases.

Capital Resources

The stockholders' equity of the Bancorp was $27.5 million at December 31, 2006 compared to $26.6 million at December 31, 2005, an increase of $0.9 million or 3.54%. The primary components of this change in stockholders' equity were retained earnings and common stock redemption. Cash dividends of $1.1 million, or $0.45 per share, were paid out of the $3.2 million of income, adding $2.1 million to retained earnings for 2006. Bancorp repurchased $1.0 million shares of its common stock in 2006 and $3.6 million in 2005. The repurchases in 2005 include shares redeemed in Bancorp's going-private transaction. The stockholders' equity was 8.59% of total assets at December 31, 2006. Management continues to monitor and evaluate the best capital structure of Bancorp. A structure that provides sufficient capital to fund future growth, yet maximizes earnings per share, is deemed optimal. Management does not project a need for capital beyond what can be provided by retained earnings.

The Federal Reserve Board ("FRB")'s risk-based capital guidelines are inapplicable to Bancorp, due to Bancorp qualifying as a "small bank holding company". However, if Bancorp's total assets exceeds $500 million, the guidelines will apply to Bancorp. The guidelines require that financial holding companies with over $500 million in total assets maintain capital commensurate with both on and off balance sheet credit risks of their operations. Under the guidelines, a financial holding company must have a minimum ratio of total capital to risk-weighted assets of 8.0%.

In addition, a financial holding company must maintain a minimum ratio of Tier 1 capital equal to 4.0% of risk-weighted assets. Tier 1 capital includes common stockholders equity, qualifying perpetual preferred stock and minority interest in equity accounts of consolidated subsidiaries less goodwill.

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 goodwill, of 3% for the most highly rated financial holding companies. All other financial holding companies are required to maintain additional Tier 1 capital yielding a leverage ratio of 4%-5%, depending on the particular circumstances and risk profile of the institution.

Management deems the current capitalization level adequate for current and anticipated strategies.

Although not currently required by FRB, the following table summarizes the capital ratios of Bancorp at the dates indicated:

		December 31, 2006	December 31, 2005
Equity to assets		8.6%	8.7%
Tier I leverage		7.2%	7.1%
Risk-based:	Tier I capital	9.7%	9.1%
	Total capital	10.8%	10.1%

The increase in capital ratios of Bancorp from December 31, 2005 to December 31, 2006 is primarily the result of the retained earnings.

Asset/Liability Management

The primary component of Bancorp's earnings is net interest income of the Bank. The Bank's asset/liability management strategy is to maximize net interest income over time by reducing the impact of fluctuating interest rates. This is accomplished by matching the mix and maturities of its assets and liabilities. At the same time the Bank's asset/liability strategies for managing interest rate risk must also accommodate customer demands for particular types of deposit and loan products. The Bank uses asset/liability management techniques in an attempt to maintain a profitable mix of financial assets and liabilities, provide deposit and loan products that meet the needs of its market area, and maintain control over interest rate risk resulting from changes in interest rates.

Net interest income, the primary component of the Bank's net income, is derived from the difference or "spread" between the yield on interest-earning assets and the cost of interest-bearing liabilities. The Bank has sought to reduce its exposure to changes in interest rates by matching more closely the effective maturities and repricings of its interest-sensitive assets and liabilities. At the same time, the Bank's asset/liability management strategies must also accommodate customer demands for particular types of deposit and loan products.

While much of the Bank's asset/liability management efforts involve strategies that increase the rate sensitivity of its loans and investments, such as the sale of long-term fixed rate loans, originations of adjustable rate loans and purchases of adjustable rate mortgage-backed securities or relatively short average life fixed-rate investments, it also uses techniques to reduce the rate sensitivity of its deposits and borrowed money. Those techniques include attracting longer-term certificates of deposit when the market will permit, emphasizing core deposits, which are less sensitive to changes in interest rates, and borrowing through long-term FHLB advances. The Bank's asset/liability management strategy will change when market rates change.

The Bank measures its exposure to interest rate fluctuations primarily by using a computer modeling system designed for savings institutions such as the Bank. The model uses assumptions which management believes are reasonable for the analysis. These assumptions include (but are not limited to) prepayment and decay rates based on nine interest rate scenarios. These assumptions are based on national statistics and may not reflect the Bank's own experience. It allows the Bank to adjust its asset-liability mix based on the interest rate risk identified. The analysis estimates the changes in the market value of the Bank's equity using interest rate change scenarios ranging from +4% to –4%, in 1% increments from current market rates. At December 31, 2006, the following table illustrates the interest rate sensitivity of the Bancorp's consolidated equity to immediate and permanent changes in market interest rates.

(in Thousands of Dollars)	
Book value of stockholders' equity	$27,549
4% increase in market rates	35,864
3% increase in market rates	36,663
2% increase in market rates	39,356
1% increase in market rates	38,611
No change (current market value of equity)	37,110
1% decrease in market rates	34,098

2% decrease in market rates	29,589
3% decrease in market rates	24,963
4% decrease in market rates	20,028

As the table shows, Bancorp's estimated market value of equity exceeds book value in most of the scenarios. That indicates that Bancorp is able to withstand fluctuations in market interest rates without posting a significant threat to either Bancorp's stockholders' equity or the federal deposit insurance system, and therefore, Bancorp can be deliberate in its actions to adjust the asset-liability mix. Bancorp would meet the regulatory minimum capital requirements in all of the interest-rate scenarios.

The Bank has an Asset-Liability Management Committee (ALCO) that meets as needed. The purpose of this Committee is to communicate, coordinate, and monitor asset-liability management procedures. The Committee establishes and monitors the volume and mix of both assets and funding sources. The objective is to manage assets and funding sources to produce results consistent with Bancorp's liquidity requirements, capital adequacy, growth, and profitability goals. To accomplish this objective, the ALCO uses internal budget variance reports, forecasts for changes in interest rates and consumer deposit activity, as well as forecasts of loan demand in each of the Bank's loan types, investment maturities and new investment alternatives, and various other internal and external reports.

Effect of Interest Rate Fluctuations

Bancorp's consolidated results of operations depend to a large extent on the Bank's level of net interest income, which is the difference between interest income earned on its loan and investment portfolios versus the interest paid on deposits and borrowed funds. If the cost of funds increases faster than the yield on its interest-earning assets, net interest income will be reduced.

Bancorp measures its interest rate risk primarily using simulation analysis. This analysis is prepared by the Chief Financial Officer and reviewed by the ALCO. ALCO is comprised of the Chief Executive Officer, Chief Financial Officer, Executive Vice President and Senior Officers of the Bank. Bancorp's Board of Directors review quarterly reports that estimate Bancorp's sensitivity to changes in interest rates. Sensitivity is estimated for net interest income and market value of portfolio equity.

While Bancorp uses various tools to monitor interest rate risk, it is unable to predict future fluctuations in interest rates or the specific impact thereof. The market value of most of Bancorp's financial assets is sensitive to fluctuations in market interest rates. Fixed-rate investments and mortgage loans decline in value as interest rates rise. Adjustable-rate investments and loans generally have less market value volatility than fixed-rate assets.

Liquidity

Bancorp maintains certain levels of liquid assets (the most liquid of which are cash and cash equivalents and investment securities) in order to meet demands from loan commitments, savings withdrawals and other obligations. Bancorp manages liquidity by maintaining a portion of its liquid assets in overnight accounts and by keeping various maturities in its portfolio of investment securities. The primary sources of liquidity are loan repayments, loan sales, maturing investments, deposit accounts, and other borrowed funds, such as FHLB borrowings.

As market interest rates increased through 2005 and held at the higher rates through 2006, deposit customers have been lured from bank deposits to other alternatives, such as money market accounts or other investments. If market interest rates continue to increase, Management expects the pressure on deposits to intensify.

Contractual Obligations

The long-term debt obligations consist of certificates of deposit and advances from the Federal Home Loan Bank. The following schedule represents principal payments only and does not include interest as of December 31, 2006.

	Payments Due by Period				
	Total	Less than 1 year	1 – 3 years	4 – 5 Years	After 5 years
Certificates of deposit	$103,143	$58,692	$31,980	$11,037	$ 1,434
FHLB advances	61,000	5,000	17,500	18,500	20,000
Total contractual obligations	$164,143	$63,692	$49,480	$29,537	$21,434

Off-balance Sheet Activities

Other Commercial Credits – The Bank is a party to credit related financial instruments with off-balance sheet risks in the normal course of business to meet the financing needs of its customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet of the Bank.

Commitments to extend credit are agreements to lend to a customer as long as there are no violations of any condition established in the contract. Commitments for equity lines of credit or overdraft protection may expire without being drawn. Therefore, total commitments do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on Management's credit evaluation of the customer. Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized, may not contain a specified maturity date and may be drawn to the total extent of the Bank's commitment.

Commercial and standby letters of credit are a conditional commitment issued by the Bank to guarantee the performance of a customer to a third party. The letters of credit are primarily used to support public and private borrowing arrangements. All letters of credit have expiration dates within one year.

At December 31, 2006, the Bank had total commitments of $5.5 million and $47.7 million on fixed rate and variable rate loans, respectively.

All of the commercial credits are underwritten using the commercial loan underwriting guidelines.

Collateral Requirements – To reduce credit risks related to the use of credit-related financial instruments, the Bank might deem it necessary to obtain collateral. The amount and nature of the collateral obtained are based on the Bank's credit evaluation of the borrower. Collateral held varies, but may include cash, securities, accounts receivable, inventory, property, plant and equipment and real estate. Although these items are used to secure loans, they are not included on the balance sheet of Bancorp.

Legal Contingencies – Various legal claims also arise from time to time in the normal course of business which, in the opinion of Management, will have no material effect on Bancorp's consolidated financial statements.

Other Off-balance Sheet Activities – During the year ended December 31, 2003, Bancorp committed to an investment for $250,000 in a venture capital company. Through December 31, 2006, Bancorp contributed $125,500 to the venture capital company. Bancorp has a minority interest of approximately 1% in the venture capital company. The venture capital company seeks viable projects in various stages of development for investment. Bancorp has an outstanding commitment of $125,000 as capital is required to fund projects.

Impact of Inflation

The majority of assets and liabilities of financial institutions are monetary in nature. Generally, changes in interest rates have a more significant impact on earnings of the Bank than inflation. Although influenced by inflation, changes in rates do not necessarily move in either the same magnitude or direction as changes in the price of goods and services. Inflation does impact the growth of total assets, creating a need to increase equity capital at a higher rate to maintain an adequate equity to assets ratio, which in turn reduces the amount of earnings available for cash dividends. Through 2006 and 2005, inflation did not have a material impact on the Bancorp.

DIRECTORS OF BANCORP

John R. Dresser	Dresser, Dresser, Haas & Caywood, P.C. Retained Counsel
Eric L. Eishen	President and Chief Executive Officer, Sturgis Bank & Trust Company
Leonard L, Eishen	Retired President and Chief Executive Officer, Sturgis Bank & Trust Company
Lawrence A. Franks	Chairman of the Board Director – Corporate Secretary and Treasurer, Burr Oak Tool, Inc. and Oak Press Systems, Inc. and Chairman of the Board for Oak Japan.
Donald L. Frost	President, LTI Printing, Inc.
James A. Goethals	Vice Chairman of the Board Retired President, Sturgis Foundry Corporation
Jeffrey M. Mohney	Owner, A. W. Ayres Agency, Inc.
Philip G. Ward	President Emeritus, Glen Oaks Community College
John T. Wiedlea	President, Automation Plus, Inc.

OFFICERS OF BANCORP

Eric L. Eishen	President, Chief Executive Officer
Ronald W. Scheske	Vice President
Brian P. Hoggatt	Chief Financial Officer, Secretary/Treasurer

DIRECTORS OF THE BANK

John R. Dresser	Dresser, Dresser, Haas & Caywood, P.C. Retained Counsel
Eric L. Eishen	President and Chief Executive Officer
Leonard L. Eishen	Retired President and Chief Executive Officer
Lawrence A. Franks	Vice Chairman of the Board Director – Corporate Secretary and Treasurer, Burr Oak Tool, Inc. and Oak Press Systems, Inc. and Chairman of the Board for Oak Japan
Donald L. Frost	President, LTI Printing, Inc.
James A. Goethals	Chairman of the Board President, Sturgis Foundry Corporation – Retired
Jeffrey M. Mohney	Owner, A. W. Ayres Agency, Inc.
Philip G. Ward	President Emeritus, Glen Oaks Community College
John T. Wiedlea	President, Automation Plus, Inc.

OFFICERS OF THE BANK

Eric L. Eishen	President, Chief Executive Officer
Steven G. Gage	Senior Vice President, Commercial Lending
Brian P. Hoggatt	Senior Vice President, Chief Financial Officer, Treasurer, Corporate Secretary
Christine M. Moline	First Vice President, Private Banking
Tracey L. Parker	Senior Vice President, Retail Lending
Ronald W. Scheske	Executive Vice President
Jose D. Albarran	Vice President
Donald G. Baldwin	First Vice President, Operations, Compliance Officer
Sandra J. Cagle	Vice President
Debora L. Capman	Vice President, Trust Officer
Brandon L. Cropsey	Vice President
Emily D. Haller	Vice President, Human Resources
Steven A. Haller	Vice President, Loss Mitigation
Jason J. Hyska	Vice President
John D. Johnson	Vice President
Gary E. Metz	Vice President
Larry W. Miller	Vice President
Marilee I. Miller	Controller
Janet M. Stahl	Vice President
Jason A. Wagner	Vice President
David E. Watters	Vice President, Senior Trust Officer
Camille M. Wilson	Vice President
Robby S. Beachy	Assistant Vice President
Tami J. De Mara	Assistant Vice President
Trudy R. Gloy	Assistant Vice President

BANK CORPORATE INFORMATION

Location	Address	City, ST ZIP	Telephone	Fax
Sturgis (Main Office)	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5512
				(269) 651-8263
				(269) 865-5902
Branch Offices				
Bronson	863 West Chicago Road	Bronson, MI 49028	(517) 369-7322	(517) 369-2347
Centreville	158 West Main	Centreville, MI 49032	(269) 467-8525	(269) 467-4180
Climax	125 North Main	Climax, MI 49034	(269) 746-4256	(269) 746-4108
Coldwater	290 East Chicago Road	Coldwater, MI 49036	(517) 278-5634	(517) 278-5613
Colon	110 South Blackstone Street	Colon, MI 49040	(269) 432-3229	(269) 432-2971
South Haven	1121 LaGrange Street	South Haven, MI 49090	(269) 637-8444	(269) 637-5560
Sturgis	1001 South Centerville Road	Sturgis, MI 49091	(269) 651-9379	(269) 651-1514
Sturgis	1501 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5609
Three Rivers	115 North Main Street	Three Rivers, MI 49093	(269) 273-8481	(269) 273-1732
White Pigeon	122 West Chicago Road	White Pigeon, MI 49099	(269) 483-9668	(269) 483-2725

MARKET INFORMATION

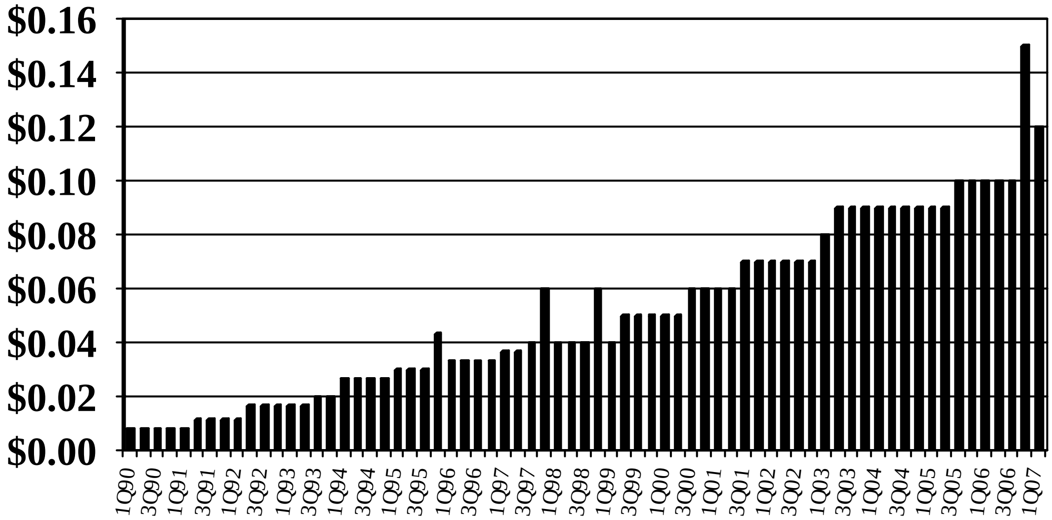
Shares of common stock of Bancorp were held by approximately 165 shareholders as of December 31, 2006. Bancorp's shares are traded on the OTC Bulletin Board under the symbol of "STBI". Trading activity has been infrequent.

The range of high and low trade prices for each quarterly period during the past two years is presented below:

	Year ended December 31,			
	2006		2005	
	High	Low	High	Low
First quarter	$13.20	$12.10	$14.94	$11.00
Second quarter	12.50	11.55	12.25	10.60
Third quarter	13.45	12.00	13.95	10.60
Fourth quarter	13.35	12.65	13.90	12.25

The trade prices listed above are based on actual transactions obtained from public Internet sources obtained by Bancorp.

Cash Dividends Per Share



On December 11, 2001, the shareholders of the Bank approved the reorganization of the Bank to become a wholly owned subsidiary of Sturgis Bancorp, Inc., a financial holding company. Sturgis Bancorp, Inc. is a financial holding company under the Bank Holding Company Act of 1956, as amended (the "Bancorp"). This reorganization was approved at a special meeting of the shareholders of the Bank on December 11, 2001. Bancorp received all of the various federal and state regulatory approvals for this reorganization.

This reorganization became effective as of the opening of business on January 1, 2002. Bancorp is a legal entity separate and distinct from its subsidiaries. Substantially all of Bancorp's revenues result from dividends paid to it by the Bank and from earnings on investments. There are statutory and regulatory requirements applicable to the payment of dividends by the Bank to Bancorp, as well as by Bancorp to its shareholders.

Under the Michigan Savings Bank Act, Bancorp may not declare a cash dividend or a dividend of any kind except out of net income then on hand after deducting all losses and bad debts, and then only if it will have a surplus amounting to not less than 20% of its capital after the payment of the dividend. Moreover, the Bank may not declare or pay any cash dividend or dividend in kind until the cumulative dividends on its preferred stock, if any, have been paid in full. Further, if the surplus of the Bank is at any time less than the amount of its capital, before the declaration of a cash dividend or dividend in kind, it must transfer to surplus not less than 10% of its net income for the preceding 6 months (in the case of quarterly or semi-annual dividends) or the preceding two consecutive 6 month periods (in the case of annual dividends).

Pursuant to the Michigan Business Corporation Act, Bancorp may not make distributions to its shareholders if, after giving effect to the distribution, the corporation would not be able to pay its debts as they become due in the usual course of business, or the corporation's total assets would be less than the sum of it total liabilities plus, unless the corporation's articles of incorporation permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

The payment of dividends by Bancorp and its subsidiaries may also be affected or limited by other factors, such as the requirements to maintain adequate capital above regulatory guidelines. In addition, if, in the opinion of the applicable regulatory authority, a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the Bank, could include the payment of dividends), such authority may require, after notice and hearing, that such bank cease and desist from such practice or prohibit the payment of future dividends. The Federal Reserve has indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve, the FDIC and the Division of Financial Institutions of the Michigan Department of Consumer & Industry Services Office of Financial and Insurance Services have issued policy statements which provide that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

INDEPENDENT ACCOUNTANTS

Bancorp employed the accounting firm of Crowe Chizek & Company LLC as Independent Accountants for the year ended December 31, 2006. Bancorp employed the accounting firm of Plante & Moran, PLLC as Independent Accountants for the year ended December 31, 2005. There have been no disagreements on accounting or financial disclosure matters within these time periods.

Crowe Chizek and Company LLC
Member Horwath International

REPORT OF INDEPENDENT AUDITORS

Board of Directors and Shareholders
Sturgis Bancorp, Inc.
Sturgis, Michigan

We have audited the accompanying consolidated balance sheet of Sturgis Bancorp, Inc. as of December 31, 2006 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Sturgis Bancorp, Inc. as of and for the year ended December 31, 2005 were audited by other auditors whose report dated February 22, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sturgis Bancorp. Inc, as of December 31, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Grand Rapids, Michigan
March 16, 2007

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2006 and 2005
(Dollar amounts in thousands, except per share data)

	2006	2005
ASSETS		
Cash and due from banks	$ 17,404	$ 13,467
Other short-term investments	253	2,207
Total cash and cash equivalents	17,657	15,674
Interest-bearing deposits in banks	8,888	3,374
Securities - Available for sale	16,703	14,810
Securities – Held to maturity (fair value 2006 - $5,896, 2005-$6,628)	5,805	6,563
Federal Home Loan Bank stock, at cost	4,135	4,567
Loans held for sale	182	1,174
Loans, net of allowance of $2,523 and $2,287	241,569	235,575
Premises and equipment, net	6,660	6,140
Goodwill	5,109	5,109
Originated mortgage servicing rights	1,476	1,611
Real estate owned	958	1,021
Bank-owned life insurance	7,430	7,153
Accrued interest receivable	2,057	1,834
Investment in limited partnerships	889	995
Other assets	1,340	1,915
Total assets	$ 320,858	$ 307,515
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	$ 21,074	$ 18,586
Interest bearing	195,060	195,007
Total Deposits	216,134	213,593
Federal Home Loan Bank advances	61,000	51,000
Repurchase agreements	13,000	13,400
Accrued interest payable	871	834
Other liabilities	2,304	2,080
Total liabilities	293,309	280,907
Stockholders' equity		
Preferred stock - $1 par value: authorized - 1,000,000 shares issued and outstanding – 0 shares		
Common stock – $1 par value: authorized – 9,000,000 shares issued and outstanding 2,416,511 shares and 2,498,064 shares at December 31, 2006 and 2005	2,417	2,498
Additional paid-in capital	12,341	13,296
Retained earnings	13,058	11,007
Accumulated other comprehensive income (loss)	(267)	(193)
Total stockholders' equity	27,549	26,608
Total liabilities and stockholders' equity	$ 320,858	$ 307,515

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2006 and 2005
(Dollar amounts in thousands, except per share data)

	2006	2005
Interest income		
Loans	$ 17,982	$ 15,453
Investment securities:		
Taxable	1,298	1,137
Tax-exempt	115	118
Dividends	215	196
Total interest income	19,610	16,904
Interest expense		
Deposits	5,372	4,104
Borrowed funds	3,053	3,077
Total interest expense	8,425	7,181
Net interest income	11,185	9,723
Provision for loan losses	493	371
Net interest income after provision for loan losses	10,692	9,352
Noninterest income:		
Service charges and other fees	1,703	1,585
Investment brokerage commission income	1,309	1,183
Mortgage banking activities	641	735
Trust fee income	337	528
Increase in value of bank owned life insurance	277	258
Other income	171	105
Total noninterest income	4,438	4,394
Noninterest expenses:		
Salaries and employee benefits	6,411	5,790
Occupancy and equipment	1,234	1,234
Data processing	636	595
Professional services	270	378
Loss on sales of securities	327	-
Real estate owned expense	139	94
Advertising	212	247
Other	1,370	1,569
Total noninterest expenses	10,599	9,907
Income before income tax expense	4,531	3,839
Provision for federal income tax	1,380	1,137
Net income	$ 3,151	$ 2,702
Basic earnings per share	$ 1.29	$ 1.06
Diluted earnings per share	$ 1.29	$ 1.06

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years ended December 31, 2006 and 2005
(Dollar amounts in thousands, except per share data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance – January 1, 2005	$ 2,723	$ 16,645	$ 9,262	$ 33	$ 28,663
Stock options exercised (including tax effect of $4)	4	35	-	-	39
Stock redemption	(229)	(3,384)	-	-	(3,613)
Net income for the year ended December 31, 2005	-	-	2,702	-	2,702
Other comprehensive income	-	-	-	(226)	(226)
Total comprehensive income					2,476
Cash dividends ($.38 per share)	-	-	(957)	-	(957)
Balance – December 31, 2005	2,498	13,296	11,007	(193)	26,608
Stock redemption	(81)	(955)	-	-	(1,036)
Net income for the year ended December 31, 2006	-	-	3,151	-	3,151
Other comprehensive income	-	-	-	129	129
Total comprehensive income					3,280
Adjustment to initially apply SFAS No. 158	-	-	-	(203)	(203)
Cash dividends ($.45 per share)	-	-	(1,100)	-	(1,100)
Balance – December 31, 2006	$ 2,417	$ 12,341	$ 13,058	$ (267)	$ 27,549

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2006 and 2005
(Dollar amounts in thousands, except per share data)

	2006	2005
Cash flows from operating activities		
Net income	$ 3,151	$ 2,702
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	497	525
Amortization of mortgage servicing rights	390	481
Provision for loan losses	493	371
Deferred income taxes	67	363
Accretion and amortization of securities	74	220
Gain on sale of loans held for sale	(529)	(630)
Proceeds from the sale of loans held for sale	21,498	32,014
Loans originated for sale	(20,271)	(29,353)
Gain on real estate owned	(62)	(85)
Loss of equity in limited partnership	106	133
Loss on sale of available for sale securities	327	-
Loss on impairment of mortgage servicing rights	39	-
Increase in cash value of bank-owned life insurance	(277)	(258)
Stock dividend from Federal Home Loan Bank stock	-	(95)
Changes in assets and liabilities:		
(Increase) decrease in accrued interest and other assets	352	(929)
Increase (decrease) in accrued interest and other liabilities	(75)	100
Net cash provided by operating activities	5,780	5,559
Cash flows from investing activities		
Net change in interest-bearing deposits in banks	(5,514)	7,112
Proceeds from maturities of securities held to maturity	115	110
Principal reductions of mortgage-backed securities held to maturity	572	2,286
Principal reductions of mortgage-backed securities available for sale	3,550	3,205
Purchase of securities available-for-sale	(17,501)	(3,302)
Proceeds from sales of securities available-for-sale	11,923	-
Net increase in loans	(7,942)	(5,052)
Redemption of Federal Home Loan Bank stock	432	-
Proceeds from sale of real estate owned	1,580	1,580
Additions to premises and equipment, net	(1,017)	(599)
Net cash provided by (used in) investing activities	(13,802)	5,340

(Continued)

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2006 and 2005
(Dollar amounts in thousands, except per share data)

	2006	2005
Cash flows from financing activities		
Net increase (decrease)in demand and savings account deposits	$ (1,479)	$ (4,536)
Net increase (decrease) in certificates of deposits	4,020	6,965
Repayment of FHLB advances	(18,000)	(21,162)
Proceeds from FHLB advances	28,000	16,000
Proceeds from repurchase agreement	5,500	-
Repayment of repurchase agreement	(5,900)	-
Cash dividends paid on common stock	(1,100)	(956)
Stock options exercised	-	34
Stock redemption	(1,036)	(3,613)
Net cash provided by (used in) financing activities	10,005	(7,268)
Net change in cash and cash equivalents	1,983	3,631
Cash and cash equivalents - beginning of year	15,674	12,043
Cash and cash equivalents - end of year	$ 17,657	$ 15,674
Supplemental information		
Cash paid for:		
Interest	$ 8,388	$ 7,080
Income taxes	970	890
Noncash investing and financing activities		
Loans transferred to real estate owned	$ 1,455	$ 2,078

See accompanying notes to consolidated financial statements.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Consolidation: The consolidated financial statements include the accounts of Sturgis Bancorp, Inc. (Bancorp), Sturgis Bank & Trust Company (Bank) and the Bank's wholly owned subsidiaries. The Bank's wholly owned subsidiaries include Oakleaf Financial Services, Inc., Ludington Service Corporation, Inc., and First Michiana Development Corporation of Sturgis, Inc. Accounts of Oak Mortgage, LLC, a subsidiary jointly owned by the Bank and Oakleaf Financial Services, Inc., are also consolidated. All significant intercompany transactions and balances have been eliminated in consolidation.

The Bank, which has been in continuous operation since 1905, formed Bancorp on January 1, 2002 via an equal exchange of common stock of Bank for common stock of Bancorp.

Use of Estimates: In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates and assumptions. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of real estate owned, deferred tax assets, mortgage servicing rights, and the impairment of goodwill.

Nature of Operations: Bancorp operates predominantly in the southwestern portion of Michigan's Lower Peninsula. Its primary services include accepting deposits, making commercial and mortgage loans, engaging in mortgage banking activities, and providing investment brokerage advisory services.

Significant Group Concentrations of Credit Risk: Most of Bancorp's activities are with customers located within southern Michigan. Note 2 discusses the types of securities in which Bancorp invests. Note 3 discusses the types of lending in which Bancorp engages. Bancorp's loan portfolio is concentrated in residential and commercial mortgage loans. Bancorp does not have any significant concentrations to any one industry or customer.

Cash and Cash Equivalents: For the purpose of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and other short-term time and investment accounts at the Federal Home Loan Bank, all of which mature within 90 days. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and repurchase agreements.

Interest-bearing Deposits in Banks: Interest-bearing deposits in banks mature within two years and are carried at cost.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Securities: Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost, that are deemed to be other than temporary, are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of Bancorp to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Federal Home Loan Bank Stock: Bancorp's minimum investment in the stock of the Federal Home Loan Bank of Indianapolis (FHLB) is an amount equal to at least 1.0% of the unpaid principal balances of Bancorp's residential mortgage loans or 0.3% of its total assets, whichever is greater. Purchases and sales of stock are made directly with the FHLB at par value. The stock is recorded at cost.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Loans: Bancorp grants mortgage, commercial, and consumer loans to customers. Loans are reported at their outstanding unpaid principal balances, adjusted for amounts charged off, nonaccrual interest paid, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment to the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent, unless the credit is well-secured and in the process of collection. In all cases, if collection of principal and interest is considered doubtful, loans are placed on nonaccrual, charged off, or charged down to the fair value of collateral.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

When a loan is placed in nonaccrual status, all interest accrued but not collected is reversed against interest income. Interest payments received on loans in nonaccrual status are accounted as reductions to the carrying value of the principal until the loan again qualifies for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses: The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance, when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision with any new information.

The allowance consists of specific and general components. The specific components relate to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for quantitative factors.

A loan is considered impaired, based on current information and events, when it is probable that Bancorp will be unable to collect the scheduled payments of principal or interest in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls are not generally classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including length of the delay, reasons for the delay, the borrower's prior payment history, and the amount of the shortfall in relation to the amount due and collateral value. Impairment on a loan is measured on a loan-by-loan basis for commercial and construction loans. Impairment is the difference between the carrying value of the loan and the loan's obtainable market price, present value of expected future cash flows discounted using the loan's effective interest rate, or the fair value of collateral for collateral-dependent loans.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Large groups of homogenous loans are collectively evaluated for impairment. Accordingly, Bancorp does not separately identify individual consumer and residential loans for impairment disclosures.

Servicing: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights compared to amortized costs. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum.

Off-Balance-Sheet Instruments: In the ordinary course of business, Bancorp has entered into commitments to extend credit, including commitments under commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Real Estate Owned: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell. Revenue and expenses from operations and changes in the valuation allowance are included in real estate owned expense.

Bank-Owned Life Insurance: The Bank has purchased life insurance policies on certain key officers. Bank-owned life insurance is recorded at its cash surrender value, or the amount that can be realized.

Investment in Limited Partnership: Bancorp has investments in limited partnerships that are structured to generate low-income housing tax credits and an investment in a Michigan partnership structured to generate commissions from the sale of title insurance. Bancorp accounts for these investments under the equity method, whereby Bancorp annually records its proportionate share of partnership profits and losses as an adjustment to the carrying value of the investment.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill: Generally, intangible assets that meet certain criteria are recognized and subsequently amortized over their estimated useful lives. Goodwill with indefinite lives are not amortized. However, such assets are tested for impairment at adoption of SFAS 142 and at least annually thereafter. There has been no impairment of goodwill.

Premises and Equipment: Land is carried at cost. Premises and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets. Buildings and related components are depreciated with useful lives ranging from 5 to 50 years. Furniture, fixtures and equipment are depreciated with useful lives ranging from 3 to 15 years.

Long-term Assets: Premises and equipment, core deposit and other intangible assets, and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Repurchase Agreements: Bancorp enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, Bancorp transfers legal control over the assets but still retains effective control through an agreement that both entitles and obligates Bancorp to repurchase the assets. As a result, repurchase agreements are accounted for as financing arrangements and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the consolidated balance sheet while the dollar amount of securities underlying the agreements remains in the respective asset accounts as pledged assets.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and the tax bases of the various balance sheet assets and liabilities. This method gives current recognition to changes in tax rates and laws. When necessary, valuation allowances are established to reduce deferred tax assets to the amount expected to be realized.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Bancorp is qualified under provisions of the Internal Revenue Code to deduct from taxable income a provision for bad debts in excess of such provision charged to income in the consolidated financial statements. Accordingly, retained earnings at December 31, 2006 and 2005 include approximately $918,000 for which no provision for federal income taxes has been made. Unrecognized deferred taxes on this amount are approximately $312,000. In the future, if this portion of retained earnings is used for any purpose other than to absorb bad debt losses, federal income taxes would be imposed at the then applicable rates.

Retirement Plans: Pension expense is the net of service and interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

Stock Compensation Plans: Effective January 1, 2006, Bancorp adopted SFAS No. 123(R), Share Based Payments, using the modified prospective transition method. However, as all of the Company's granted options were fully vested prior to January 1, 2005, no compensation expense is recorded for 2006 and there is no pro forma affect for 2005.

Bancorp has no stock option plans with authority for additional grants. However, if Bancorp adopts a new stock option plan and grants options under it, Bancorp would record stock-based compensation cost using the fair value method.

Earnings Per Common Share: Basic earnings per share represents income available to common stockholder divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share includes outstanding additional common shares that would have been outstanding, if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential shares that may be issued by Bancorp relate solely to outstanding stock options, and are determined using the treasury stock method.

Earnings per common share have been computed based on the following:

	2006	2005
Net income	$ 3,151	$ 2,702
Weighted average number of common shares outstanding	2,446,823	2,546,648
Effect of dilutive options	2,820	3,382
Weighted average number of common shares outstanding used to calculate diluted earnings per share	2,449,643	2,550,030

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Outstanding non-dilutive options were 95,700 shares for the years ended December 31, 2006 and 2005.

Comprehensive Income: Accounting principles generally require that recognized revenue, expense, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income.

Legal Contingencies: Various legal claims arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on Bancorp's consolidated financial statements.

Recent Accounting Pronouncement: In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its balance sheet, beginning with year end 2006, and to recognize changes in the funded status in the year in which the changes occur through comprehensive income beginning in 2007. Bancorp elected to adopt SFAS No. 158 effective December 31, 2006. Additionally, defined benefit plan assets and obligations are to be measured as of the date of the employer's fiscal year-end, starting in 2008. Adoption had the following effect on individual line items in the 2006 balance sheet:

	Before Application of SFAS No. 158	Adjustments	After Application of SFAS No.158
Liability for pension benefits	$ 235	$ 203	$ 438
Deferred income taxes	24	69	93
Total liabilities	293,106	203	293,309
Accumulated other comprehensive income	(64)	(203)	(267)
Total stockholders' equity	27,752	(203)	27,549

Reclassification: Certain amounts appearing in the prior years' financial statements have been reclassified to conform to the current year's financial statements.

(Dollar amounts in thousands, except per share data)

NOTE 2 – SECURITIES

The amortized cost and fair value of securities with gross unrealized gains and losses follow:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2006				
Available-for-sale securities:				
Mortgage backed	$ 16,800	$ 12	$ (109)	$ 16,703
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 2,493	$ 25	$ (14)	$ 2,504
Mortgage-backed securities	2,887	25	(20)	2,892
Other securities	425	75	-	500
	$ 5,805	$ 125	$ (34)	$ 5,896
2005				
Available-for-sale securities:				
Mortgage backed	$ 15,102	$ -	$ (292)	$ 14,810
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 2,611	$ 54	$ (54)	$ 2,611
Mortgage-backed securities	3,527	29	(39)	3,517
Other securities	425	75	-	500
	$ 6,563	$ 158	$ (93)	$ 6,628

Securities with a carrying value of $19,712 (market value of $19,618) and $18,190 (market value of $18,177) were pledged at December 31, 2006 and 2005, respectively, to secure U.S. Treasury tax and loan payments, FHLB advances, and repurchase agreements.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 2 – SECURITIES (Continued)

The amortized cost and fair value of debt securities by contractual maturity at December 31, 2006 are shown below. Actual and expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

	Held-to-Maturity		Available-for-Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 115	$ 115	$ -	$ -
Due after one through five years	967	964	-	-
Due after five through ten years	-	-	-	-
Due after ten years	1,836	1,925	-	-
Total	2,918	3,004	-	-
Mortgage-backed securities	2,887	2,892	16,800	16,703
	$ 5,805	$ 5,896	$ 16,800	$ 16,703

For the years ended December 31, 2006 and 2005, proceeds from sales of securities available for sale amounted to $11,923 and $0, respectively. Gross realized losses amounted to $327 and $0 for the years ended December 31, 2006 and 2005, respectively. The tax benefit applicable to these net realized losses amounted to $111 and $0, respectively.

Information pertaining to securities with gross unrealized losses at December 31, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less than 12 months		>= 12 months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
2006				
Available-for-sale securities:				
Mortgage backed	$ (109)	$ 12,059	$ -	$ -
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ -	$ -	$ (14)	$ 668
Mortgage-backed securities	-	-	(20)	1,605
	$ -	$ -	$ (34)	$ 2,273

(Dollar amounts in thousands, except per share data)

NOTE 2 – SECURITIES (Continued)

	Less than 12 months		>= 12 months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
2005				
Available-for-sale securities:				
Mortgage backed	$ (188)	$ 9,634	$ (103)	$ 5,175
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ (36)	$ 153	$ (18)	$ 592
Mortgage-backed securities	(1)	64	(39)	2,043
	$ (37)	$ 217	$ (57)	$ 2,635

Unrealized losses on securities have not been recognized into income, because the issuers' bonds are of high credit quality, Bancorp has the intent and ability to hold the securities for the foreseeable future, and the decline in fair value is primarily due to increased market interest rates. The fair value is expected to recover as the bonds approach the maturity date.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 3 – LOANS

A summary of the balances of loans follows:

	2006	2005
Mortgage loans:		
Residential 1-4 family	$ 118,982	$ 120,409
Commercial	90,783	88,627
Construction loans – residential	4,800	4,314
Construction loans – commercial	5,644	3,021
Total mortgage loans	220,209	216,371
Commercial nonmortgage loans	15,217	12,794
Consumer and installment loans:		
Consumer and installment	7,714	7,524
Other	722	921
Total consumer and installment loans	8,436	8,445
	243,862	237,610
Less:		
Allowance for loan losses	2,523	2,287
Unearned interest	24	77
	241,315	235,246
Add:		
Deferred loan origination and other costs, net of fees	254	329
Loans, net	$ 241,569	$ 235,575

An analysis of the allowance for loan losses follows:

	2006	2005
Balance – Beginning of year	$ 2,287	$ 2,616
Provision for loan losses	493	371
Loans charged off	(328)	(852)
Recoveries of loans previously charged off	71	152
Balance – End of year	$ 2,523	$ 2,287

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 3 – LOANS (Continued)

The following is a summary of information pertaining to impaired loans:

	2006	2005
Impaired loans with a valuation allowance	$ 1,276	$ 1,373
Impaired loans without a valuation allowance	1,408	-
Total impaired loans	$ 2,684	$ 1,373
Valuation allowance related to impaired loans	$ 361	$ 261
Average investment in impaired loans	$ 1,892	$ 2,324
Interest income recognized on impaired loans	$ 162	$ 5
Interest income recognized on a cash basis on impaired loans	$ 162	$ 5

No additional funds are committed to be advanced in connection with impaired loans.

Nonperforming loans were as follows:

Total non-accrual loans	$ 1,854	$ 1,730
Total loans past due 90 days or more and still accruing	$ 621	$ 529

Nonperforming loans include both smaller balance homogenous loans that are collectively evaluated for impairment and individually classified impaired loans.

NOTE 4 – SERVICING

Loans serviced for others are not included in the accompanying consolidated balance sheet. The unpaid principal balance of mortgages and other loans serviced for others approximated $205.8 million and $208.0 million at December 31, 2006 and 2005, respectively.

The fair values of the rights to service these loans were $2,171 and $2,364 at December 31, 2006 and 2005, respectively. The fair value of servicing rights was determined using the discount rate of 9% and PSA prepayment speeds of 172%-426% at December 31, 2006. The fair value of servicing rights was determined using the discount rate of 8% and PSA prepayment speeds of 215%-486% at December 31, 2005.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 4 – SERVICING (Continued)

The following summarizes the activity in mortgage servicing rights and the related valuation allowance:

	2006	2005
Mortgage servicing rights:		
Balance at beginning of year	$ 1,611	$ 1,774
Mortgage servicing rights capitalized	294	318
Mortgage servicing rights amortized	(390)	(481)
Provision for loss in fair value	(39)	-
Balance at end of year	$ 1,476	$ 1,611
Valuation allowance:		
Balance at beginning of year	$ -	$ -
Additions	39	-
Reductions	-	-
Write-downs	-	-
Balance at end of year	$ 39	$ -

NOTE 5 – REAL ESTATE INVESTMENT – LIMITED PARTNERSHIP

In February 2003, Bancorp acquired 24.75% interest in a limited partnership operating in Elkhart County, Indiana. The limited partnership was formed to construct and operate multi-family housing units. All income, expenses and tax credits will be allocated to Bancorp based upon ownership percentage. As an investor, Bancorp is able to exercise influence over operating and financial policies of the management through provisions of the partnership agreement that require a majority approval of the limited partners. At such time as the project is sold, the limited partners will receive a share of the net proceeds proportionate to each limited partner's outstanding capital balance. Under the terms of the limited partnership agreement, Bancorp contributed $1,050,000 in cash, and is allocated tax losses and affordable housing federal income tax credits.

As of December 31, 2006 and 2005, the balance in this investment was $889 and $995. The recognized loss on this investment for 2006 and 2005 was $104 and $95.

(Dollar amounts in thousands, except per share data)

NOTE 5 – REAL ESTATE INVESTMENT – LIMITED PARTNERSHIP (Continued)

Condensed financial information for the investee partnership is summarized as follows:

	2006	2005
Balance sheet:		
Cash	$ 80	$ 50
Property and land	13,790	14,210
Other assets	50	44
Total assets	$ 13,920	$ 14,304
Accrued and other liabilities	$ 416	$ 452
Bridge loan	1,808	2,037
Note payable – mortgage	8,870	8,875
Note payable – developer	1,927	2,054
Partners' equity	899	886
Total liabilities and partners' equity	$ 13,920	$ 14,304
Net loss	$ 414	$ 352

Bancorp's share of tax credits generated by the investee partnership totaled $102 and $106 in 2006 and 2005, respectively.

NOTE 6 – PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation of premises and equipment follows:

	2006	2005
Land	$ 705	$ 702
Land improvements	58	47
Office buildings	6,803	6,243
Furniture, fixtures and equipment	4,079	3,829
Construction in progress	436	265
Total premises and equipment	12,081	11,086
Less accumulated depreciation	(5,421)	(4,946)
Net carrying amount	$ 6,660	$ 6,140

Depreciation expense for the years ended December 31, 2006 and 2005 amounted to $497 and $525, respectively.

(Dollar amounts in thousands, except per share data)

NOTE 7 – DEPOSITS

Interest-bearing deposit balances at December 31 are summarized as follows:

	2006	2005
Passbook and savings deposits	$ 46,581	$ 44,373
NOW accounts	45,336	51,511
Time:		
$100,000 and over	55,186	50,525
Under $100,000	47,957	48,598
	$ 195,060	$ 195,007

At December 31, 2006, the scheduled maturities of time deposits are as follows:

Maturing in the Year Ending December 31,	Under $100,000	$100,000 and Over
2007	$ 26,303	$ 32,389
2008	11,131	6,853
2009	6,028	7,969
2010	3,499	3,142
2011	859	3,537
Thereafter	137	1,296
	$ 47,957	$ 55,186

NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES

The Bank has advances from the Federal Home Loan Bank of Indianapolis (FHLB) of $61,000,000 and $51,000,000 at December 31, 2006 and 2005, respectively, which mature through 2016. At December 31, 2006 and 2005, the interest rates ranged from 4.29% to 5.50% and from 4.20% to 5.50%, respectively. The advances are subject to prepayment penalties as defined in the credit policy of FHLB.

Included in the above advances are four advances from FHLB totaling $31,000,000 at December 31, 2006, which mature through 2012. These advances have put options which allow FHLB to convert the interest rates to the three-month LIBOR with quarterly resets starting in March 2007 through maturity. The interest rate may only be converted by FHLB if the three-month LIBOR exceeds certain rates.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES (Continued)

The advances are collateralized by securities held in safekeeping at FHLB, performing residential and commercial non-employee mortgage loans. The unpaid principal balance of pledged loans was approximately $150.7 million and $150.9 million at December 31, 2006 and 2005, respectively. Mortgage-backed securities with a carrying value of $2.6 million (market value $2.6 million) were held in safekeeping at FHLB and were pledged at December 31, 2006. Mortgage-backed securities with a carrying value of $3.2 million (market value $3.2 million) were held in safekeeping at FHLB and were pledged at December 31, 2005.

Annual payments of FHLB advances are as follows:

2007	$ 5,000
2008	15,000
2009	2,500
2010	5,000
2011	13,500
2012 and thereafter	20,000
	$ 61,000

NOTE 9 – REPURCHASE AGREEMENTS

Repurchase agreements are secured by available for sale mortgage-backed securities held by a third-party trustee with a market value of $16,703 and $14,810 at December 31, 2006 and 2005, respectively.

These agreements are fixed rate financing arrangements that, at December 31, 2006, mature in 2007 ($5,500) and 2009 ($7,500). At maturity, the securities underlying the agreements are returned to Bancorp. Information concerning repurchase agreements is summarized as follows:

	2006	2005
Average daily balance during the year	$ 13,056	$ 14,448
Average interest rate during the year	4.20%	3.48%
Maximum month-end balance during the year	13,400	15,000
Weighted average interest rate at year end	4.17%	3.93%

If the fair values of the pledged available for sale securities decline, either through principal reductions or market value fluctuations, so that the aggregate fair values are insufficient collateral for the repurchase agreements, additional alternative collateral will be pledged.

(Dollar amounts in thousands, except per share data)

NOTE 10 – FEDERAL INCOME TAXES

Sturgis Bancorp, Inc. and Subsidiaries file a consolidated federal income tax return. The following is a summary of the provision for income taxes for the two years ended December 31:

	2006	2005
Current expense	$ 1,480	$ 774
Deferred expense (benefit)	(100)	363
	$ 1,380	$ 1,137

A reconciliation of the difference between total federal income tax expense and the amount computed by applying the statutory tax rates to income before income taxes is as follows:

	2006	2005
Amount computed at statutory rate	$ 1,541	$ 1,305
Tax-exempt income from Bank-owned life insurance	(94)	(89)
Tax-exempt interest income	(69)	(59)
Low-income housing tax credits	(113)	(106)
Other, net	115	86
	$ 1,380	$ 1,137

The components of the net deferred tax asset (liability) are as follows:

	2006	2005
Deferred tax assets:		
Investment impairment	$ 25	$ 25
Allowance for loan losses	709	508
Unrealized loss on available-for-sale securities	33	99
Unfunded pension liability	69	-
Other	202	106
	1,038	738
Deferred tax liabilities:		
Deferred loan fees	(86)	(149)
Mortgage servicing rights	(502)	(406)
Amortization	(661)	(504)
Depreciation	(256)	(272)
FHLB stock dividends	(137)	(152)
Other	(150)	(112)
	(1,792)	(1,595)
Net deferred tax liability	$ (754)	$ (857)

(Continued)

NOTE 11 – RETIREMENT BENEFITS

Bancorp is a participant in the multi-employer Financial Institutions Retirement Fund (FIRF or the Plan), which covers substantially all of the officers and employees of the Bank and its Subsidiaries. The defined benefit plan provides benefits to all full-time employees with one year of service, based on basic compensation and years of service. Bancorp contributions are determined by FIRF and generally represent the normal cost of the Plan. Specific Plan assets and accumulated benefit information for Bancorp's portion of the fund are not available. Under the Employee Retirement Income Security Act (ERISA), a contributor to a multi-employer pension plan may be liable in the event of complete or partial withdrawal for the benefit payments guaranteed under ERISA. Bancorp has no present intention to withdraw from the fund. The expenses of the Plan allocated to Bancorp for the years ended December 31, 2006 and 2005 were $491 and $383, respectively.

The Bank also sponsors a non-qualified unfunded defined benefit plan to provide supplemental retirement benefits for certain executives. These benefits include pre-retirement disability and death benefits, as well as post-retirement payments for 15 years. The expense incurred the plan for 2006 and 2005 was $71 and $58, and the total deferred compensation liability was $438 and $164 as of December 31, 2006 and 2005.

To assist with the funding of the DB obligation and other employee benefits, the Bank has purchased insurance policies on the lives of certain officers of the Bank. The Bank is owner and beneficiary of these policies. At December 31, 2006 and 2005, the cash value of all bank-owned life insurance policies was $7,430 and $7,153, respectively. The cash value is available to fund future benefit obligations. The Bank uses a measurement date of December 31 for the DB. The Bank does not anticipate paying benefits in connection with this plan over the next 10 years.

(Continued)

NOTE 12 – COMMON STOCK AND OPTIONS

Shareholder Repurchase Agreement
In September 2005, the Bancorp entered into an agreement with a shareholder to repurchase up to 197,200 shares of common stock. The agreement is an irrevocable right and option to purchase the shares upon the death of the shareholder at market price as quoted on the OTC Bulletin Board or such similar quotation service on which the Bancorp's shares trade. The option period expires on the 90th day following the death of the shareholder.

Stock Option Plans
Additionally, the Bank has had three stock option plans under which grants have been extended to employees and directors.

Director Plan - All options granted under the Director Plan were exercised before December 31, 1988. Because the Director Plan expired in May 1998, no new stock options will be granted under the Director Plan.

Employee Plan – Options granted under the Employee Plan expire 10 years after the date of the grant. If employment is terminated prior to that time for reasons other than death or disability, the options expire 30 days after termination of employment. If employment with the Bank is terminated by reason of death or disability, the options expire 90 days after termination of employment. Unexercised stock option grants under the Employee Plan were 99,651 and 101,976 shares at December 31, 2006 and 2005, respectively. All outstanding options under the Employee Plan became fully vested in 2001. Because the Employee Plan expired in May 1998, no new stock options will be granted under the Employee Plan.

New Director Plan – The New Director Plan provided active directors with stock options that expire 10 years and one day after the grant date. If a grantee ceases to be a director prior to that time for reasons other than death or disability, the options expire 30 days after cessation of director status. If cessation of director status results from death or disability, the options expire 90 days after cessation of director status. Unexercised stock option grants under the New Director Plan were 4,725 at December 31, 2006 and 2005. Because the New Director Plan expired in December 1999, no new stock options will be granted under the New Director Plan.

(Dollar amounts in thousands, except per share data)

NOTE 12 – COMMON STOCK AND OPTIONS (Continued)

The following is a summary of the activity with respect to Bancorp's stock option plans for the years ended December 31, 2006 and 2005:

	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding – January 1, 2005	110,451	$ 13.66
Granted	-	-
Cancelled	-	-
Exercised	(3,750)	9.15
Outstanding – December 31, 2005	106,701	13.81
Granted	-	
Cancelled	(2,325)	13.10
Exercised	-	-
Outstanding – December 31, 2006	104,376	$ 13.83

For options outstanding at December 31, 2006, the exercise price ranged from $9.00 to $15.88 and the weighted average remaining contractual life of the options was approximately 16 months. The aggregate intrinsic value of options outstanding at December 31, 2006 was $37.

NOTE 13 – MINIMUM REGULATORY CAPITAL REQUIREMENTS

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on Bancorp's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Bancorp and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies such as Bancorp.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 13 – MINIMUM REGULATORY CAPITAL REQUIREMENTS (Continued)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios, as set forth in the following table. Total capital, Tier 1 capital, risk-weighted assets and average assets are measures used to analyze capital adequacy. These measures are defined in federal banking regulations. Ratios must be met regarding total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. At December 31, 2006 and 2005, the Bank met all minimum capital requirements to which it is subject.

At December 31, 2006, the Federal Deposit Insurance Corporation categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since December 31, 2006 that management believes have changed the Bank's well-capitalized status.

The Bank's actual capital amounts and ratios at December 31, 2006 and 2005 were as follows:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2006						
Total capital (to risk weighted assets)						
Bank	$ 25,425	10.9%	$ 18,612	8.0%	$ 23,264	10.0%
Tier 1 capital (to risk weighted assets)						
Bank	22,902	9.8	9,306	4.0	13,959	6.0
Tier 1 capital (to adjusted total assets)						
Bank	22,902	7.3	12,550	4.0	15,688	5.0
December 31, 2005						
Total capital (to risk weighted assets)						
Bank	$ 24,186	10.2%	$ 18,932	8.0%	$ 23,665	10.0%
Tier 1 capital (to risk weighted assets)						
Bank	21,899	9.3	9,466	4.0	14,199	6.0
Tier 1 capital (to adjusted total assets)						
Bank	21,899	7.2	12,207	4.0	15,258	5.0

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 14 – OFF-BALANCE-SHEET ACTIVITIES

Credit-related Financial Instruments: Bancorp is a party to credit-related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing need of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. To various degrees, such commitments involve elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheet.

Bancorp's exposure to credit loss is represented by the contractual amount of the commitments. Bancorp follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2006 and 2005, the following financial instruments with credit risk were outstanding:

	2006	2005
Commitments to grant loans	$ 16,167	$ 9,915
Unfunded commitments under lines of credit	36,656	31,740
Commercial and standby letters of credit	349	45

Commitments to extend credit are agreements to lend to a customer, as long as there are no violations of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may requirement the payment of fees. These commitments, especially related to equity lines of credit, may expire without being drawn. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral secured by Bancorp is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. The equity and commercial lines of credit are collateralized, may not have a specified maturity date, and may be drawn to the full extent of Bancorp's commitment.

Commercial and standby letters of credit are conditional commitments issued by Bancorp to guarantee the performance of a customer to a third party. The letters of credit are primarily used to support public and private borrowing arrangements. All letters of credit issued by Bancorp have expiration dates within one year.

(Continued)

(Dollar amounts in thousands, except per share data)

NOTE 14 – OFF-BALANCE-SHEET ACTIVITIES (Continued)

Collateral Requirements: To reduce credit risk related to the use of credit-related financial instruments, Bancorp might deem it necessary to obtain collateral. The amount and nature of the collateral obtained are based on Bancorp's credit evaluation of the customer. Collateral types vary, including cash, securities, accounts receivable, inventory, real estate, property, plant and equipment.

Commitments: During 2003, Bancorp committed to purchase an investment for $250 in a venture capital company. Advances on this commitment totaled $50 and $38 during the years ended December 31, 2006 and 2005, respectively. At December 31, 2006, $125 remains committed to the purchase of this investment. Distributions of $100 and $14 were received in 2006 and 2005, respectively, from the venture capital company. Bancorp owns approximately 1.23% of the venture capital company.

NOTE 15 – RELATED PARTY TRANSACTIONS

In the ordinary course of business, Bancorp has granted loans to principal officers, directors and affiliates. A summary of the related party loan transactions for the years ended December 31, 2006 and 2005 is as follows:

	2006	2005
Related party loans - beginning of the year	$ 1,473	$ 1,264
Advances	808	824
Principal repayments	(195)	(615)
Related party loans – end of the year	$ 2,086	$ 1,473

Deposits from related parties held by the Bank at December 31, 2006 and 2005 approximated $1,237 and $2,000, respectively.

A former director of Bancorp is the majority stockholder in a law firm that provides legal counsel to Bancorp and its subsidiaries. Legal fees and disbursements to the law firm totaled $119 and $130 for 2006 and 2005, respectively.

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for Bancorp's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The following methods and assumptions were used by Bancorp in estimating fair value disclosures for financial instruments:

Cash and Cash Equivalents: The carrying amounts of cash and short-term instruments approximate fair values.

Interest-bearing Deposits in Banks: The carrying amounts of interest-bearing deposits maturing within 90 days approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities: Fair values for securities, excluding Federal Home Loan Bank stock, are based on quoted market prices. The carrying value of Federal Home Loan Bank stock approximate fair value based on the redemption provisions of the Federal Home Loan Bank. If quoted market prices are not available, fair values are based on quoted market prices of comparable investment.

Mortgage Loans Held for Sale: Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.

Loans Receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values, as adjusted for estimated credit losses. Fair values for other loans (e.g., commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Deposit Liabilities: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, 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). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. 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 aggregated expected monthly maturities on time deposits.

FHLB Advances: The carrying amount of short-term FHLB advances is a reasonable estimate of their fair value due to their variable interest rates and short-term maturities. The estimated fair value of long-term FHLB is determined by discounting the future cash flows of outstanding advances using rates currently available on advances from the FHLB with similar characteristics.

Repurchase Agreements: The estimated fair value of repurchase agreements is determined by discounting the future cash flows of outstanding advances using rates currently available on similar instruments.

Accrued Interest: The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet items: The fair value of off-balance-sheet items is based on the current fees or cost that would be charged to enter into or terminate such arrangements, and was not considered material to this presentation.

(Continued)

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The estimated fair values and related carrying or notional amounts of Bancorp's financial instruments are as follows (000s omitted):

	2006		2005	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 17,657	$ 17,657	$ 15,674	$ 15,674
Interest-bearing deposits in banks	8,888	8,919	3,374	3,397
Available for sale securities	16,703	16,703	14,810	14,810
Held to maturity securities	5,805	5,896	6,563	6,628
FHLB stock	4,135	4,135	4,567	4,567
Loans held for sale	182	184	1,174	1,184
Loans in portfolio, net	241,569	240,597	235,575	235,917
Accrued interest receivable	2,057	2,057	1,834	1,834
Financial liabilities:				
Deposits	216,134	207,500	213,593	210,628
Accrued interest payable	871	871	834	834
FHLB advances	61,000	60,111	51,000	50,711
Repurchase agreements	13,000	12,924	13,400	13,256

NOTE 17 – RESTRICTIONS ON DIVIDENDS

Banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to Bancorp. The total amount of dividends that may be paid at any date is generally limited to the retained earnings of the Bank. However, dividends paid by the Bank would be prohibited, if the effect thereof would cause the Bank's capital to be reduced below applicable minimum standards. At December 31, 2006, the Bank's retained earnings available for the payment of dividends was $4,678,000. Accordingly, approximately $23,270,000 of Bancorp's investment in the Bank was restricted at December 31, 2006.

Loans or advances made by the Bank to Bancorp are generally limited to 10% of the Bank's capital stock and surplus and require the pledging of collateral.

(Dollar amounts in thousands, except per share data)

NOTE 18 - OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) components and related tax effects were as follows:

	2006	2005
Unrealized holding gains on available for sale securities	$ 522	$ (342)
Reclassification adjustment for losses (gains) realized in income	(327)	-
Net unrealized gains	195	(342)
Tax effect	(66)	116
	$ 129	$ (226)