# 2010 Annual Report

# Table of Contents

To Our Shareholders ........ 1
Five-Year Overview ........ 5
Regional Review ........ 7
Selected Financial Highlights ........ 13
Quarterly Financial Summary ........ 14
Report of Independent Registered Public Accounting Firm ........ 15
Consolidated Balance Sheets ........ 16
Consolidated Statements of Operations ........ 17
Consolidated Statements of Changes in Shareholders' Equity ........ 18
Consolidated Statements of Cash Flows ........ 19
Notes to Consolidated Financial Statements ........ 20
Selected Financial Data ........ 48
Summary Quarterly Financial Information ........ 50
Market Information ........ 51
Shareholder Return Performance Graph ........ 52
Forward-Looking Statements ........ 53
Management's Discussion and Analysis of Financial
Condition and Results of Operations ........ 54
Directors and Officers ........ 77

---

**BUSINESS OF THE CORPORATION**

Mackinac Financial Corporation is a registered bank holding company formed under the Bank Holding Company Act of 1956 with assets in excess of $475 million and whose common stock is traded on the NASDAQ stock market as "MFNC." The principal subsidiary of the Corporation is mBank. Headquartered in Manistique, Michigan, mBank has 11 branch locations; seven in the Upper Peninsula, three in the Northern Lower Peninsula and one in Oakland County, Michigan. The Company's banking services include commercial lending and treasury management products and services geared toward small to mid-sized businesses, as well as a full array of personal and business deposit products and consumer loans.

**FORM 10-K**

**A copy of the Annual Report to the Securities and Exchange Commission on Form 10-K is available without charge by writing the Shareholders' Relations Department, Mackinac Financial Corporation, 130 South Cedar Street, Manistique, Michigan, 49854**.

**MARKET SUMMARY**

The Corporation's common stock is traded on the Nasdaq Capital Market under the symbol MFNC. The Corporation had 1,216 shareholders of record as of March 30, 2011.

# To Our Shareholders

March 31, 2011

Dear Shareholders:

This letter will provide you with an update of the 2010 results of operations for Mackinac Financial Corporation ("MFNC"), the progress we are making in reducing nonperforming assets and the relative success we've had in other areas of the Corporation to build franchise value in this trying and difficult economic environment.

**Following are several areas that we believe improved franchise value during 2010 and are indicative of increased earnings potential for future periods:**

- We grew core bank deposits by $80 million. This reduced our reliance on wholesale deposits by $115.4 million, reducing balance sheet risk. We experienced core deposit growth in all of our markets, with $40 million in Northern Lower Michigan, $11 million in Southeast Michigan and $29 million in the Upper Peninsula. Most of our 2010 deposit growth occurred in low cost transactional accounts which grew by $44 million.

- We continued to experience good loan demand with approximately $114 million of new loan production, which included $37 million of mortgage loans sold in the secondary market. At 2010 year-end, the Corporation's loans stood at $383.086 million, a slight decrease from the 2009 year-end balances of $384.310 million. Our total outstanding loans declined by $1.2 million after reductions for loan sales, (both SBA/USDA and secondary market) amortization and payoffs, some associated with the elimination of problem assets. We continue to be highly successful in producing well priced high quality loans in the Upper Peninsula with 2010 loan production of $81 million. Loan production totaled $22 million in Northern Lower Michigan and $11 million in Southeast Michigan where the market have been hit the hardest by the recession.

- In 2010 we had continued success in the origination and sales of SBA/USDA loans with total fee income of $.9 million in 2010 compared to $.5 million in fee income during 2009. We continue to be a state leader in these programs.

- One of our initiatives for 2010 was the expansion of our consumer lending program by hiring several key mortgage loan producers and the centralization of our consumer lending processing. This was successful, with secondary market fee income of $.5 million in 2010 compared to $.3 million in 2009 and an increase in total consumer loan production from $39 million in 2009 to $60 million in 2010. We also have retained the servicing of approximately $27 million of mortgage loans which provides future refinancing opportunities and is a source of core deposits.

- We improved our net interest margin from 3.74% in the fourth quarter of 2009 to 3.88% in 2010's fourth quarter. Given our current funding structure, we expect to see this improve throughout 2011 as well.

- We had an overall reduction in nonperforming assets from $21.0 million at the end of 2009 to $16.1 million at the end of 2010. As noted above, the resolution of problem assets during 2010 impacted our earnings but we divested these problem loans and OREO properties so that we could eliminate holding costs and forego the opportunity cost that impacts longer-term shareholder value creation.

# To Our Shareholders

***2010 Earnings Recap***

In 2010, our operating results were disappointing, as we reported an after tax loss of $1.160 million, or $.34 per share. This loss occurred as a result of credit related charges that included a $6.500 million loan loss provision, $2.753 million in OREO charges and other related costs associated with problem assets such as legal services and OREO carrying costs.

**Earnings Analysis**

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Income before tax and preferred dividends, as reported: | $ (3,917) | $ 3,536 | $ 2,659 |
| **Credit related costs:** | | | |
| Loan loss provision | 6,500 | 3,700 | 2,300 |
| OREO write-downs/gains and losses | 2,753 | 208 | (80) |
| **Noncore income:** | | | |
| Security gains | 215 | 1,471 | 64 |
| Gain on sale of branch offices | - | 1,208 | - |
| "Adjusted" income before taxes and preferred dividends (Excluding items, noted above) | **$ 5,121** | **$ 4,765** | **$ 4,815** |

As you will note from the chart above, which is not a GAAP measure, the company's "core earnings" run rate outside of credit related charges and other one-time items has improved as the result of lowered funding costs from the significant growth in our core deposit base, control of non-interest expenses, and increases in non-interest income from our SBA/USDA lending programs

***Loan Growth/Production***

As stated previously we continue to experience good loan demand as demonstrated with approximately $114 million in new loan production during 2010, including $37 million of mortgage loans sold in the secondary market. Our loan balances actually declined slightly from year-end 2009 balances. The table below details the 2010 activity.

| | |
|---|---|
| Loan balances as of December 31, 2009 | $ 384,310 |
| Production, excluding secondary market mortgage loans | 77,093 |
| SBA loan sales | (12,571) |
| Loans transferred to OREO | (5,373) |
| Loans charged off, net of recoveries | (5,112) |
| Normal amortization/paydowns and payoffs | (55,261) |
| Loan balances as of December 31, 2010 | $ 383,086 |

Loan production, excluding secondary market mortgage loans of $37 million, in our three geographical regions is shown below.

| (dollars in thousands) | For the Year Ending December 31, | | |
|---|---|---|---|
| | **2010** | 2009 | 2008 |
| **REGION** | | | |
| Upper Peninsula | **$ 55,475** | $ 43,777 | $ 37,040 |
| Northern Lower Peninsula | **10,972** | 35,027 | 14,183 |
| Southeast Michigan | **10,646** | 9,318 | 10,374 |
| TOTAL | **$ 77,093** | $ 88,122 | $ 61,597 |

We have generated loan growth in all regions and we will continue to evaluate growth potential in markets where we can grow loans with good credit quality and acceptable loan pricing enhanced by fee income.

# To Our Shareholders

## *Government Guaranteed Lending Programs*

**SBA Loans Originated**
**For the Year Ended December 31,**

| | 2010 | | | 2009 | | | 2008 | | |
|---|---|---|---|---|---|---|---|---|---|
| | # Loans | SBA Amount | Premium | # Loans | SBA Amount | Premium | # Loans | SBA Amount | Premium |
| UP | 13 | $ 8,733 | $ 609 | 32 | $ 6,797 | $ 373 | 2 | $ 386 | $ 18 |
| NLP | 8 | 3,838 | 258 | 10 | 5,829 | 125 | 6 | 1,009 | 5 |
| SEM | - | - | - | - | - | - | 3 | 572 | 3 |
| Total | 21 | $ 12,571 | $ 867 | 42 | $ 12,626 | $ 498 | 11 | $ 1,967 | $ 26 |

The Corporation has made a concentrated effort to become a premier SBA/USDA lender throughout the State of Michigan and separate ourselves from our local competition in terms of the adjudication of these types of loans to minimize credit risk and increase noninterest income through the sale of the guaranteed portion of the loans for a premium. As you will note from the chart shown below, we have had success due to the strong competencies of our lenders and credit personnel. In addition to the level of SBA production generated, the Corporation recorded $.868 million in fees for 2010, for a total of $1.680 million over the last four years. The Corporation does not sell all the loan guarantees from every credit, only those where acceptable market rates are paid above par that warrant recognizing the income now, and where the Corporation feels that the reinvestment of the monies paid can be lent out again in sufficient time to exceed the lost interest income from the loan sold.

We are pleased with the progress we have made here; first in terms to the benefit of the Corporation, but also for the many local businesses in these markets that through these programs are provided the capital to grow their organization to help rebuild the economic base of the State.

## *Core Deposit Growth*

One of our primary objectives during 2010 was to decrease our reliance on wholesale funding.

Shown below is the mix of our deposits for the three most recent years.

**DEPOSIT MIX**

| | As of December 31, | | | | | | Percent Change | |
|---|---|---|---|---|---|---|---|---|
| | **2010** | **Mix** | 2009 | Mix | 2008 | Mix | **2010/2009** | 2009/2008 |
| **CORE DEPOSITS** | | | | | | | | |
| Transactional accounts: | | | | | | | | |
| Noninterest bearing | **$ 41,264** | **10.67 %** | $ 35,878 | 8.51 % | $ 30,099 | 8.11 % | **15.01 %** | 19.20 % |
| NOW, money market, checking | **134,703** | **34.83** | 95,790 | 22.73 | 70,584 | 19.02 | **40.62** | 35.71 |
| Savings | **17,670** | **4.57** | 18,207 | 4.32 | 20,730 | 5.59 | **(2.95)** | (12.17) |
| *Total transactional accounts* | **193,637** | **50.07** | 149,875 | 35.56 | 121,413 | 32.72 | **29.20** | 23.44 |
| Certificates of deposit <$100,000 | **96,977** | **25.07** | 59,953 | 14.23 | 73,752 | 19.87 | **61.76** | (18.71) |
| ***Total core deposits*** | **290,614** | **75.14** | 209,828 | 49.79 | 195,165 | 52.59 | **38.50** | 7.51 |
| **NONCORE DEPOSITS** | | | | | | | | |
| Certificates of deposit >$100,000 | **22,698** | **5.87** | 36,385 | 8.63 | 25,044 | 6.75 | **(37.62)** | 45.28 |
| Brokered CDs | **73,467** | **18.99** | 175,176 | 41.58 | 150,888 | 40.66 | **(58.06)** | 16.10 |
| ***Total noncore deposits*** | **96,165** | **24.86** | 211,561 | 50.21 | 175,932 | 47.41 | **(54.55)** | 20.25 |
| **TOTAL DEPOSITS** | **$ 386,779** | **100.00 %** | $ 421,389 | 100.00 % | $ 371,097 | 100.00 % | **(8.21) %** | 13.55 % |

As shown in the table above, core deposits grew by more than $80 million in 2010, 38.5%.

## *Noninterest Expense*

Controlling noninterest expense is a distinct challenge for a strategy based upon growth. We accept this challenge and recognize that certain operational costs will increase in future periods; however, we will continue to use a cost benefit analysis to evaluate any major initiatives. In 2010, our operating costs were negatively impacted by costs associated with nonperforming assets, which we expect to reduce in 2011. We have been successful in controlling most other areas of noninterest expense and will continue to focus on becoming more efficient.

# To Our Shareholders

***Capital/Shareholders' Equity***

At the end of 2010, the Corporation and the Bank had strong capital positions. The Corporation had a Tier 1 ratio of 9.25% and total risk based capital of 12.62%. The Bank's Tier 1 capital ratio stood at 8.09% with a total risk based capital ratio of 11.18%. Common equity of MFNC totaled $43.176 million with book value per share at $12.63. We believe that our franchise is undervalued with a year-end market value of $4.58 per share, which is 36% of book value.

***Building Franchise Value***

As mentioned earlier, with this letter are various charts and graphs which track the performance of the company through the last five years in terms of key shareholder metrics and operating performance levels. Over this period the Corporation has increased its common stock book value of stock from $7.75 per share at December 31, 2005 to $12.63 at 2010 year end, an increase of $4.88 per share, or 63%. During this five year period, we significantly increased total assets, loans, and core deposits which provides the foundation that will lead to future increases in common shareholders' equity. Following this letter is an overview which provides a snapshot of the three distinctively different regions of our franchise, (Upper Peninsula "UP", Northern Lower Peninsula, and Southeast Michigan).

***Looking Forward***

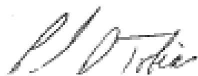
In 2011, we will again focus on increased franchise value with one of our key initiatives being the reduction in nonperforming assets. Another objective is to continue our core deposit growth momentum within all of our markets. We expect to have continued success in new loan production with increased fee contribution from both secondary market mortgage loans and SBA/USDA loan sales.

While nonperforming assets are currently below peer levels, we still face challenges in accomplishing our goal for further reduction given the current Michigan economy. Our 2011 Operating Plan calls for aggressive disposition of these nonearning assets in order to minimize carrying costs.

The Corporation is, and will remain dedicated to the primary strategic objective of enhancing franchise and shareholder value by building a strong banking franchise in our local markets and serving the communities that provide the business opportunities for the company to prosper.

We sincerely thank you for your continued support during these difficult times and we will work diligently and prudently to provide improved shareholder results in the years to come.

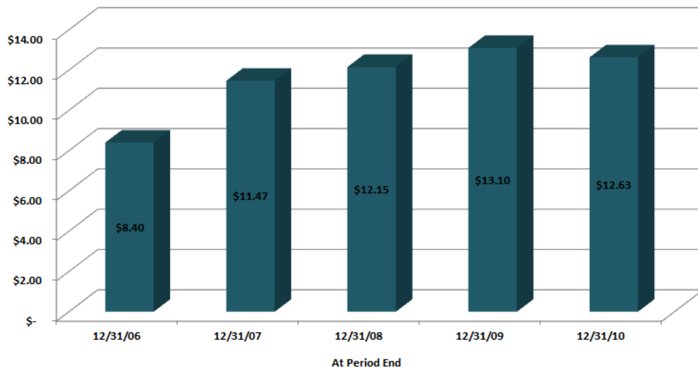
Sincerely,

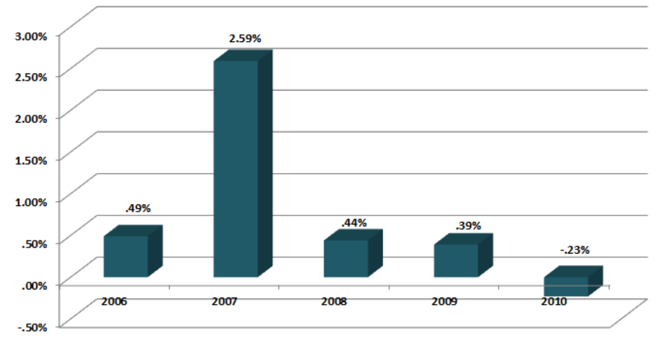


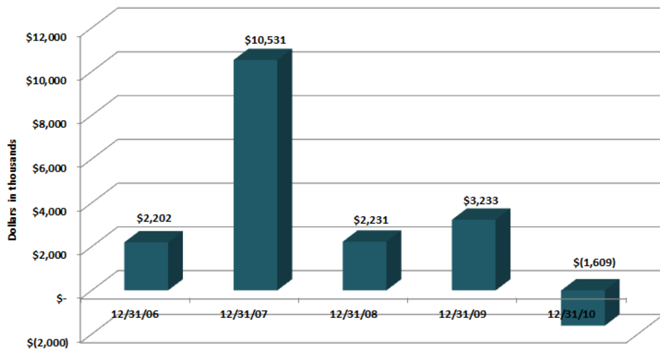
**Paul D. Tobias**
Chairman and CEO
Mackinac Financial Corporation

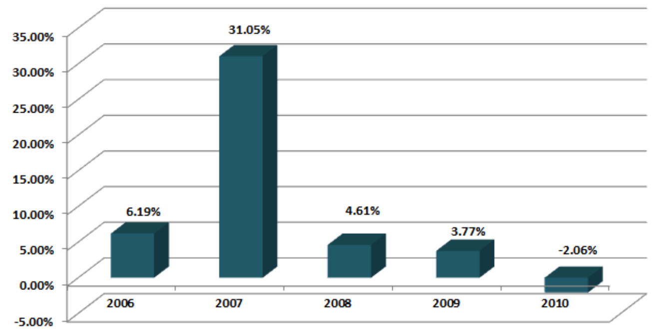
**Kelly W. George**
President and CEO
mBank

# Five Year Overview

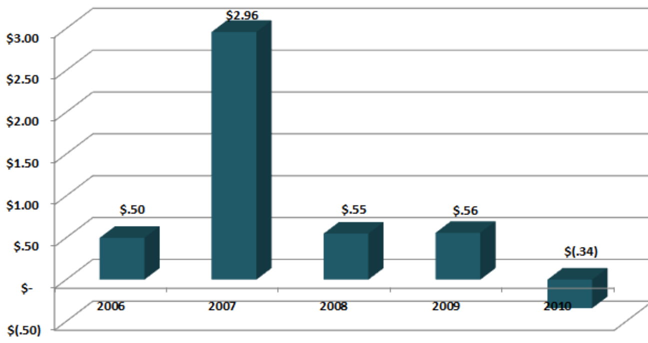


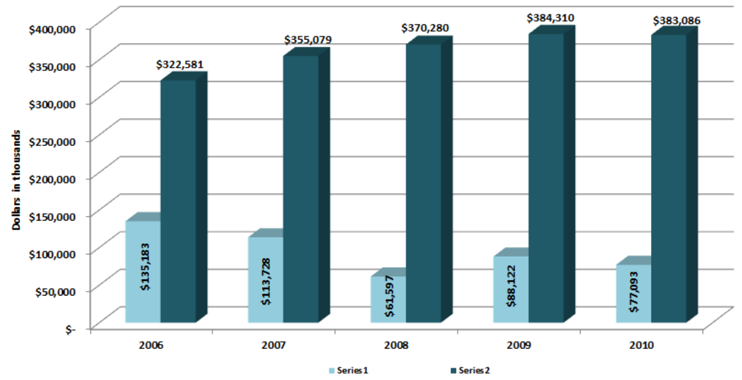



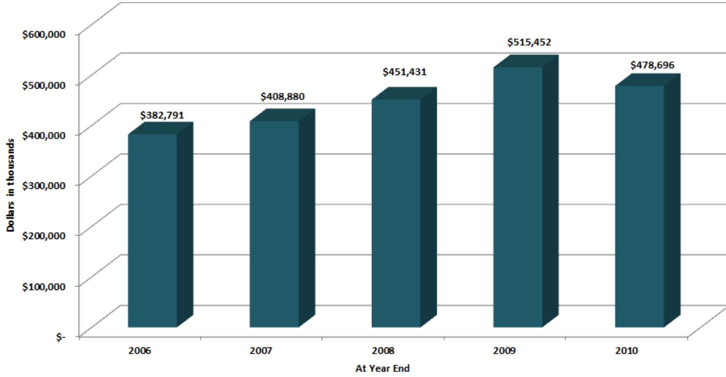



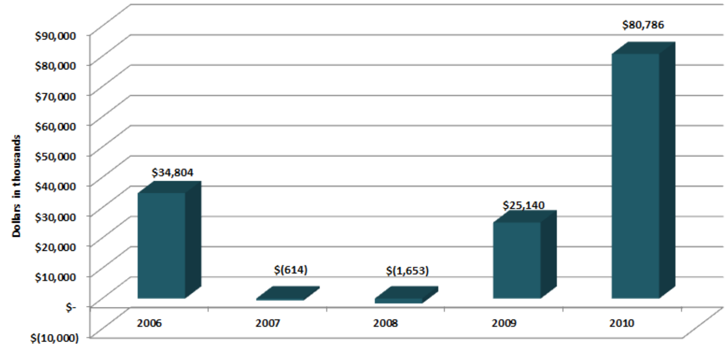



# Five Year Overview



# Regional Review – Upper Peninsula

***BRANCH LOCATIONS***

*ESCANABA*
*Located in Menards*
*3300 Ludington Street*
*Escanaba, MI 49829*
*(906) 233-9443*
*Manager: Debbie L. Peterson*

*MANISTIQUE*
*130 South Cedar Street*
*Manistique, MI 49854*
*(906) 341-2413*
*Manager: Magan L. MacArthur*

*MARQUETTE*
*300 North McClellan*
*Marquette, MI 49855*
*(906) 226-5000*
*Manager: Teresa M. Same*

*NEWBERRY*
*414 Newberry Avenue*
*Newberry, MI 49868*
*(906) 293-5165*
*Manager: Michael A. Slaght*

*SAULT STE. MARIE*
*138 Ridge Street*
*Sault Ste. Marie, MI 49783*
*(906) 635-3992*
*Manager: David R. Thomas*

*STEPHENSON*
*S216 Menominee Street*
*Stephenson, MI 49887*
*(906) 753-2225*
*Manager: Barbara A. Parrett*

*MANISTIQUE - LAKESHORE*
*Located in Jack's Supervalu*
*Manistique, MI 49854*
*(906) 341-7190*
*Manager: Magan L. MacArthur*

**BALANCE SHEET HIGHLIGHTS**

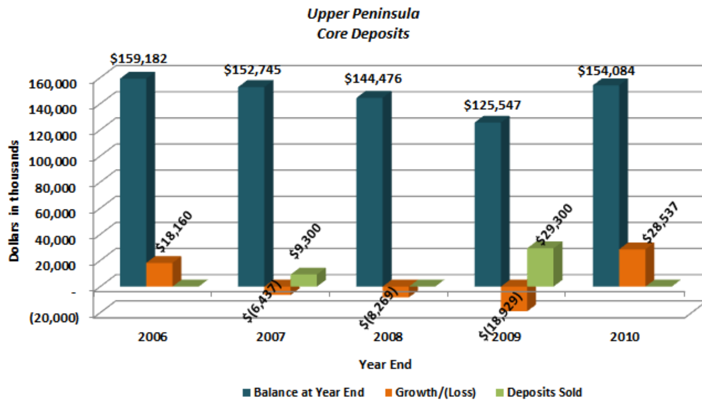
| *(dollars in thousands)* | At December 31, 2010 | | 2010 Activity | |
|---|---|---|---|---|
| | **Loans** | **Deposits** | **Loan Production** | **Core Deposit Growth** |
| Escanaba | $ 5,772 | $ 4,747 | $ 9,087 | $ 3,192 |
| Manistique | 64,131 | 34,024 | 19,222 | 2,334 |
| Marquette | 72,251 | 40,423 | 35,773 | 11,967 |
| Newberry | 15,441 | 35,368 | 3,929 | 123 |
| Sault Ste. Marie | 42,249 | 22,104 | 10,665 | 6,337 |
| Stephenson | 7,383 | 30,809 | 2,112 | 4,584 |
| TOTAL UPPER PENINSULA | $ 207,227 | $ 167,475 | $ 80,788 | $ 28,537 |

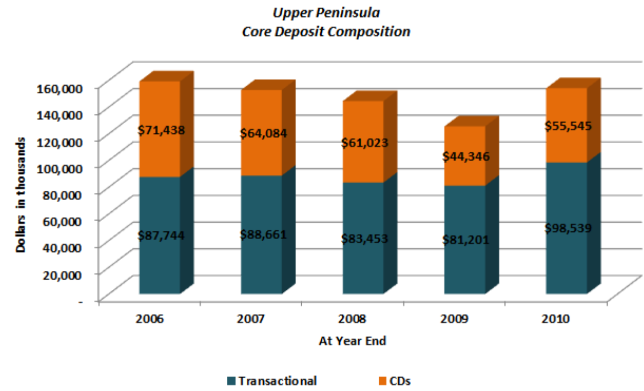
**** Includes production of mortgage loans sold on the secondary market.***

**CONTRIBUTION TO OTHER INCOME**

| *(dollars in thousands)* | Secondary Market | | SBA/USDA | |
|---|---|---|---|---|
| | **Production/Sold** | **Gains/Fee Income** | **Production/Sold** | **Gains/Fee Income** |
| Escanaba | $ 4,852 | $ 62 | $ 197 | $ 18 |
| Manistique | 1,717 | 30 | 5,278 | 310 |
| Marquette | 15,317 | 207 | 2,547 | 221 |
| Newberry | 1,323 | 26 | 582 | 47 |
| Sault Ste. Marie | 1,589 | 25 | 129 | 13 |
| Stephenson | 516 | 9 | - | - |
| TOTAL UPPER PENINSULA | $ 25,314 | $ 359 | $ 8,733 | $ 609 |

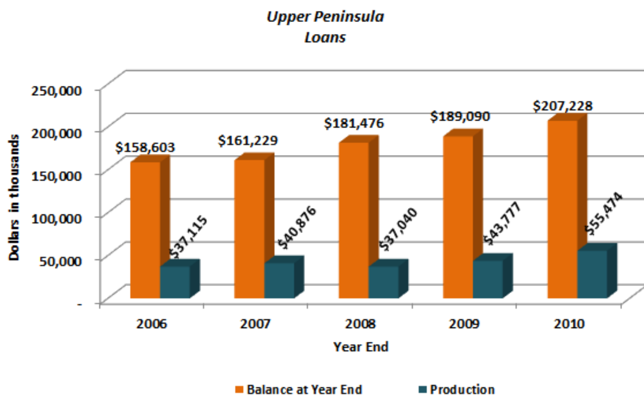
# Regional Review – Upper Peninsula

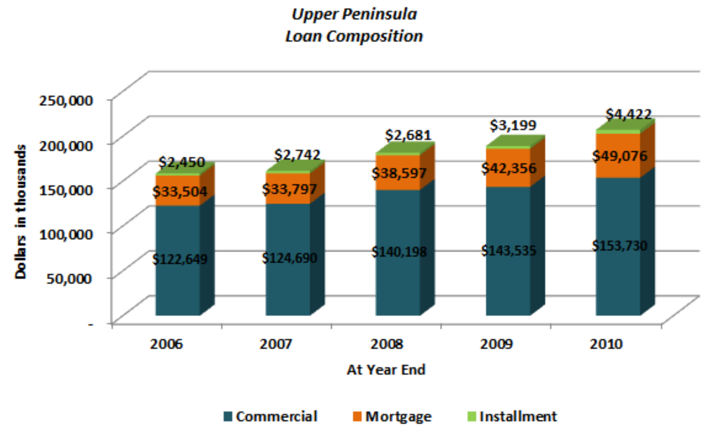



***Excluding the branch sales, which were predominantly transactional accounts, total deposits grew $44.8 million in the five year period, with transactional deposits comprising roughly $39.4 million of that growth.***

***Core deposits are defined as demand deposits, interest bearing checking accounts, money markets, savings and CDs less than $100,000.***




***Total loan production over the five year period amounted to $214.3 million.***

***Nonperforming assets in the Upper Peninsula totaled $3.504 million at the end of 2010, which included $.682 million of OREO and $2.822 million of nonperforming loans. Nonperforming loans as a percent of total loans was 1.36%.***

# Regional Review – Northern Lower Peninsula

***Andrew P. Sabatine, Regional President – NLP***

***BRANCH LOCATIONS***

*GAYLORD*
*1955 South Otsego Avenue*
*Gaylord, MI 49735*
*(989) 732-3750*
*Manager: Joni L. Freel*

*KALEVA*
*14429 Wuoksi Avenue*
*Kaleva, MI*
*(231)362-3223*
*Manager: Barb J. Miller*

*TRAVERSE CITY*
*3530 North Country Drive*
*Traverse City, MI 49684*
*(231) 929-5600*
*Manager: Andrea Pease*

**BALANCE SHEET HIGHLIGHTS**

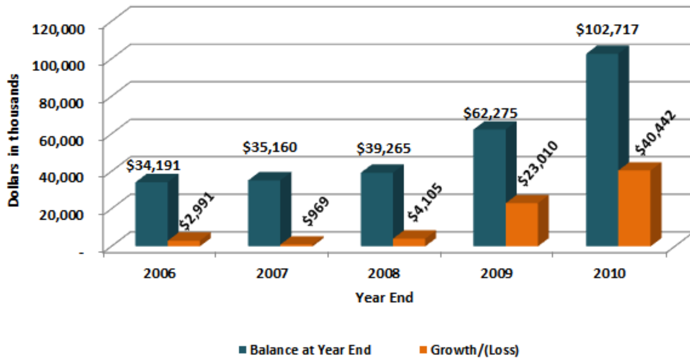
| *(dollars in thousands)* | At December 31, 2010 | | 2010 Activity | |
|---|---|---|---|---|
| | **Loans** | **Deposits** | **Loan Production*** | **Core Deposit Growth** |
| Gaylord | $ 38,428 | $ 43,391 | $ 12,770 | $ 13,387 |
| Kaleva | 498 | 14,137 | 466 | 3,180 |
| Traverse City | 49,280 | 51,545 | 9,100 | 23,875 |
| TOTAL NORTHERN LOWER PENINSULA | $ 88,206 | $ 109,073 | $ 22,336 | $ 40,442 |

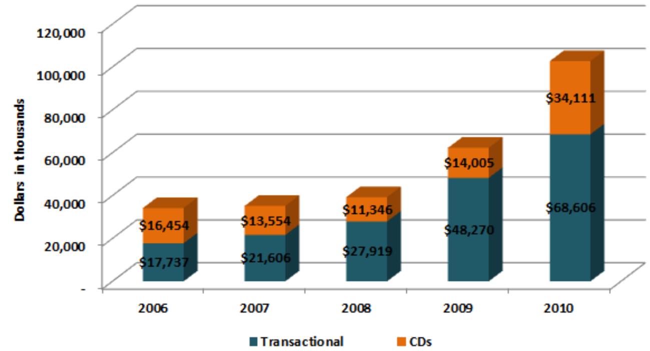
***** Includes production of mortgage loans sold on the secondary market.***

**CONTRIBUTION TO OTHER INCOME**

| *(dollars in thousands)* | Secondary Market | | SBA/USDA | |
|---|---|---|---|---|
| | **Production/Sold** | **Gains/Fee Income** | **Production/Sold** | **Gains/Fee Income** |
| Gaylord | $ 8,777 | $ 135 | $ 1,886 | $ 158 |
| Kaleva | 72 | 2 | - | - |
| Traverse City | 2,515 | 43 | 1,952 | 100 |
| TOTAL NORTHERN LOWER PENINSULA | $ 11,364 | $ 180 | $ 3,838 | $ 258 |

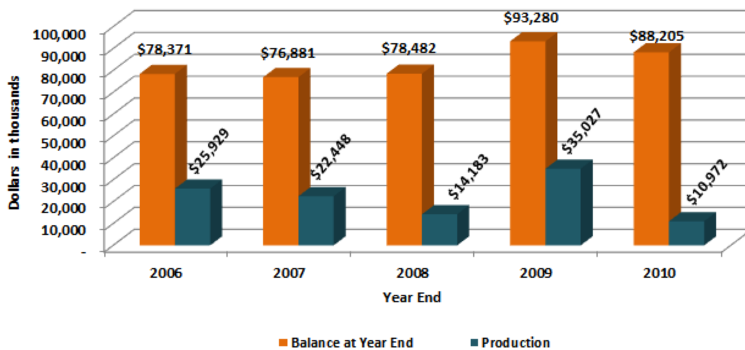
# Regional Review – Northern Lower Peninsula

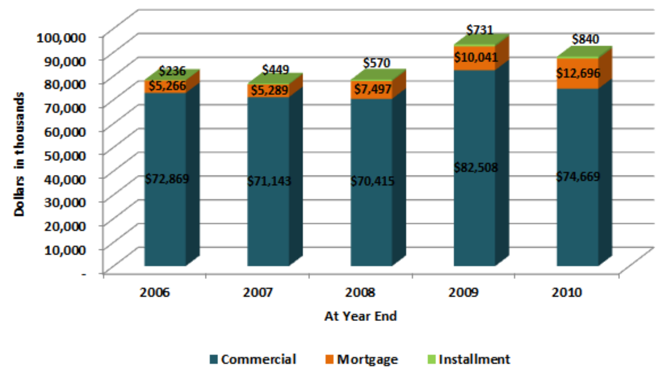



*Total deposit growth amounted to $71.5 million over the five year period, largely in transactional accounts.*

*Core deposits are defined as demand deposits, interest bearing checking accounts, money markets, savings and CDs less than $100,000.*




*Total loan production over the five year period amounted to $108.6 million.*

*Nonperforming assets in the Northern Lower Peninsula totaled $7.964 million at the end of 2010, which included $1.668 million of OREO and $6.296 million of nonperforming loans. Nonperforming loans as a percent of total loans was 7.14%*

# Regional Review – Southeast Michigan

***Jesse A. Deering, First VP/Southeast Michigan Executive***

***BRANCH LOCATION***

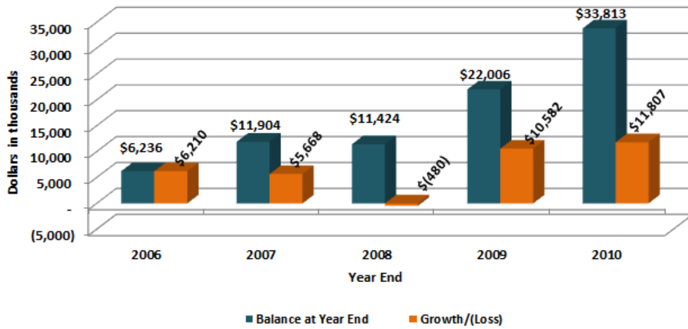
*BIRMINGHAM*
*260 East Brown Street, Suite 300*
*Birmingham, MI 48009*
*(248) 290-5900*
*Manager: Elena Dritsas*

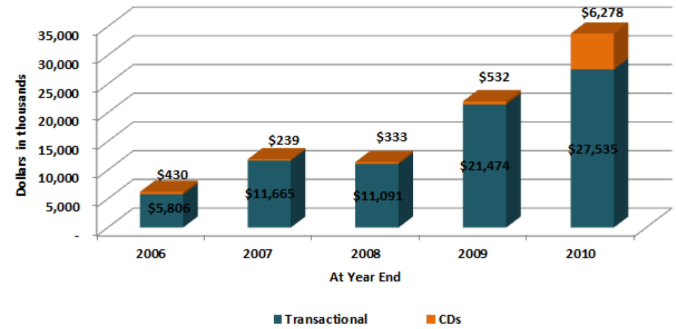
**BALANCE SHEET HIGHLIGHTS**

| | At December 31, 2010 | | 2010 Activity | |
|---|---|---|---|---|
| *(dollars in thousands)* | **Loans** | **Deposits** | **Loan Production** | **Core Deposit Growth** |
| Birmingham | $ 87,653 | $ 36,763 | $ 10,646 | $ 11,807 |

***Southeast Michigan had no contribution to other income for the year ended 2010 due in part to a lack of a secondary market mortgage loan producer and management's focus on overall credit issues in order to reduce levels of nonperforming assets.***

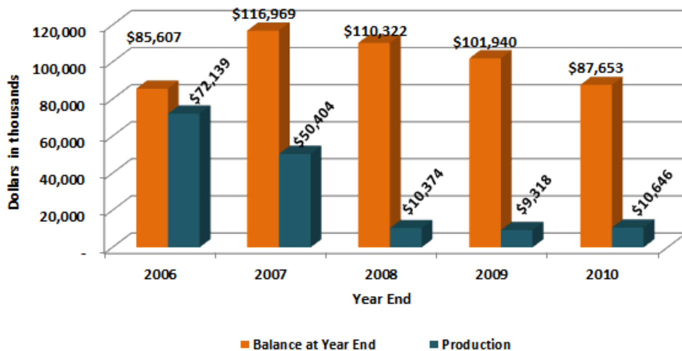
# Regional Review – Southeast Michigan

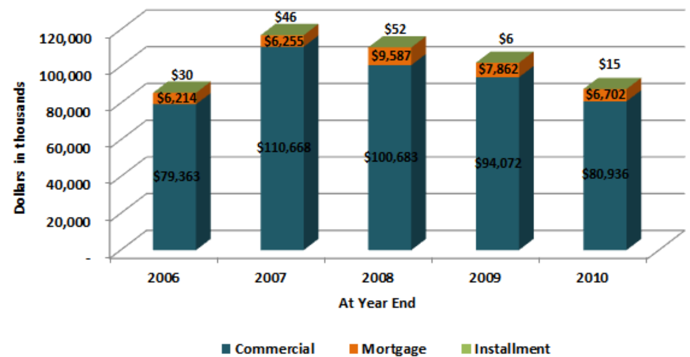



*Total deposit growth amounted to $33.8 million over the five year period, almost solely in transactional accounts.*

*Core deposits are defined as demand deposits, interest bearing checking accounts, money markets, savings and CDs less than $100,000.*




*Total loan production over the five year period amounted to $152.9 million.*

*Nonperforming assets in Southeast Michigan totaled $4.657 million at the end of 2010, which included $3.212 million of OREO and $1.445 million of nonperforming loans. Nonperforming loans as a percent of total loans was 1.65%.*

# Selected Financial Highlights

(Dollars in Thousands, Except Per Share Data)

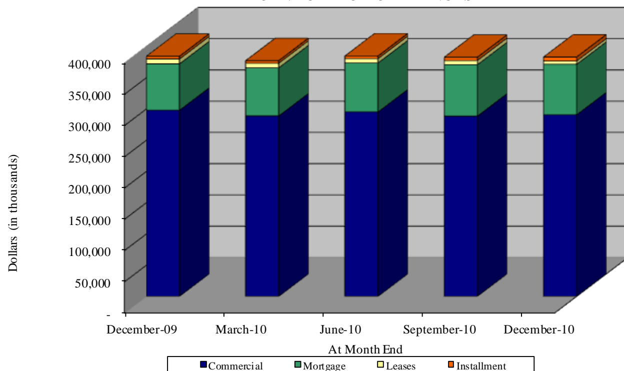
| (Dollars in thousands, except per share data) | For The Years Ended December 31, **2010** (Unaudited) | 2009 (Unaudited) |
|---|---|---|
| **Selected Financial Condition Data** ***(at end of period)*** **:** | | |
| Assets | **$ 478,696** | $ 515,377 |
| Loans | **383,086** | 384,310 |
| Investment securities | **33,860** | 46,513 |
| Deposits | **386,779** | 421,389 |
| Borrowings | **36,069** | 36,140 |
| Common shareholders' equity | **43,176** | 44,785 |
| Total shareholders' equity | **53,882** | 55,299 |
| **Selected Statements of Income Data:** | | |
| Net interest income | **$ 16,385** | $ 16,287 |
| Income before taxes and preferred dividend | **(3,918)** | 3,536 |
| Net income | **(1,160)** | 1,907 |
| Income per common share - Basic | **(.34)** | .56 |
| Income per common share - Diluted | **(.34)** | .56 |
| Weighted average shares outstanding | **3,419,736** | 3,419,736 |
| **Selected Financial Ratios and Other Data:** | | |
| ***Performance Ratios:*** | | |
| Net interest margin | **3.66 %** | 3.59 % |
| Efficiency ratio | **72.57** | 72.24 |
| Return on average assets | **(.23)** | .39 |
| Return on average common equity | **(2.64)** | 4.42 |
| Return on average total equity | **(2.06)** | 3.77 |
| Average total assets | **$ 502,993** | $ 493,652 |
| Average common shareholders' equity | **43,981** | 43,169 |
| Average total shareholders' equity | **56,171** | 50,531 |
| Average loans to average deposits ratio | **94.36 %** | 92.99 % |
| ***Common Share Data at end of period:*** | | |
| Market price per common share | **$ 4.58** | $ 4.64 |
| Book value per common share | **$ 12.63** | $ 13.10 |
| Common shares outstanding | **3,419,736** | 3,419,736 |
| ***Other Data at end of period:*** | | |
| Allowance for loan losses | **$ 6,613** | $ 5,225 |
| Non-performing assets | **$ 16,125** | $ 21,041 |
| Allowance for loan losses to total loans | **1.73 %** | 1.36 % |
| Non-performing assets to total assets | **3.37 %** | 4.08 % |
| Texas ratio | **26.66 %** | 34.77 % |
| Number of: | | |
| Branch locations | **11** | **10** |
| FTE Employees | **110** | **100** |

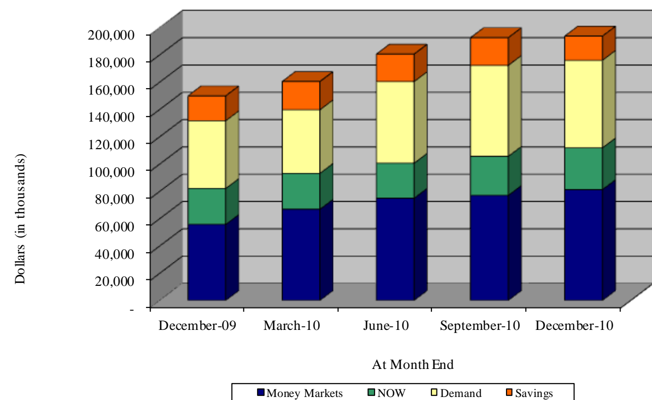
The above summary should be read in connection with the related consolidated financial statements and notes included elsewhere in this report.

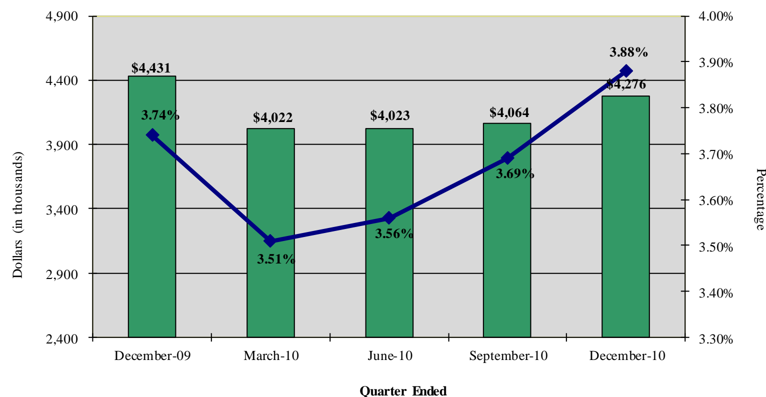
## MACKINAC FINANCIAL CORPORATION

(Unaudited)

| Quarter Ended | Average Assets | Average Loans | Average Deposits | Average Shareholders' Equity | Return on Average Assets | Return on Average Equity | Net Interest Margin | Efficiency Ratio | Net Income Per Share | Book Value Per Share |
|---|---|---|---|---|---|---|---|---|---|---|
| **December 31, 2010** | **$ 488,320** | **$ 385,296** | **$ 393,266** | **$ 55,015** | **(1.70) %** | **(15.09) %** | **3.88 %** | **65.05 %** | **$ (.61)** | **$ 12.63** |
| **September 30, 2010** | **512,335** | **385,268** | **416,847** | **56,668** | **(.08)** | **(.73)** | **3.69** | **75.98** | **(.03)** | **13.26** |
| **June 30, 2010** | **502,942** | **382,169** | **405,449** | **57,889** | **(1.98)** | **(17.24)** | **3.56** | **76.04** | **(.73)** | **13.34** |
| **March 31, 2010** | **508,495** | **384,640** | **413,897** | **55,109** | **2.81** | **25.95** | **3.51** | **78.12** | **1.03** | **14.08** |
| December 31, 2009 | 514,102 | 386,203 | 418,280 | 55,665 | (.14) | (1.28) | 3.74 | 71.03 | (.05) | 13.10 |
| September 30, 2009 | 513,687 | 370,310 | 419,102 | 54,594 | 1.19 | 11.16 | 3.66 | 70.09 | .45 | 13.25 |
| June 30, 2009 | 491,205 | 371,609 | 401,510 | 49,855 | 0.38 | 3.71 | 3.58 | 76.55 | .13 | 12.73 |
| March 31, 2009 | 454,740 | 370,943 | 372,669 | 41,813 | .08 | 0.87 | 3.35 | 82.36 | .03 | 12.24 |
| December 31, 2008 | 441,583 | 366,077 | 358,213 | 41,516 | (.23) | (2.42) | 3.20 | 80.30 | (.07) | 12.15 |



# Report of Independent Registered Public Accounting Firm

Plante & Moran, PLLC
Suite 400
634 Front Avenue N.W.
Grand Rapids, MI 49504
Tel: 616.774.8221
Fax: 616.774.0702
plantemoran.com

Report of Independent Registered Public Accounting Firm

Board of Directors
Mackinac Financial Corporation, Inc.

We have audited the consolidated statement of financial condition of Mackinac Financial Corporation, Inc. as of December 31, 2010 and 2009 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each year in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mackinac Financial Corporation, Inc. as of December 31, 2010 and 2009 and the consolidated results of their operations and their cash flows for each year in the three-year period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

Grand Rapids, Michigan
March 30, 2011

Plante & Moran, PLLC

# Consolidated Balance Sheets

**MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES**
**December 31, 2010 and 2009**
(Dollars in Thousands)

| | **December 31, 2010** | December 31, 2009 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 22,719** | $ 18,433 |
| Federal funds sold | **12,000** | 27,000 |
| Cash and cash equivalents | **34,719** | 45,433 |
| Interest-bearing deposits in other financial institutions | **713** | 678 |
| Securities available for sale | **33,860** | 46,513 |
| Federal Home Loan Bank stock | **3,423** | 3,794 |
| Loans: | | |
| Commercial | **297,047** | 305,670 |
| Mortgage | **80,756** | 74,350 |
| Installment | **5,283** | 4,290 |
| Total Loans | **383,086** | 384,310 |
| Allowance for loan losses | **(6,613)** | (5,225) |
| Net loans | **376,473** | 379,085 |
| Premises and equipment | **9,660** | 10,165 |
| Other real estate held for sale | **5,562** | 5,804 |
| Other assets | **14,286** | 23,905 |
| **TOTAL ASSETS** | **$ 478,696** | $ 515,377 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Liabilities: | | |
| Non-interest-bearing deposits | **$ 41,264** | $ 35,878 |
| Interest-bearing deposits: | | |
| NOW, Money Market, Checking | **134,703** | 95,790 |
| Savings | **17,670** | 18,207 |
| CDs<$100,000 | **96,977** | 59,953 |
| CDs>$100,000 | **22,698** | 36,385 |
| Brokered | **73,467** | 175,176 |
| Total deposits | **386,779** | 421,389 |
| Borrowings: | | |
| Federal Home Loan Bank | **35,000** | 35,000 |
| Other | **1,069** | 1,140 |
| Total borrowings | **36,069** | 36,140 |
| Other liabilities | **1,966** | 2,549 |
| Total liabilities | **424,814** | 460,078 |
| Shareholders' equity: | | |
| Preferred stock - No par value: | | |
| Authorized 500,000 shares, 11,000 shares issued and outstanding | **10,706** | 10,514 |
| Common stock and additional paid in capital - No par value | | |
| Authorized - 18,000,000 shares | | |
| Issued and outstanding - **3,419,736 shares** | **43,525** | 43,493 |
| Retained earnings (accumulated deficit) | **(961)** | 199 |
| Accumulated other comprehensive income | **612** | 1,093 |
| Total shareholders' equity | **53,882** | 55,299 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 478,696** | $ 515,377 |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Operations

**MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES**
**Years Ended December 31, 2010, 2009, and 2008**
(Dollars in Thousands, Except Per Share Data)

| | For The Years Ended December 31, | | |
|---|---|---|---|
| | **2010** | 2009 | 2008 |
| **INTEREST INCOME:** | | | |
| Interest and fees on loans: | | | |
| Taxable | **$ 21,091** | $ 20,521 | $ 22,555 |
| Tax-exempt | **188** | 292 | 404 |
| Interest on securities: | | | |
| Taxable | **1,406** | 2,783 | 1,293 |
| Tax-exempt | **28** | 19 | 5 |
| Other interest income | **127** | 93 | 305 |
| Total interest income | **22,840** | 23,708 | 24,562 |
| **INTEREST EXPENSE:** | | | |
| Deposits | **5,607** | 6,431 | 10,115 |
| Borrowings | **848** | 990 | 1,583 |
| Total interest expense | **6,455** | 7,421 | 11,698 |
| Net interest income | **16,385** | 16,287 | 12,864 |
| Provision for loan losses | **6,500** | 3,700 | 2,300 |
| Net interest income after provision for loan losses | **9,885** | 12,587 | 10,564 |
| **OTHER INCOME:** | | | |
| Service fees | **990** | 1,023 | 838 |
| Net security gains | **215** | 1,471 | 64 |
| Income from loans sold | **1,407** | 830 | 120 |
| Proceeds from settlement of lawsuits | **-** | - | 3,475 |
| Gain on sales of branch offices | **-** | 1,208 | - |
| Other | **183** | 219 | 156 |
| Total other income | **2,795** | 4,751 | 4,653 |
| **OTHER EXPENSES:** | | | |
| Salaries and employee benefits | **6,918** | 6,583 | 6,886 |
| Occupancy | **1,313** | 1,385 | 1,374 |
| Furniture and equipment | **806** | 805 | 771 |
| Data processing | **740** | 862 | 844 |
| Professional service fees | **627** | 603 | 508 |
| Loan and deposit | **910** | 725 | 488 |
| ORE writedowns and (gains) losses on sale | **2,753** | 208 | (80) |
| FDIC insurance premiums | **957** | 839 | 81 |
| Other | **1,574** | 1,792 | 1,686 |
| Total other expenses | **16,598** | 13,802 | 12,558 |
| Income before provision for (benefit of) income taxes | **(3,918)** | 3,536 | 2,659 |
| Provision for (benefit of) income taxes | **(3,500)** | 1,120 | 787 |
| **NET INCOME (LOSS)** | **$ (418)** | $ 2,416 | $ 1,872 |
| **Preferred dividend and accretion of discount** | **742** | 509 | - |
| **NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS** | **$ (1,160)** | $ 1,907 | $ 1,872 |
| **INCOME (LOSS) PER COMMON SHARE** | | | |
| Basic | **$ (.34)** | $ .56 | $ .55 |
| Diluted | **$ (.34)** | $ .56 | $ .55 |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Changes in Shareholders' Equity

**MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES**
**Years Ended December 31, 2010, 2009, and 2008**
(Dollars in Thousands)

| | Shares of Common Stock | Preferred Stock Series A | Common Stock and Additional Paid in Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income | Total |
|---|---|---|---|---|---|---|
| **Balance, January 1, 2008** | **3,428,695** | $ - | **$ 42,843** | **$ (3,582)** | **$ 60** | **$ 39,321** |
| Purchase of oddlot shares | (8,959) | - | (110) | - | - | (110) |
| Net income | - | - | - | 1,872 | - | 1,872 |
| Other comprehensive income: | | | | | | |
| Net unrealized loss on securities available for sale | - | - | - | - | 385 | 385 |
| Other | - | - | - | 2 | - | 2 |
| Total comprehensive income | | | | | | 2,259 |
| Stock option compensation | - | - | 82 | - | - | 82 |
| **Balance, December 31, 2008** | **3,419,736** | **-** | **42,815** | **(1,708)** | **445** | **41,552** |
| Net income | - | | - | 2,416 | - | 2,416 |
| Other comprehensive income: | | | | | | |
| Net unrealized income on securities available for sale | - | - | - | - | 648 | 648 |
| Total comprehensive income | | | | | | 3,064 |
| Stock option compensation | - | - | 60 | - | - | 60 |
| Dividend on preferred stock | - | - | - | (377) | - | (377) |
| Issuance of preferred stock, 11,000 shares | - | 10,382 | - | - | - | 10,382 |
| Issuance of common stock warrants | - | - | 618 | - | - | 618 |
| Accretion of preferred stock discount | - | 132 | - | (132) | - | - |
| **Balance, December 31, 2009** | **3,419,736** | **10,514** | **43,493** | **199** | **1,093** | **55,299** |
| Net income (loss) | - | - | - | (418) | - | (418) |
| Other comprehensive income: | | | | | | |
| Net unrealized income on securities available for sale | - | - | - | - | (481) | (481) |
| Total comprehensive income (loss) | | | | | | (899) |
| Stock option compensation | - | - | 32 | - | | 32 |
| Dividend on preferred stock | - | - | - | (550) | - | (550) |
| Accretion of preferred stock discount | - | 192 | - | (192) | - | - |
| **Balance, December 31, 2010** | **3,419,736** | **$ 10,706** | **$ 43,525** | **$ (961)** | **$ 612** | **$ 53,882** |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Cash Flows

**MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES**
**Years Ended December 31, 2010, 2009, and 2008**
(Dollars in Thousands)

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net income (loss) | **$ (418)** | $ 2,416 | $ 1,872 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | **1,643** | 2,027 | 1,355 |
| Provision for loan losses | **6,500** | 3,700 | 2,300 |
| Provision for (benefit of) income taxes | **(3,500)** | 1,120 | 787 |
| (Gain) loss on sales/calls of securities available for sale | **(215)** | (1,471) | (64) |
| (Gain) loss on sale of secondary market loans | **(445)** | (224) | (107) |
| Origination of secondary market loans held for sale | **(36,678)** | (21,722) | (9,985) |
| Proceeds from secondary market loans held for sale | **37,217** | 22,039 | 10,126 |
| (Gain) on sales of branch offices | **-** | (1,208) | - |
| (Gain) loss on sale of premises, equipment, and other real estate | **48** | 23 | (77) |
| Writedown of other real estate | **2,703** | 187 | 964 |
| Stock option compensation | **32** | 60 | 82 |
| Change in other assets | **13,174** | (15,626) | 333 |
| Change in other liabilities | **(583)** | (22) | (210) |
| Net cash (used in) provided by operating activities | **19,478** | (8,701) | 7,376 |
| **Cash Flows from Investing Activities:** | | | |
| Net (increase) in loans | **(9,355)** | (21,218) | (21,173) |
| Net (increase) decrease in interest-bearing deposits in other financial institutions | **(35)** | (96) | 1,228 |
| Purchase of securities available for sale | **(5,000)** | (50,113) | (50,813) |
| Proceeds from maturities, sales, calls or paydowns of securities available for sale | **16,788** | 52,742 | 25,373 |
| Capital expenditures | **(606)** | (679) | (618) |
| Proceeds from sale of premises, equipment, and other real estate | **2,876** | 581 | 1,956 |
| Redemption of FHLB stock | **371** | - | - |
| Net cash paid in connection with branch sales | **-** | (28,578) | - |
| Net cash provided by (used in) investing activities | **5,039** | (47,361) | (44,047) |
| **Cash Flows from Financing Activities:** | | | |
| Net increase (decrease) in deposits | **(34,610)** | 80,760 | 50,270 |
| Issuance of Series A Preferred Stock and common stock warrants | **-** | 11,000 | - |
| Dividend on preferred stock | **(550)** | (307) | - |
| Net (decrease) in federal funds purchased | **-** | - | (7,710) |
| Net (decrease) in lines of credit | **-** | - | (1,959) |
| Repurchase of common stock-oddlot shares | **-** | - | (110) |
| Principal payments on borrowings | **(71)** | (70) | (70) |
| Net cash provided by (used in) financing activities | **(35,231)** | 91,383 | 40,421 |
| Net increase (decrease) in cash and cash equivalents | **(10,714)** | 35,321 | 3,750 |
| Cash and cash equivalents at beginning of period | **45,433** | 10,112 | 6,362 |
| Cash and cash equivalents at end of period | **$ 34,719** | $ 45,433 | $ 10,112 |
| **Supplemental Cash Flow Information:** | | | |
| Cash paid during the year for: | | | |
| Interest | **$ 6,548** | $ 7,584 | $ 11,961 |
| Income taxes | **75** | 90 | 70 |
| **Noncash Investing and Financing Activities:** | | | |
| Transfers of Foreclosures from Loans to Other Real Estate Held for Sale (net of adjustments made through the allowance for loan losses) | **5,373** | 4,879 | 2,849 |
| **Assets and Liabilities Divested in Branch Sales:** | | | |
| Loans | **-** | 31 | - |
| Premises and equipment | **-** | 651 | - |
| Deposits | **-** | 29,260 | - |

See accompanying notes to consolidated financial statements.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of Mackinac Financial Corporation (the "Corporation") and Subsidiaries conform to accounting principles generally accepted in the United States and prevailing practices within the banking industry. Significant accounting policies are summarized below.

### ***Principles of Consolidation***

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, mBank (the "Bank") and other minor subsidiaries, after elimination of intercompany transactions and accounts.

### ***Nature of Operations***

The Corporation's and the Bank's revenues and assets are derived primarily from banking activities. The Bank's primary market area is the Upper Peninsula, the northern portion of the Lower Peninsula of Michigan, and Oakland County in Lower Michigan. The Bank provides to its customers commercial, real estate, agricultural, and consumer loans, as well as a variety of traditional deposit products. A portion, approximately 2.1%, of the Bank's commercial loan portfolio consists of leases to commercial and governmental entities, which are secured by various types of equipment. These leases are dispersed geographically throughout the country. Less than 1.0% of the Corporation's business activity is with Canadian customers and denominated in Canadian dollars.

While the Corporation's chief decision makers monitor the revenue streams of the various Corporation products and services, operations are managed and financial performance is evaluated on a Corporation-wide basis. Accordingly, all of the Corporation's banking operations are considered by management to be aggregated in one reportable operating segment.

### ***Use of Estimates in Preparation of Financial Statements***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of investment securities, the valuation of foreclosed real estate, deferred tax assets, and impairment of intangible assets.

### ***Cash and Cash Equivalents***

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing deposits in correspondent banks, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

### ***Securities***

The Corporation's securities are classified and accounted for as securities available for sale. These securities are stated at fair value. Premiums and discounts are recognized in interest income using the interest method over the period to maturity. Unrealized holding gains and losses on securities available for sale are reported as accumulated other comprehensive income within shareholders' equity until realized. When it is determined that securities or other investments are impaired and the impairment is other than temporary, an impairment loss is recognized in earnings and a new basis in the affected security is established. Gains and losses on the sale of securities are recorded on the trade date and determined using the specific-identification method.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

***Federal Home Loan Bank Stock***

As a member of the Federal Home Loan Bank (FHLB) system, the Bank is required to hold stock in the FHLB based on the anticipated level of borrowings to be advanced. This stock is recorded at cost, which approximates fair value. Transfer of the stock is substantially restricted.

***Interest Income and Fees on Loans***

Interest income on loans is reported on the level-yield method and includes amortization of deferred loan fees and costs over the loan term. Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period. The accrual of interest on loans is discontinued when, in the opinion of management, it is probable that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Interest income on impaired and nonaccrual loans is recorded on a cash basis.

***Allowance for Loan Losses***

The allowance for loan losses includes specific allowances related to commercial loans, when they have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan's initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The Corporation continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for possible loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation's past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management's opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

***Other Real Estate Held for Sale***

Other real estate held for sale consists of assets acquired through, or in lieu of, foreclosure and other long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Other real estate held for sale is initially recorded at the lower of cost or fair value, less costs to sell, establishing a new cost basis. Valuations are periodically performed by management, and the assets' carrying values are adjusted to the lower of cost basis or fair value less costs to sell. Impairment losses are recognized for any initial or subsequent write-downs. Net revenue and expenses from operations of other real estate held for sale are included in other expense.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

***Premises and Equipment***

Premises and equipment are stated at cost less accumulated depreciation. Maintenance and repair costs are charged to expense as incurred. Gains or losses on disposition of premises and equipment are reflected in income. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

***Stock Option Plans***

The Corporation sponsors three stock option plans. One plan was approved during 2000 and applies to officers, employees, and nonemployee directors. This plan was amended as a part of the December 2004 stock offering and recapitalization. The amendment, approved by shareholders, increased the shares available under this plan by 428,587 shares from the original 25,000 (adjusted for the 1:20 reverse stock split), to a total authorized share balance of 453,587. The other two plans, one for officers and employees and the other for nonemployee directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 split), were made available for grant under these plans. Options under all of the plans are granted at the discretion of a committee of the Corporation's Board of Directors. Options to purchase shares of the Corporation's stock were granted at a price equal to the market price of the stock at the date of grant. The committee determined the vesting of the options when they were granted as established under the plan. All of the option plans have expired.

***Comprehensive Income (Loss)***

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) is composed of unrealized gains and losses on securities available for sale, net of tax.

***Earnings per Common Share***

Earnings per share are based upon the weighted average number of shares outstanding. The issuance of shares as a result of stock options and common stock warrants issued under the TARP Capital Purchase Program did not have a dilutive effect on earnings for the year ended December 31, 2010 and 2009.

The following shows the computation of basic and diluted earnings per share for the year ended December 31, 2010 and 2009 (dollars in thousands, except per share data):

| | Year Ended December 31, | |
|---|---|---|
| | **2010** | 2009 |
| Net income (loss) | **$ (418)** | $ 2,416 |
| Preferred stock dividends | **742** | 509 |
| Net income (loss) available to common shareholders | **$ (1,160)** | $ 1,907 |
| Weighted average shares outstanding | **3,419,736** | 3,419,736 |
| Effect of dilutive stock options and common stock warrants outstanding | **60,161** | - |
| Diluted weighted average shares outstanding | **3,479,897** | 3,419,736 |
| Income (loss) per common share: | | |
| Basic | **$ (.34)** | $ .56 |
| Diluted | **$ (.34)** | $ .56 |

The effect of dilutive common stock warrants is not taken into account when calculating the loss per share in 2010, since it would be anti-dilutive.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### *Income Taxes*

Deferred income taxes have been provided under the liability method. Deferred tax assets and liabilities are determined based upon the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences are expected to reverse. Deferred tax expense (credit) is the result of changes in the deferred tax asset and liability. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred asset will not be realized.

### *Off-Balance-Sheet Financial Instruments*

In the ordinary course of business, the Corporation has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. For letters of credit, the Corporation recognizes a liability for the fair market value of the obligations it assumes under that guarantee.

### *Recent Developments*

In January 2010, the FASB issued ASU No. 2010-06 "Fair Value Measurements and Disclosures (Topic 820) — Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends the fair value disclosure guidance. The amendments include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on the Company's disclosures is reflected in Note 18 of the consolidated financial statements.

In July 2010, FASB issued ASU No. 2010-20 "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses". The standard requires the Company to expand disclosures about the credit quality of our loans and the related reserves against them. The additional disclosures will include details on our past due loans and credit quality indicators. For public entities, ASU 2010-20 disclosures of period-end balances are effective for interim and annual reporting periods ending on or after December 15, 2010 and are included in Note 4 of the financial statements. Disclosures related to activity that occurs during the reporting period are required for interim and annual reporting periods beginning on or after December 15, 2010. The Company will adopt the disclosures related to the activity that occurs during the reporting period beginning with our March 31, 2011 consolidated financial statements.

### *Reclassifications*

Certain amounts in the 2009 and 2008 consolidated financial statements have been reclassified to conform to the 2010 presentation.

## NOTE 2 – RESTRICTIONS ON CASH AND CASH EQUIVALENTS

Cash and cash equivalents in the amount of $2.275 million were restricted on December 31, 2010 to meet the reserve requirements of the Federal Reserve System.

In the normal course of business, the Corporation maintains cash and due from bank balances with correspondent banks. Balances in these accounts may exceed the Federal Deposit Insurance Corporation's insured limit of $250,000.

Management believes that these financial institutions have strong credit ratings and the credit risk related to these deposits is minimal.

## NOTE 3 – SECURITIES AVAILABLE FOR SALE

The carrying value and estimated fair value of securities available for sale are as follows (dollars in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| ***December 31, 2010*** | | | | |
| **US Agencies - MBS** | **$ 26,787** | **$ 923** | **$ -** | **$ 27,710** |
| **US Agencies** | **5,000** | **-** | **(27)** | **4,973** |
| **Obligations of states and political subdivisions** | **1,146** | **35** | **(4)** | **1,177** |
| **Total securities available for sale** | **$ 32,933** | **$ 958** | **$ (31)** | **$ 33,860** |
| *December 31, 2009* | | | | |
| US Agencies - MBS | $ 43,651 | $ 1,642 | $ (55) | $ 45,238 |
| Obligations of states and political subdivisions | 1,207 | 68 | - | 1,275 |
| Total securities available for sale | $ 44,858 | $ 1,710 | $ (55) | $ 46,513 |

Following is information pertaining to securities with gross unrealized losses at December 31, 2010 and 2009 aggregated by investment category and length of time these individual securities have been in a loss position (dollars in thousands):

| | Less Than Twelve Months | | Over Twelve Months | |
|---|---|---|---|---|
| | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |
| ***December 31, 2010*** | | | | |
| **US Agencies - MBS** | **$ (27)** | **$ 4,973** | **$ -** | **$ -** |
| **Obligations of states and political subdivisions** | **(4)** | **325** | **-** | **-** |
| **Total securities available for sale** | **$ (31)** | **$ 5,298** | **$ -** | **$ -** |
| *December 31, 2009* | | | | |
| US Agencies - MBS | $ (55) | $ 3,309 | $ - | $ - |
| Total securities available for sale | $ (55) | $ 3,309 | $ - | $ - |

There were two securities in an unrealized loss position in 2010 and two in 2009. The gross unrealized losses in the current portfolio are considered temporary in nature and related to interest rate fluctuations. The Corporation has both the ability and intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

Following is a summary of the proceeds from sales and calls of securities available for sale, as well as gross gains and losses for the years ended December 31 (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Proceeds from sales and calls | **$ 8,302** | $ 44,611 | $ 12,047 |
| Gross gains on sales | **216** | 1,472 | 65 |
| Gross (losses) on sales and calls | **(1)** | (1) | (1) |

## NOTE 3 – SECURITIES AVAILABLE FOR SALE (CONTINUED)

The carrying value and estimated fair value of securities available for sale at December 31, 2010, by contractual maturity, are shown below (dollars in thousands):

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Due in one year or less | $ 6 | $ 6 |
| Due after one year through five years | 5,634 | 5,617 |
| Due after five years through ten years | 506 | 527 |
| Due after ten years | - | - |
| Subtotal | 6,146 | 6,150 |
| US Agencies - MBS | 26,787 | 27,710 |
| Total | $ 32,933 | $ 33,860 |

Contractual maturities may differ from expected maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. See Note 8 for information on securities pledged to secure borrowings from the Federal Home Loan Bank.

## NOTE 4 - LOANS

The composition of loans at December 31 is as follows (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Commercial real estate | **$ 194,859** | $ 208,895 |
| Commercial, financial, and agricultural | **68,858** | 72,184 |
| One to four family residential real estate | **75,074** | 67,232 |
| Construction : | | |
| Consumer | **5,682** | 7,118 |
| Commerical | **33,330** | 24,591 |
| Consumer | **5,283** | 4,290 |
| Total loans | **$ 383,086** | $ 384,310 |

An analysis of the allowance for loan losses for the years ended December 31 is as follows (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Balance, January 1 | **$ 5,225** | $ 4,277 | $ 4,146 |
| Recoveries on loans previously charged off | **374** | 66 | 121 |
| Loans charged off | **(5,486)** | (2,818) | (2,290) |
| Provision | **6,500** | 3,700 | 2,300 |
| Balance, December 31 | **$ 6,613** | $ 5,225 | $ 4,277 |

In 2010, net charge off activity was $5.112 million, or 1.33% of average loans outstanding compared to net charge-offs of $2.752 million, or .73% of average loans, in the same period in 2009 and $2.169 million, or .60% of average loans, in 2008. During 2010, a provision of $6.500 million was made to increase the reserve. This provision was made in accordance with the Corporation's allowance for loan loss reserve policy, which calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

**NOTE 4 – LOANS (CONTINUED)**

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2010 is as follows (dollars in thousands):

| | Commercial real estate | Commercial, financial and agricultural | Commercial construction | One to four family residential real estate | Consumer construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| Beginning balance ALLR | $ 3,284 | $ 1,135 | $ 386 | $ 23 | $ - | $ 13 | $ 384 | $ 5,225 |
| Charge-offs | (2,426) | (1,804) | (720) | (416) | - | (9) | (111) | (5,486) |
| Recoveries | 18 | 260 | 67 | - | - | 15 | 14 | 374 |
| Provision | 2,584 | 1,427 | 656 | 2,015 | - | (19) | (163) | 6,500 |
| Unallocated assignment | - | - | - | - | - | - | - | - |
| Ending balance ALLR | $ 3,460 | $ 1,018 | $ 389 | $ 1,622 | $ - | $ - | $ 124 | $ 6,613 |
| ***Loans:*** | | | | | | | | |
| Ending balance | $ 194,859 | $ 68,858 | $ 33,330 | $ 75,074 | $ 5,682 | $ 5,283 | $ - | $ 383,086 |
| Ending balance ALLR | (3,460) | (1,018) | (389) | (1,622) | - | - | (124) | (6,613) |
| Net loans | $ 191,399 | $ 67,840 | $ 32,941 | $ 73,452 | $ 5,682 | $ 5,283 | $ (124) | $ 376,473 |
| Ending balance ALLR | $ 3,460 | $ 1,018 | $ 389 | $ 1,622 | $ - | $ - | $ 124 | $ 6,613 |
| Individually evaluated | 1,601 | 330 | 39 | 696 | - | - | - | 2,666 |
| Collectively evaluated | 1,859 | 688 | 350 | 926 | - | - | 124 | 3,947 |
| Total | $ 3,460 | $ 1,018 | $ 389 | $ 1,622 | $ - | $ - | $ 124 | $ 6,613 |

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan's credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below. In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

***Excellent (1)***
Borrower is not vulnerable to sudden economic or technological changes and is in a non-seasonal business or industry. These loans generally would be characterized by having good experienced management and a strong liquidity position with minimal leverage.

***Good (2)***
Borrower shows limited vulnerability to sudden economic change with modest seasonal effect. Borrower has "above average" financial statements and an acceptable repayment history with minimal leverage and a profitability that exceeds peers.

***Average (3)***
Generally, a borrower rated as average may be susceptible to unfavorable changes in the economy and somewhat affected by seasonal factors. Some product lines may be affected by technological change. Borrowers in this category exhibit stable earnings, with a satisfactory payment history.

***Acceptable (4)***
The loan is an otherwise acceptable credit that warrants a higher level of administration due to various underlying weaknesses. These weaknesses, however, have not and may never deteriorate to the point of a Special Mention rating or Classified status. This rating category may include new businesses not yet having established a firm performance record.

**NOTE 4 – LOANS (CONTINUED)**

***Special Mention (5)***
The loan is not considered as a Classified status, however may exhibit material weaknesses that, if not corrected, may cause future problems. Borrowers in this category warrant special attention but have not yet reached the point of concern for loss. The borrower may have deteriorated to the point that they would have difficulty refinancing elsewhere. Similarly, purchasers of these businesses would not be eligible for bank financing unless they represent a significantly lessened credit risk.

***Substandard (6)***
The loan is Classified and exhibits a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans within this category clearly represent troubled and deteriorating credit situations requiring constant supervision and an action plan must be developed and approved by the appropriate officers to mitigate the risk.

***Doubtful (7)***
Loans in this category exhibit the same weaknesses used to describe the substandard credit; however, the traits are more pronounced. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

***Charge-off/Loss (8)***
Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

***General Reserves:***
For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. Within the commercial loan portfolio, the historical loss rates are used for specific industries such as hospitality, gaming, petroleum, and forestry. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Below is a breakdown of loans by risk category as of December 31, 2010 (dollars in thousands):

| | (1) Excellent | (2) Good | (3) Average | (4) Acceptable | (5) Sp. Mention | (6) Substandard | (7) Doubtful | Rating Unassigned | Total |
|---|---|---|---|---|---|---|---|---|---|
| Commercial real estate | $ 4,745 | $ 16,975 | $ 44,408 | $ 109,911 | $ 3,789 | $ 10,997 | $ 3,956 | $ 78 | $ 194,859 |
| Commercial, financial and agricultural | 3,726 | 5,275 | 16,466 | 39,844 | 259 | 2,636 | - | 652 | 68,858 |
| Commercial construction | - | 579 | 4,416 | 22,280 | 1,921 | 568 | - | 3,566 | 33,330 |
| One-to-four family residential real estate | 33 | 3,589 | 3,146 | 4,271 | 1,464 | 3,941 | - | 58,630 | 75,074 |
| Consumer construction | - | - | - | - | - | - | - | 5,682 | 5,682 |
| Consumer | - | - | 34 | 368 | - | - | - | 4,881 | 5,283 |
| Total loans | $ 8,504 | $ 26,418 | $ 68,470 | $ 176,674 | $ 7,433 | $ 18,142 | $ 3,956 | $ 73,489 | $ 383,086 |

**NOTE 4 – LOANS (CONTINUED)**

***Impaired Loans***

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. The interest income recorded during impairment and that which would have been recognized were $.141 million and $.583 million for the year ended December 31, 2010. For the year ended December 31, 2009, the amounts were $.040 million and $.700 million.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

## NOTE 4 – LOANS (CONTINUED)

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

| | Nonaccrual Basis | Accrual Basis | Average Investment | Related Valuation Reserve | Interest Income Recognized During Impairment | Interest Income on Accrual Basis |
|---|---|---|---|---|---|---|
| ***December 31, 2010*** | | | | | | |
| ***With no valuation reserve:*** | | | | | | |
| **Commercial real estate** | **$ 960** | **$ -** | **$ 987** | **$ -** | **$ -** | **$ 71** |
| **Commercial, financial and agricultural** | **51** | **-** | **13** | **-** | **-** | **1** |
| **Commercial construction** | **458** | **-** | **1,186** | **-** | **11** | **33** |
| **One to four family residential real estate** | **362** | **105** | **237** | **-** | **1** | **13** |
| **Consumer construction** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Consumer** | **-** | **-** | **-** | **-** | **-** | **-** |
| ***With a valuation reserve:*** | | | | | | |
| **Commercial real estate** | **$ 2,562** | **$ 4,537** | **$ 6,531** | **$ 1,258** | **$ 117** | **$ 306** |
| **Commercial, financial and agricultural** | **709** | **-** | **1,660** | **279** | **-** | **95** |
| **Commercial construction** | **-** | **-** | **-** | **-** | **-** | **21** |
| **One to four family residential real estate** | **767** | **-** | **730** | **230** | **12** | **39** |
| **Consumer construction** | **52** | **-** | **52** | **1** | **-** | **4** |
| **Consumer** | | **-** | **-** | **-** | **-** | |
| ***Total:*** | | | | | | |
| **Commercial real estate** | **$ 3,522** | **$ 4,537** | **$ 7,518** | **$ 1,258** | **$ 117** | **$ 377** |
| **Commercial, financial and agricultural** | **760** | **-** | **1,673** | **279** | **-** | **96** |
| **Commercial construction** | **458** | **-** | **1,186** | **-** | **11** | **54** |
| **One to four family residential real estate** | **1,129** | **105** | **967** | **230** | **13** | **52** |
| **Consumer construction** | **52** | **-** | **52** | **1** | **-** | **4** |
| **Consumer** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Total** | **$ 5,921** | **$ 4,642** | **$ 11,396** | **$ 1,768** | **$ 141** | **$ 583** |
| *December 31, 2009* | | | | | | |
| *With no valuation reserve:* | | | | | | |
| Commercial real estate | $ 1,293 | $ 869 | $ 1,954 | $ - | $ 40 | $ 133 |
| Commercial, financial and agricultural | 397 | - | 349 | - | - | 21 |
| Commercial construction | 986 | - | 2,399 | - | - | 163 |
| One to four family residential real estate | 292 | - | 212 | - | - | 18 |
| Consumer construction | 52 | - | 10 | - | - | - |
| Consumer | - | - | 3 | - | - | - |
| *With a valuation reserve:* | | | | | | |
| Commercial real estate | $ 6,997 | $ - | $ 5,187 | $ 961 | $ - | $ 349 |
| Commercial, financial and agricultural | 2,249 | - | 173 | 1,497 | - | 11 |
| Commercial construction | 933 | - | 72 | 1 | - | 2 |
| One to four family residential real estate | 1,169 | - | 90 | 246 | - | 3 |
| Consumer construction | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - |
| *Total:* | | | | | | |
| Commercial real estate | $ 8,290 | $ 869 | $ 7,141 | $ 961 | $ 40 | $ 482 |
| Commercial, financial and agricultural | 2,646 | - | 522 | 1,497 | - | 32 |
| Commercial construction | 1,919 | - | 2,471 | 1 | - | 165 |
| One to four family residential real estate | 1,461 | - | 302 | 246 | - | 21 |
| Consumer construction | 52 | - | 10 | - | - | - |
| Consumer | - | - | 3 | - | - | - |
| Total | $ 14,368 | $ 869 | $ 10,449 | $ 2,705 | $ 40 | $ 700 |

**NOTE 4 – LOANS (CONTINUED)**

A summary of past due loans at December 31, 2010 is as follows (dollars in thousands):

| | **2010** | | | 2009 | | |
|---|---|---|---|---|---|---|
| | **30-89 days Past Due (accruing)** | **90+ days Past Due/ Nonaccrual** | **Total** | 30-89 days Past Due (accruing) | 90+ days Past Due/ Nonaccrual | Total |
| Commercial real estate | **$ 19** | **$ 3,522** | **$ 3,541** | $ 4,607 | $ 8,290 | $ 12,897 |
| Commercial, financial and agricultural | **382** | **760** | **1,142** | 492 | 2,646 | 3,138 |
| Commercial construction | **-** | **458** | **458** | 25 | 1,971 | 1,996 |
| One to four family residential real estate | **923** | **1,129** | **2,052** | 226 | 1,461 | 1,687 |
| Consumer construction | **-** | **52** | **52** | - | - | - |
| Consumer | **20** | **-** | **20** | 68 | - | 68 |
| Total past due loans | **$ 1,344** | **$ 5,921** | **$ 7,265** | $ 5,418 | $ 14,368 | $ 19,786 |

A summary of troubled debt restructurings at December 31 is as follows (dollars in thousands):

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Number of Modifications** | **Recorded Investment** | Number of Modifications | Recorded Investment |
| Commercial real estate | **7** | **$ 4,537** | 2 | $ 869 |
| Commercial, financial and agricultural | **-** | **-** | - | - |
| Commercial construction | **-** | **-** | - | - |
| One to four family residential real estate | **1** | **105** | - | - |
| Consumer construction | **-** | **-** | - | - |
| Consumer | **-** | **-** | - | - |
| Total troubled debt restructurings | **8** | **$ 4,642** | 2 | $ 869 |

A roll-forward of troubled debt restructuring during the year ended December 31, 2010 (dollars in thousands):

| | **Commercial Real Estate** | **Commercial, Financial and Agricultural** | **Commercial Construction** | **One to four family residential real estate** | **Consumer and Consumer Construction** | **Total** |
|---|---|---|---|---|---|---|
| **ACCRUING** | | | | | | |
| Beginning balance | $ 869 | $ - | $ - | $ - | $ - | $ 869 |
| Principal payments | (48) | - | (2) | - | - | (50) |
| Charge-offs | - | - | (632) | - | - | (632) |
| Advances | - | - | - | - | - | - |
| New restructured | 4,692 | - | 634 | 609 | - | 5,935 |
| Class transfers | - | - | - | - | - | - |
| Transfers to nonaccrual | (976) | - | - | (504) | - | (1,480) |
| Ending balance | $ 4,537 | $ - | $ - | $ 105 | $ - | $ 4,642 |

**NOTE 4 – LOANS (CONTINUED)**

A roll-forward of nonaccrual activity during the year ended December 31, 2010 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer Construction | Consumer | Total |
|---|---|---|---|---|---|---|---|
| **NONACCRUAL** | | | | | | | |
| Beginning balance | $ 8,290 | $ 2,646 | $ 1,919 | $ 1,461 | $ 52 | $ - | $ 14,368 |
| Principal payments | (5,323) | (1,095) | (86) | (35) | - | - | (6,539) |
| Charge-offs | (2,274) | (1,539) | (48) | (1,311) | - | - | (5,172) |
| Advances | 245 | - | - | - | - | - | 245 |
| Class transfers | - | - | - | - | - | - | - |
| Transfers to OREO | (4,501) | (150) | (1,361) | (368) | - | - | (6,380) |
| Transfers to accruing | (54) | (36) | - | - | - | - | (90) |
| Transfers from accruing | 6,987 | 933 | 24 | 1,368 | - | - | 9,312 |
| Other | 152 | 1 | 10 | 14 | - | - | 177 |
| Ending balance | $ 3,522 | $ 760 | $ 458 | $ 1,129 | $ 52 | $ - | $ 5,921 |

***Insider Loans***

The Bank, in the ordinary course of business, grants loans to the Corporation's executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Loans outstanding, January 1 | **$ 8,552** | $ 6,516 |
| New loans | **5,243** | 2,160 |
| Net activity on revolving lines of credit | **2,065** | 1,189 |
| Change in related party interest | **-** | 297 |
| Repayment | **(6,328)** | (1,610) |
| Loans outstanding, December 31 | **$ 9,532** | $ 8,552 |

There were no loans to related-parties classified substandard as of December 31, 2010 and 2009. In addition to the outstanding balances above, there were unfunded commitments of $.351 million to related parties at December 31, 2010.

## NOTE 5 – PREMISES AND EQUIPMENT

Details of premises and equipment at December 31 are as follows (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Land | **$ 1,811** | $ 1,811 |
| Buildings and improvements | **11,925** | 11,816 |
| Furniture, fixtures, and equipment | **4,770** | 4,346 |
| Construction in progress | **12** | 84 |
| Total cost basis | **18,518** | 18,057 |
| Less - accumulated depreciation | **8,858** | 7,892 |
| Net book value | **$ 9,660** | $ 10,165 |

In August 2009, the Bank sold its Ontonagon and South Range branch offices, with deposits of approximately $29.300 million, premises and equipment with a net book value of $.600 million, and loans totaling approximately $31,000.

Depreciation of premises and equipment charged to operating expenses amounted to $1.098 million in 2010, $1.050 million in 2009, and $1.035 million in 2008.

## NOTE 6 – OTHER REAL ESTATE HELD FOR SALE

An analysis of other real estate held for sale for the years ended December 31 is as follows (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Balance, January 1 | **$ 5,804** | $ 2,189 |
| Other real estate transferred from loans due to foreclosure | **5,373** | 4,879 |
| Reclassification of redemption ORE | **-** | (475) |
| Other real estate sold | **(2,862)** | (581) |
| OREO writedowns | **(2,703)** | (187) |
| Loss on ORE | **(50)** | (21) |
| Balance, December 31 | **$ 5,562** | $ 5,804 |

## NOTE 7 – DEPOSITS

The distribution of deposits at December 31 is as follows (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Noninterest bearing | **$ 41,264** | $ 35,878 |
| NOW, money market, checking | **134,703** | 95,790 |
| Savings | **17,670** | 18,207 |
| CDs <$100,000 | **96,977** | 59,953 |
| CDs >$100,000 | **22,698** | 36,385 |
| Brokered | **73,467** | 175,176 |
| Total deposits | **$ 386,779** | $ 421,389 |

**NOTE 7 – DEPOSITS (CONTINUED)**

Maturities of non-brokered time deposits outstanding at December 31, 2010, are as follows (dollars in thousands):

| | |
|---|---|
| 2011 | $ 67,851 |
| 2012 | 34,256 |
| 2013 | 9,248 |
| 2014 | 6,163 |
| 2015 | 1,840 |
| Thereafter | 317 |
| Total | $ 119,675 |

Brokered deposits of $70.739 million mature in 2011 and $2.728 million matures thereafter.

**NOTE 8 – BORROWINGS**

Federal Home Loan Bank borrowings consist of the following at December 31 (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Federal Home Loan Bank fixed rate advances at rates ranging from .61% to 2.10% maturing in 2011 and 2014 | **$ 15,000** | $ 15,000 |
| Federal Home Loan Bank variable rate advances at rates ranging from .306% to .309% maturing in 2011 | **20,000** | 20,000 |
| Farmers Home Administration, fixed-rate note payable, maturing August 24, 2024 interest payable at 1% | **1,069** | 1,140 |
| | **$ 36,069** | $ 36,140 |

The Federal Home Loan Bank borrowings are collateralized at December 31, 2010 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $34.577 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $13.286 million and $13.919 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.423 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of December 31, 2010. The $20.0 million FHLB advances which matured early in 2011 were refinanced into longer term fixed rate maturities.

The U.S.D.A. Rural Development borrowing is collateralized by loans totaling $.256 million originated and held by the Corporation's wholly owned subsidiary, First Rural Relending and an assignment of a demand deposit account in the amount of $.920 million, and guaranteed by the Corporation.

**NOTE 8 – BORROWINGS (CONTINUED)**

Maturities of borrowings outstanding at December 31, 2010 are as follows (dollars in thousands):

| | |
|---|---|
| 2011 | $ 25,072 |
| 2012 | 72 |
| 2013 | 73 |
| 2014 | 10,074 |
| 2015 | 74 |
| Thereafter | 704 |
| Total | $ 36,069 |

**NOTE 9 – INCOME TAXES**

The components of the federal income tax provision (credit) for the years ended December 31 are as follows (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Current tax expense (benefit) | **$ -** | $ - | $ - |
| Change in valuation allowance | **(2,136)** | - | - |
| Deferred tax expense (benefit) | **(1,364)** | 1,120 | 787 |
| Total provision (credit) for income taxes | **$ (3,500)** | $ 1,120 | $ 787 |

A summary of the source of differences between income taxes at the federal statutory rate and the provision (credit) for income taxes for the years ended December 31 is as follows (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Tax expense at statutory rate | **$ (1,332)** | $ 1,202 | $ 904 |
| Increase (decrease) in taxes resulting from: | | | |
| Tax-exempt interest | **(73)** | (106) | (137) |
| Change in valuation allowance | **(2,136)** | - | - |
| Other | **41** | 24 | 20 |
| Provision for (benefit of) income taxes, as reported | **$ (3,500)** | $ 1,120 | $ 787 |

**NOTE 9 – INCOME TAXES (CONTINUED)**

Deferred income taxes are provided for the temporary differences between the financial reporting and tax bases of the Corporation's assets and liabilities. The major components of net deferred tax assets at December 31 are as follows (dollars in thousands):

| | 2010 | 2009 |
|---|---|---|
| Deferred tax assets: | | |
| NOL carryforward | $ 9,342 | $ 9,520 |
| Allowance for loan losses | 2,248 | 1,776 |
| Alternative Minimum Tax Credit | 1,463 | 1,463 |
| OREO Tax basis > book basis | 1,081 | 80 |
| Tax credit carryovers | 672 | 672 |
| Deferred compensation | 247 | 273 |
| Stock option compensation | 204 | 196 |
| Depreciation | 118 | 72 |
| Intangible assets | 95 | 112 |
| Other | 11 | 49 |
| Total deferred tax assets | 15,481 | 14,213 |
| Valuation allowance | $ (6,010) | $ (8,146) |
| Deferred tax liabilities: | | |
| FHLB stock dividend | (128) | (128) |
| Unrealized gain (loss) on securities | (315) | (563) |
| Other | - | (95) |
| Total deferred tax liabilities | (443) | (786) |
| Net deferred tax asset | $ 9,028 | $ 5,281 |

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. At March 31, 2010 Management evaluated the valuation allowance. An analysis of the deferred tax asset was made to determine the utilization of those tax benefits based upon projected future taxable income. At that time, based upon management's determination and in accordance with the generally accepted accounting principles, that it was "more likely than not" that a portion of these benefits would be utilized, a $3.500 million valuation adjustment was made as a credit to income tax expense. Among the criteria that management considered in evaluating the deferred tax asset was taxable income for the three most recent taxable years ending December 31, 2009 which totaled $8.2 million. This taxable income allowed the Corporation to utilize NOL carryforwards.

Management assessed the valuation allowance for the second and third quarters of 2010 and determined that no additional adjustment was deemed appropriate. At December 31, 2010, based upon further analysis, and in recognition of the current period operating loss before taxes, management determined that an adjustment to the valuation was appropriate and increased the valuation allowance by $1.364 million with an increase to current tax expense. The Corporation, as of December 31, 2010 had a net operating loss and tax credit carryforwards for tax purposes of approximately $27.5 million, and $2.1 million, respectively.

The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it became "more likely than not" that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $17.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.477 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

**NOTE 10 – OPERATING LEASES**

The Corporation currently maintains three operating leases for branch office locations. The first operating lease, for our location in Birmingham, was originated in September 2005 and had an original term of 66 months with an option to renew for an additional five year period. It is anticipated that the original term of this will be extended for an additional three year term.

The second operating lease, for our location in Escanaba, was executed in December 2008, the terms of which began in April 2009. The original term of this lease is three years and will automatically renew and extend for four additional consecutive terms of two years each, but either party may elect to terminate by providing notice of such election to the other party at least 120 days prior to the end of the then-current term. The additional terms call for a lease adjustment based on the Consumer Price Index at time of renewal.

The third operating lease, for our new location in Manistique, was executed in April 2010, the terms of which began at that time. The original term of this lease is three years and will automatically renew and extend for four additional consecutive terms of two years each.

Future minimum payments, by year and in the aggregate, under the initial terms of the operating lease agreements, consist of the following (dollars in thousands):

| | |
|---|---|
| 2011 | $ 90 |
| 2012 | 25 |
| 2013 | 4 |
| Total | $ 119 |

Rent expense for all operating leases amounted to $270,000 in 2010, $207,000 in 2009, and $195,000 in 2008.

**NOTE 11 – RETIREMENT PLAN**

The Corporation has established a 401(k) profit sharing plan. Employees who have completed three months of service and attained the age of 18 are eligible to participate in the plan. Eligible employees can elect to have a portion, not to exceed 80%, of their annual compensation paid into the plan. In addition, the Corporation may make discretionary contributions into the plan. Retirement plan contributions charged to operations totaled $110,000, $120,000, and $90,000 in 2010, 2009, and 2008, respectively.

**NOTE 12 – DEFERRED COMPENSATION PLAN**

As an incentive to retain key members of management and directors, the Corporation established a deferred compensation plan, with benefits based on the number of years the individuals have served the Corporation. This plan was discontinued and no longer applies to current officers and directors. A liability was recorded on a present value basis and discounted using the rates in effect at the time the deferred compensation agreement was entered into. The liability may change depending upon changes in long-term interest rates. The liability at December 31, 2010 and 2009, for vested benefits under this plan, was $.725 million and $.815 million, respectively. These benefits were originally contracted to be paid over a ten to fifteen-year period. The final payment is scheduled to occur in 2023. The deferred compensation plan is unfunded; however, the Bank maintains life insurance policies on the majority of the plan participants. The cash surrender value of the policies was $1.559 million and $1.464 million at December 31, 2010 and 2009, respectively. Deferred compensation expense for the plan was $43,000, $72,000, and $84,000 for 2010, 2009, and 2008, respectively.

## NOTE 13 – REGULATORY MATTERS

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management has determined that, as of December 31, 2010, the Corporation is well capitalized.

To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. In addition, federal banking regulators have established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action.

The Corporation's and the Bank's actual and required capital amounts and ratios as of December 31 are as follows (dollars in thousands):

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **2010** | | | | | | |
| **Total capital to risk weighted assets:** | | | | | | |
| **Consolidated** | **$ 49,132** | **12.6%** | **≥ $ 31,157** | **≥ 8.0%** | **N/A** | |
| **mBank** | **$ 43,477** | **11.2%** | **≥ $ 31,118** | **≥ 8.0%** | **≥ $ 38,897** | **10.0%** |
| **Tier 1 capital to risk weighted assets:** | | | | | | |
| **Consolidated** | **$ 44,242** | **11.4%** | **≥ $ 15,579** | **≥ 4.0%** | **N/A** | |
| **mBank** | **$ 38,594** | **9.9%** | **≥ $ 15,559** | **≥ 4.0%** | **≥ $ 23,338** | **6.0%** |
| **Tier 1 capital to average assets:** | | | | | | |
| **Consolidated** | **$ 44,242** | **9.3%** | **≥ $ 19,130** | **≥ 4.0%** | **N/A** | |
| **mBank** | **$ 38,594** | **8.1%** | **≥ $ 19,092** | **≥ 4.0%** | **≥ $ 23,865** | **5.0%** |
| 2009 | | | | | | |
| Total capital to risk weighted assets: | | | | | | |
| Consolidated | $ 54,587 | 13.2% | ≥ $ 33,155 | ≥ 8.0% | N/A | |
| mBank | $ 47,630 | 11.5% | ≥ $ 33,166 | ≥ 8.0% | ≥ $ 41,458 | 10.0% |
| Tier 1 capital to risk weighted assets: | | | | | | |
| Consolidated | $ 49,406 | 11.9% | ≥ $ 16,578 | ≥ 4.0% | N/A | |
| mBank | $ 42,446 | 10.2% | ≥ $ 16,583 | ≥ 4.0% | ≥ $ 24,875 | 6.0% |
| Tier 1 capital to average assets: | | | | | | |
| Consolidated | $ 49,406 | 9.8% | ≥ $ 20,272 | ≥ 4.0% | N/A | |
| mBank | $ 42,446 | 8.4% | ≥ $ 20,261 | ≥ 4.0% | ≥ $ 25,326 | 5.0% |

At December 31, 2010, the Bank was not authorized to pay dividends to the Corporation without prior regulatory approval because of a negative retained earnings balance due to cumulative losses.

## NOTE 14 – STOCK OPTION PLANS

The Corporation sponsors three stock option plans. All historical information presented below has been adjusted to reflect the 1 for 20 reverse stock split which occurred on December 16, 2004. One plan was approved during 2000 and applies to officers, employees, and non-employee directors. A total of 25,000 shares were made available for grant under this plan. This plan was amended as a part of the recapitalization to provide for additional authorized shares equal to 12.50% of all outstanding shares subsequent to the recapitalization, which amounted to 428,587 shares. This plan expired on February 15, 2010. The other two plans, one for officers and employees and the other for non-employee directors, were approved in 1997 and expired in 2007. A total of 30,000 shares were made available for grant under these plans. Options under all of the plans are granted at the discretion of a committee of the Corporation's Board of Directors. Options to purchase shares of the Corporation's stock are granted at a price equal to the market price of the stock at the date of grant. The committee determines the vesting of the options when they are granted as established under the plan.

A summary of stock option transactions for the years ended December 31 is as follows:

| | **2010** | 2009 |
|---|---|---|
| Outstanding shares at beginning of year | **411,057** | 446,237 |
| Granted during the year | **-** | - |
| Exercised during the year | **-** | - |
| Expired / forfeited during the year | **(16,985)** | (35,180) |
| Outstanding shares at end of year | **394,072** | 411,057 |
| Exercisable shares at end of year | **150,781** | 157,266 |
| Weighted average exercise price per share at end of year | **$ 10.98** | $ 12.03 |
| Shares available for grant at end of year | **0** | 24,780 |

There were no options granted in 2010 and in 2009.

Following is a summary of the options outstanding and exercisable at December 31, 2010:

| Exercise Price | Number of Shares | | | Weighted Average Remaining Contractual Life-Years |
|---|---|---|---|---|
| | Outstanding | Exercisable | Unvested Options | |
| $ 9.16 | 5,000 | 2,000 | 3,000 | 4.96 |
| $ 9.75 | 257,152 | 120,861 | 136,291 | 3.96 |
| $ 10.65 | 50,000 | 10,000 | 40,000 | 5.96 |
| $ 11.50 | 40,000 | 8,000 | 32,000 | 4.75 |
| $ 12.00 | 40,000 | 8,000 | 32,000 | 4.46 |
| $ 156.00 | 1,920 | 1,920 | - | .83 |
| | 394,072 | 150,781 | 243,291 | 4.34 |

**NOTE 14 – STOCK OPTION PLANS (CONTINUED)**

Options issued since the Corporation's recapitalization in December of 2004 call for 20% immediate vesting upon issue and subsequent vesting to occur over a two to five year period, based upon the market value appreciation of the underlying Corporation's stock. Compensation related to these options is expensed based upon the vesting period without consideration given to market value appreciation. There are no future compensation expenses related to existing option programs.

**NOTE 15 – OTHER COMPREHENSIVE INCOME (LOSS)**

Other comprehensive income (loss) components and related taxes for the years ended December 31 are as follows (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Unrealized holding gains (losses) on available for sale securities | **$ (513)** | $ 2,451 | $ 681 |
| Less reclassification adjustments for gains (losses) later recognized in income | **215** | 1,471 | 64 |
| Net unrealized gains (losses) | **(728)** | 980 | 617 |
| Tax effect | **(247)** | 331 | 232 |
| Other comprehensive income (loss) | **$ (481)** | $ 649 | $ 385 |

**NOTE 16 – SHAREHOLDERS' EQUITY**

***Participation in the TARP Capital Purchase Program***

On April 24, 2009, the Corporation entered into and closed a Letter Agreement, including the Securities Purchase Agreement-Standard Terms (collectively, the "Securities Purchase Agreement"), related to the CPP. Pursuant to the Securities Purchase Agreement, the Corporation issued and sold to the Treasury (i) 11,000 shares of the Corporation's Series A Preferred Shares, and (ii) a 10-year Warrant to purchase 379,310 shares of the Corporation's Common Shares, at an exercise price of $4.35 per share (subject to certain anti-dilution and other adjustments), for aggregate proceeds of $11.000 million in cash.

As a result of the CPP transaction, the Corporation is required to take certain actions, for so long as the Treasury holds any securities acquired from the Corporation pursuant to the CPP (excluding any period in which the Treasury holds only the Warrant to purchase Common Shares of the Corporation) (the "CPP Period"), to ensure that its executive compensation and benefit plans with respect to Senior Executive Officers (as defined in the relevant agreements) comply with Section 111(b) of Emergency Economic Stabilization Act of 2008 ("EESA"), as implemented by any guidance or regulations issued under Section 111(b) of EESA, and not adopt any benefit plans with respect to, or which cover, the Corporation's Senior Executive Officers that do not comply with EESA, as amended by the American Recovery and Reinvestment Act of 2009 (the "ARRA"), which was passed by Congress and signed by the President on February 17, 2009. The applicable executive compensation standards generally remain in effect during the CPP Period and apply to the Corporation's Senior Executive Officers (which for purposes of the ARRA and the CPP agreements, includes the Corporation's Chief Executive Officer, its Chief Financial Officer, and the next three most highly-compensated executive officers, even though the Corporation's senior executive officers consist of a smaller group of executives for purposes of the other compensation disclosures in this proxy statement).

## NOTE 16 – SHAREHOLDERS' EQUITY (CONTINUED)

Amounts recorded for Preferred Stock and Warrant Common Stock were estimated based on an allocation of the total proceeds from the issuance on the relative fair values of both instruments. Fair value of the Preferred Stock was determined based on assumptions regarding the discount rate (market rate) on the Preferred Stock (estimated 12%). Fair value of the Warrant Common Stock is based on the value of the underlying Preferred Stock based on an estimate for a three year term. The allocation of the proceeds received resulted in the recording of a discount on the Preferred Stock and a premium on the Warrant Common Stock. The discount on the preferred will be accreted on an effective yield basis over a three-year term. The allocated carrying value of the Preferred Stock and Warrant Common Stock on the date of issuance (based on their relative fair values) was $10.382 million and $.618 million, respectively. Cumulative dividends on the Preferred Stock are payable at 5% annum for the first five years and at a rate of 9% per annum thereafter on the liquidation preference of $1,000 per share. The Company is prohibited from paying any dividend with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock for all past dividend periods. The Preferred Stock is non-voting, other than class voting rights on matters that could adversely affect the Preferred Stock. The Preferred Stock may be redeemed at any time with regulatory approval. The Treasury may also transfer the Preferred Stock to a third party at any time. The preferred stock qualifies as Tier 1 Capital for regulatory purposes at the holding company.

The Corporation has the right to redeem the Series A Preferred Shares at any time after consulting with its primary regulator, in which case the executive compensation standards would no longer apply to the Corporation.

The Corporation is considering whether or not to participate in the U.S. Treasury's Small Business Lending Fund program ("SBLF"). The Corporation has applied for funding under the SBLF, but has not yet received approval, nor has the Corporation determined if it will participate if approved. This SBLF program would allow the Corporation to pay off the TARP preferred and also requires an injection of capital into the Bank which is dependent upon the amount of the total SBLF funding less the $11 million of TARP preferred.

## NOTE 17 - COMMITMENTS, CONTINGENCIES, AND CREDIT RISK

### ***Financial Instruments with Off-Balance-Sheet Risk***

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Corporation's exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments at December 31 are as follows (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| Commitments to extend credit: | | |
| Variable rate | **$ 18,092** | $ 24,839 |
| Fixed rate | **13,034** | 6,039 |
| Standby letters of credit - Variable rate | **2,192** | 1,279 |
| Credit card commitments - Fixed rate | **2,737** | 2,714 |
| | **$ 36,055** | $ 34,871 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's

**NOTE 17 - COMMITMENTS, CONTINGENCIES, AND CREDIT RISK (CONTINUED)**

creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit.

Credit card commitments are commitments on credit cards issued by the Corporation's subsidiary and serviced by other companies. These commitments are unsecured.

***Contingencies***

In the normal course of business the Corporation is involved in various legal proceedings.

***Concentration of Credit Risk***

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at December 31, 2010 represents $58.114 million, or 19.56%, compared to $48.689 million, or 15.93%, of the commercial loan portfolio on December 31, 2009. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture, and construction. Due to the diversity of the Bank's locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

**NOTE 18 - FAIR VALUE**

Fair value estimates, methods, and assumptions are set forth below for the Corporation's financial instruments:

***Cash, cash equivalents, and interest-bearing deposits*** - The carrying values approximate the fair values for these assets.

***Securities*** - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

***Federal Home Loan Bank stock*** – Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

***Loans*** - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan's effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

**NOTE 18 - FAIR VALUE (CONTINUED)**

***Deposits*** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

***Borrowings*** - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

***Accrued interest*** - The carrying amount of accrued interest approximates fair value.

***Off-balance-sheet instruments*** - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

The following table presents information for financial instruments at December 31 (dollars in thousands):

| | Fair Value Measurements | | | |
|---|---|---|---|---|
| | **2010** | | 2009 | |
| | **Carrying Amount** | **Estimated Fair Value** | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | **$ 34,719** | **$ 34,719** | $ 45,433 | $ 45,433 |
| Interest-bearing deposits | **713** | **713** | 678 | 678 |
| Securities available for sale | **33,860** | **33,860** | 46,513 | 46,513 |
| Federal Home Loan Bank stock | **3,423** | **3,423** | 3,794 | 3,794 |
| Net loans | **376,473** | **376,713** | 379,085 | 382,352 |
| Accrued interest receivable | **1,155** | **1,155** | 1,413 | 1,413 |
| Total financial assets | **$ 450,343** | **$ 450,583** | $ 476,916 | $ 480,183 |
| Financial liabilities: | | | | |
| Deposits | **$ 386,779** | **$ 387,885** | $ 421,389 | $ 421,124 |
| Borrowings | **36,069** | **36,234** | 36,140 | 36,447 |
| Accrued interest payable | **232** | **232** | 325 | 325 |
| Total financial liabilities | **$ 423,080** | **$ 424,351** | $ 457,854 | $ 457,896 |

***Limitations*** **-** Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

**NOTE 18 - FAIR VALUE (CONTINUED)**

The following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at December 31, 2010, and the valuation techniques used by the Corporation to determine those fair values.

**Level 1:** In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

**Level 2:** Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

**Level 3:** Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

The fair value of all investment securities at December 31, 2010 and December 31, 2009 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to "Note 3 – Investment Securities."

The Corporation had no Level 3 assets or liabilities on a recurring basis as of December 31, 2010 or December 31, 2009.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

**NOTE 18 - FAIR VALUE (CONTINUED)**

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

**Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2010**

| (dollars in thousands) | Balance at December 31, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Losses for Year Ended December 31, 2010 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Impaired loans | $ 10,563 | $ - | $ - | $ 10,563 | $ 1,666 |
| Other real estate owned | 5,562 | - | - | 5,562 | 2,753 |
| | | | | | $ 4,419 |

**Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2009**

| (dollars in thousands) | Balance at December 31, 2009 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Losses for Year Ended December 31, 2009 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Impaired Loans | $ 15,237 | $ - | $ - | $ 15,237 | $ 1,300 |
| Other real estate owned | 5,804 | - | - | 5,804 | 399 |
| | | | | | $ 1,699 |

The Corporation had no investments subject to fair value measurement on a nonrecurring basis.

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management’s best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

**NOTE 19 - PARENT COMPANY ONLY FINANCIAL STATEMENTS**

**BALANCE SHEETS**
**December 31, 2010 and 2009**
(Dollars in Thousands)

| ASSETS | 2010 | 2009 |
|---|---|---|
| Cash and cash equivalents | **$ 5,353** | $ 7,480 |
| Investment in subsidiaries | **49,016** | 48,575 |
| Other assets | **275** | 156 |
| **TOTAL ASSETS** | **$ 54,644** | $ 56,211 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Other liabilities | **$ 762** | $ 912 |
| Shareholders' equity: | | |
| Preferred stock - no par value: | | |
| Authorized 500,000 shares, 11,000 shares issued and outstanding | **10,706** | 10,514 |
| Common stock and additional paid in capital - no par value | | |
| Authorized 18,000,000 shares | | |
| Issued and outstanding - 3,419,736 | **43,525** | 43,493 |
| Accumulated earnings (deficit) | **(961)** | 199 |
| Accumulated other comprehensive income | **612** | 1,093 |
| Total shareholders' equity | **53,882** | 55,299 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 54,644** | $ 56,211 |

**NOTE 19 - PARENT COMPANY ONLY FINANCIAL STATEMENTS (CONTINUED)**

**STATEMENTS OF OPERATIONS**
**Years Ended December 31, 2010, 2009, and 2008**
(Dollars in Thousands)

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| **INCOME:** | | | |
| Proceeds from settlement of lawsuits | **$ -** | $ - | $ 3,475 |
| Other | **11** | 8 | 9 |
| Total income | **11** | 8 | 3,484 |
| **EXPENSES:** | | | |
| Salaries and benefits | **218** | 250 | 265 |
| Interest | **-** | - | 51 |
| Professional service fees | **136** | 196 | 55 |
| Other | **147** | 227 | 141 |
| Total expenses | **501** | 673 | 512 |
| Income (loss) before income taxes and equity in undistributed net income (loss) of subsidiaries | **(490)** | (665) | 2,972 |
| Provision for (benefit of) income taxes | **-** | (226) | 1,005 |
| Income (loss) before equity in undistributed net income (loss) of subsidiaries | **(490)** | (439) | 1,967 |
| Equity in undistributed net income (loss) of subsidiaries | **72** | 2,855 | (95) |
| Net income (loss) | **(418)** | 2,416 | 1,872 |
| Preferred dividend and accretion of discount | **742** | 509 | - |
| **NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS** | **$ (1,160)** | $ 1,907 | $ 1,872 |

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

**NOTE 19 - PARENT COMPANY ONLY FINANCIAL STATEMENTS (CONTINUED)**

**STATEMENTS OF CASH FLOWS**
**Years Ended December 31, 2010, 2009, and 2008**
(Dollars in Thousands)

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net income | **$ (418)** | $ 2,416 | $ 1,872 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed net (income) loss of subsidiaries | **(72)** | (2,855) | 95 |
| Increase in capital from stock option compensation | **32** | 60 | 82 |
| Change in other assets | **31** | (348) | 49 |
| Change in other liabilities | **(149)** | 32 | 765 |
| Net cash (used in) provided by operating activities | **(576)** | (695) | 2,863 |
| **Cash Flows from Financing Activities:** | | | |
| Proceeds from issuance of Series A Preferred Stock and common stock warrants | **-** | 11,000 | - |
| Dividend on preferred stock | **(550)** | (307) | - |
| Net increase (decrease) in lines of credit | **-** | - | (1,959) |
| Purchase of common stock - oddlot shares | **-** | - | (110) |
| Payments from subsidiaries | **-** | 69 | - |
| Investments in subsidiaries | **(1,000)** | (3,000) | (500) |
| Net cash (used) provided by financing activities | **(1,550)** | 7,762 | (2,569) |
| Net increase (decrease) in cash and cash equivalents | **(2,126)** | 7,067 | 294 |
| Cash and cash equivalents at beginning of period | **7,480** | 413 | 119 |
| Cash and cash equivalents at end of period | **$ 5,354** | $ 7,480 | $ 413 |

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

## SELECTED FINANCIAL DATA
(Unaudited)
(Dollars in Thousands, Except Per Share Data)

| | Years Ended December 31 | | | | |
|---|---|---|---|---|---|
| | **2010** | 2009 | 2008 | 2007 | 2006 |
| ***SELECTED FINANCIAL CONDITION DATA:*** | | | | | |
| Total assets | **$ 478,696** | $ 515,377 | $ 451,431 | $ 408,880 | $ 382,791 |
| Loans | **383,086** | 384,310 | 370,280 | 355,079 | 322,581 |
| Securities | **33,860** | 46,513 | 47,490 | 21,597 | 32,769 |
| Deposits | **386,779** | 421,389 | 371,097 | 320,827 | 312,421 |
| Borrowings | **36,069** | 36,140 | 36,210 | 45,949 | 38,307 |
| Common shareholders' equity | **43,176** | 44,785 | 41,552 | 39,321 | 28,790 |
| Total shareholders' equity | **53,882** | 55,299 | 41,552 | 39,321 | 28,790 |
| ***SELECTED OPERATIONS DATA:*** | | | | | |
| Interest income | **$ 22,840** | $ 23,708 | $ 24,562 | $ 28,695 | $ 24,052 |
| Interest expense | **6,455** | 7,421 | 11,698 | (15,278) | (12,459) |
| Net interest income | **16,385** | 16,287 | 12,864 | 13,417 | 11,593 |
| Provision for loan losses | **6,500** | 3,700 | 2,300 | 400 | (861) |
| Net security gains (losses) | **215** | 1,471 | 64 | (1) | (1) |
| Other income | **2,580** | 3,280 | 4,589 | 2,007 | 984 |
| Other expenses | **(16,598)** | (13,802) | (12,558) | (12,100) | (12,221) |
| Income (loss) before income taxes | **(3,918)** | 3,536 | 2,659 | 2,923 | 1,216 |
| Provision (credit) for income taxes | **(3,500)** | 1,120 | 787 | (7,240) | (500) |
| Net income (loss) | **(418)** | 2,416 | 1,872 | 10,163 | 1,716 |
| Preferred dividend and accretion of discount | **742** | 509 | - | - | - |
| Net income available to common shareholders | **$ (1,160)** | $ 1,907 | $ 1,872 | $ 10,163 | $ 1,716 |
| ***PER SHARE DATA:*** | | | | | |
| Earnings (loss) - Basic | **$ (.34)** | $ .56 | $ .55 | $ 2.96 | $ .50 |
| Earnings (loss) - Diluted | **(.34)** | .56 | .55 | 2.96 | .50 |
| Cash dividends declared | **-** | - | - | - | - |
| Book value | **12.63** | 13.10 | 12.15 | 11.47 | 8.40 |
| Market value - closing price at year end | **4.58** | 4.64 | 4.40 | 8.98 | 11.50 |
| ***FINANCIAL RATIOS:*** | | | | | |
| Return on average common equity | **(2.64) %** | 4.42 % | 4.61 % | 31.05 % | 6.19 % |
| Return on average total equity | **(2.06)** | 3.77 | 4.61 | 31.05 | 6.19 |
| Return on average assets | **(.23)** | .39 | .44 | 2.59 | .49 |
| Dividend payout ratio | **N/A** | N/A | N/A | N/A | N/A |
| Average equity to average assets | **11.17** | 10.24 | 9.55 | 8.34 | 7.97 |
| Efficiency ratio | **72.57** | 72.24 | 85.51 | 79.46 | 93.95 |
| Net interest margin | **3.66** | 3.59 | 3.23 | 3.60 | 3.51 |

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

## SUMMARY QUARTERLY FINANCIAL INFORMATION

(Unaudited)

(Dollars in Thousands, Except per Share Data)

| | FOR THE QUARTER ENDED 2010 | | | | FOR THE QUARTER ENDED 2009 | | | |
|---|---|---|---|---|---|---|---|---|
| | 12/31 | 9/30 | 6/30 | 3/31 | 12/31 | 9/30 | 6/30 | 3/31 |
| **BALANCE SHEET** | | | | | | | | |
| Total loans | **$ 383,086** | **$ 382,727** | **$ 384,839** | **$ 377,311** | $ 384,310 | $ 384,100 | $ 372,004 | $ 370,776 |
| Allowance for loan losses | **(6,613)** | **(5,437)** | **(6,371)** | **(4,737)** | (5,225) | (4,081) | (4,119) | (4,793) |
| Total loans, net | **376,473** | **377,290** | **378,468** | **372,574** | 379,085 | 380,019 | 367,885 | 365,983 |
| Intangible assets | **-** | **-** | **-** | **-** | - | - | 6 | 26 |
| Total assets | **478,696** | **499,006** | **500,774** | **502,427** | 515,377 | 513,180 | 506,304 | 466,375 |
| Core deposits | **290,614** | **287,055** | **271,026** | **236,227** | 209,828 | 200,541 | 202,892 | 196,860 |
| Noncore deposits [1] | **96,165** | **117,469** | **134,758** | **168,985** | 211,561 | 218,040 | 210,260 | 188,897 |
| Total deposits | **386,779** | **404,524** | **405,784** | **405,212** | 421,389 | 418,581 | 413,152 | 385,757 |
| Total borrowings | **36,069** | **36,069** | **36,140** | **36,140** | 36,140 | 36,140 | 36,210 | 36,210 |
| Total shareholders' equity | **53,882** | **55,987** | **56,231** | **58,722** | 55,299 | 55,766 | 53,939 | 41,864 |
| Total shares outstanding | **3,419,736** | **3,419,736** | **3,419,736** | **3,419,736** | 3,419,736 | 3,419,736 | 3,419,736 | 3,419,736 |
| **AVERAGE BALANCE SHEET** | | | | | | | | |
| Total loans | **$ 385,296** | **$ 385,268** | **$ 382,169** | **$ 384,640** | $ 386,203 | $ 370,310 | $ 371,609 | $ 370,943 |
| Allowance for loan losses | **(5,816)** | **(6,094)** | **(5,159)** | **(5,073)** | (3,872) | (4,231) | (4,847) | (4,405) |
| Total loans, net | **379,480** | **379,174** | **377,010** | **379,567** | 382,331 | 366,079 | 366,762 | 366,538 |
| Intangible assets | **-** | **-** | **-** | **-** | - | 1 | 16 | 35 |
| Total assets | **488,320** | **512,335** | **502,942** | **508,495** | 514,102 | 513,687 | 491,205 | 454,740 |
| Core deposits | **286,807** | **285,697** | **255,023** | **221,284** | 204,972 | 201,854 | 198,631 | 194,962 |
| Noncore deposits [1] | **106,459** | **131,150** | **150,426** | **192,613** | 213,308 | 217,248 | 202,879 | 177,707 |
| Total deposits | **393,266** | **416,847** | **405,449** | **413,897** | 418,280 | 419,102 | 401,510 | 372,669 |
| Total borrowings | **36,069** | **36,115** | **36,140** | **36,140** | 36,140 | 36,194 | 36,376 | 36,648 |
| Total shareholders' equity | **55,015** | **56,668** | **57,889** | **55,109** | 55,665 | 54,594 | 49,855 | 41,813 |
| **ASSET QUALITY RATIOS** | | | | | | | | |
| Nonperforming loans/total loans | **2.76 %** | **2.94 %** | **2.87 %** | **2.62 %** | 3.96 % | 3.00 % | 2.66 % | 3.52 % |
| Nonperforming assets/total assets | **3.37** | **3.41** | **3.34** | **3.51** | 4.08 | 3.38 | 2.93 | 3.27 |
| Allowance for loan losses/total loans | **1.73** | **1.42** | **1.66** | **1.26** | 1.36 | 1.06 | 1.11 | 1.29 |
| Allowance for loan losses/nonperforming loans | **62.61** | **48.34** | **57.69** | **47.87** | 34.29 | 35.40 | 41.71 | 36.72 |
| Net charge-offs/average loans | **.16** | **.50** | **.31** | **.36** | .30 | .20 | .22 | .01 |
| Texas Ratio [2] | **26.66** | **27.68** | **26.71** | **27.76** | 34.76 | 28.99 | 25.53 | 32.69 |
| **CAPITAL ADEQUACY RATIOS** | | | | | | | | |
| Tier 1 leverage ratio | **9.25 %** | **9.22 %** | **9.38 %** | **9.85 %** | 9.75 % | 9.74 % | 9.65 % | 7.86 % |
| Tier 1 capital to risk weighted assets | **11.36** | **11.73** | **11.65** | **12.48** | 11.92 | 12.18 | 11.94 | 9.31 |
| Total capital to risk weighted assets | **12.62** | **12.98** | **12.91** | **13.69** | 13.17 | 13.19 | 13.00 | 10.56 |
| Average equity/average assets | **11.27** | **11.06** | **11.51** | **10.84** | 10.83 | 10.63 | 10.15 | 9.19 |
| Tangible equity/tangible assets | **11.27** | **11.06** | **11.51** | **10.84** | 10.83 | 10.87 | 10.65 | 8.97 |

[1] *Noncore deposits include brokered deposits and CDs greater than $100,000*

[2] *Texas Ratio: Nonperforming Assets Divided by Total Equity plus Allowance for Loan Losses*

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

## SUMMARY QUARTERLY FINANCIAL INFORMATION

(Unaudited)

(Dollars in Thousands, Except per Share Data)

| | FOR THE QUARTER ENDED 2010 | | | | FOR THE QUARTER ENDED 2009 | | | |
|---|---|---|---|---|---|---|---|---|
| | 12/31 | 9/30 | 6/30 | 3/31 | 12/31 | 9/30 | 6/30 | 3/31 |
| **INCOME STATEMENT** | | | | | | | | |
| Net interest income | $ 4,276 | $ 4,064 | $ 4,023 | $ 4,022 | $ 4,431 | $ 4,310 | $ 4,051 | $ 3,495 |
| Provision for loan losses | 1,800 | 1,000 | 2,800 | 900 | 2,300 | 700 | 150 | 550 |
| Net interest income after provision | 2,476 | 3,064 | 1,223 | 3,122 | 2,131 | 3,610 | 3,901 | 2,945 |
| Total noninterest income | 747 | 648 | 593 | 807 | 1,503 | 2,418 | 439 | 391 |
| Total noninterest expense | 4,037 | 3,601 | 5,330 | 3,629 | 3,650 | 3,443 | 3,470 | 3,239 |
| Income before taxes | (814) | 111 | (3,514) | 300 | (16) | 2,585 | 870 | 97 |
| Provision for income taxes | 1,093 | 30 | (1,212) | (3,411) | (22) | 864 | 271 | 7 |
| Net income | (1,907) | 81 | (2,302) | 3,711 | 6 | 1,721 | 599 | 90 |
| Preferred dividend and accretion of discount | 185 | 185 | 186 | 185 | 186 | 185 | 138 | - |
| Net income available to common shareholders | $ (2,092) | $ (104) | $ (2,488) | $ 3,526 | $ (180) | $ 1,536 | $ 461 | $ 90 |
| **PER SHARE DATA** | | | | | | | | |
| Earnings per share - basic | $ (.61) | $ (.03) | $ (.73) | $ 1.03 | $ (.05) | $ .45 | $ .13 | $ .03 |
| Earnings per share - diluted | (.61) | (.03) | (.73) | 1.03 | (.05) | .45 | .13 | .03 |
| Book value per share | 12.63 | 13.26 | 13.34 | 14.08 | 13.10 | 13.25 | 12.73 | 12.24 |
| Market value per share | 4.58 | 5.10 | 6.50 | 4.72 | 4.64 | 4.10 | 4.50 | 4.00 |
| **PROFITABILITY RATIOS** | | | | | | | | |
| Return on average assets | (1.70) % | (.08) % | (1.98) % | 2.81 % | (.14) % | 1.19 % | .38 % | .08 % |
| Return on average common equity | (18.76) | (.91) | (21.28) | (30.77) | (1.59) | 13.72 | 4.33 | .87 |
| Return on average total equity | (15.09) | (0.73) | (17.24) | 25.95 | (1.28) | 11.16 | 3.71 | .87 |
| Net interest margin | 3.88 | 3.69 | 3.56 | 3.51 | 3.74 | 3.66 | 3.58 | 3.35 |
| Efficiency ratio | 65.05 | 75.98 | 76.04 | 78.12 | 71.03 | 70.09 | 76.55 | 82.36 |
| Average loans/average deposits | 97.97 | 92.42 | 94.26 | 92.93 | 92.33 | 88.36 | 92.55 | 99.54 |

MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

## MARKET INFORMATION

(Unaudited)

The Corporation's common stock is traded on the NASDAQ Capital Market under the symbol MFNC. The following table sets forth the range of high and low trading prices of the Corporation's common stock from January 1, 2009 through December 31, 2010, as reported by NASDAQ.

| | For the Quarter Ended | | | |
|---|---|---|---|---|
| **2010** | **March 31** | **June 30** | **September 30** | **December 31** |
| **High** | **$ 5.20** | **$ 7.39** | **$ 6.95** | **$ 5.28** |
| **Low** | **4.09** | **4.51** | **4.74** | **3.95** |
| **Close** | **4.72** | **6.50** | **5.10** | **4.58** |
| **Book value, at quarter end** | **14.08** | **13.34** | **13.26** | **12.63** |
| 2009 | | | | |
| High | $ 4.72 | $ 4.50 | $ 6.37 | $ 5.85 |
| Low | 2.45 | 3.76 | 4.00 | 4.00 |
| Close | 4.00 | 4.50 | 4.10 | 4.64 |
| Book value, at quarter end | 12.24 | 12.73 | 13.25 | 13.10 |

The Corporation had 1,216 shareholders of record as of March 30, 2011.

The holders of the Corporation's common stock are entitled to dividends when, and if declared by the Board of Directors of the Corporation, out of funds legally available for that purpose. In determining dividends, the Board of Directors considers the earnings, capital requirements and financial condition of the Corporation and its subsidiary bank, along with other relevant factors. The Corporation's principal source of funds for cash dividends is the dividends paid by the Bank. The ability of the Corporation and the Bank to pay dividends is subject to regulatory restrictions and requirements. The Bank currently has a negative retained earnings position which precludes payment of dividends. The Bank, in order to pay dividends, would need to eliminate the negative retained earnings position and have regulatory approval. There were no dividends declared or paid in 2008, 2009 and 2010. There were no sales of unregistered securities in 2010, nor were there any repurchases of the Corporation's common stock in 2010.

# Shareholder Return Performance Graph

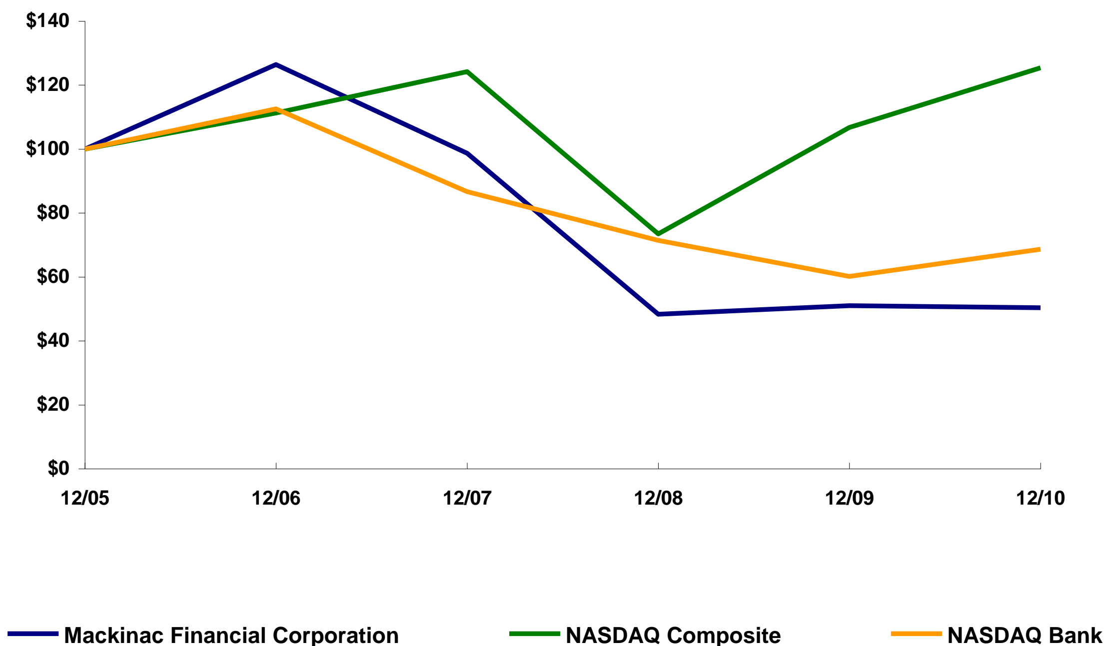
MACKINAC FINANCIAL CORPORATION AND SUBSIDIARIES

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on the Corporation's common stock with that of the cumulative total return on the NASDAQ Bank Index and the NASDAQ Composite Index for the five-year period ended December 31, 2010. The following information is based on an investment of $100, on December 31, 2005 in the Corporation's common stock, the NASDAQ Bank Index, and the NASDAQ Composite Index, with dividends reinvested.

This graph and other information contained in this section shall not be deemed to be "soliciting" material or to be "filed" with the Securities and Exchange Commission or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN***

Among Mackinac Financial Corporation, the NASDAQ Composite Index
and the NASDAQ Bank Index




*$100 invested on 12/31/05 in stock or index, including reinvestment of dividends.
Fiscal year ending December 31.

# Forward Looking Statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Corporation intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words "believe", "expect", "intend", "anticipate", "estimate", "project", or similar expressions. The Corporation's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

- The highly regulated environment in which the Corporation operates could adversely affect its ability to carry out its strategic plan due to restrictions on new products, funding opportunities or new market entrances;
- General economic conditions, either nationally or in the state(s) in which the Corporation does business;
- Legislation or regulatory changes which affect the business in which the Corporation is engaged;
- Changes in the level and volatility of interest rates which may negatively affect the Corporation's interest margin;
- Changes in securities markets with respect to the market value of financial assets and the level of volatility in certain markets such as foreign exchange;
- Significant increases in competition in the banking and financial services industry resulting from industry consolidation, regulatory changes and other factors, as well as action taken by particular competitors;
- The ability of borrowers to repay loans;
- The effects on liquidity of unusual decreases in deposits;
- Changes in consumer spending, borrowing, and saving habits;
- Technological changes;
- Acquisitions and unanticipated occurrences which delay or reduce the expected benefits of acquisitions;
- Difficulties in hiring and retaining qualified management and banking personnel;
- The Corporation's ability to increase market share and control expenses;
- The effect of compliance with legislation or regulatory changes;
- The effect of changes in accounting policies and practices;
- The costs and effects of existing and future litigation and of adverse outcomes in such litigation; and
- An increase in the Corporation's FDIC insurance premiums, or the collection of special assessments by the FDIC.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation's financial results, is included in the Corporation's filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

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

*OVERVIEW*

The following discussion and analysis presents the more significant factors affecting the Corporation's financial condition as of December 31, 2010 and 2009 and the results of operations for 2008 through 2010. This discussion also covers asset quality, liquidity, interest rate sensitivity, and capital resources for the years 2009 and 2010. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. Throughout this discussion, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

Taxable equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 34% federal tax rate, thus making tax-exempt yields comparable to taxable asset yields.

Dollar amounts in tables are stated in thousands, except for per share data.

*EXECUTIVE SUMMARY*

The purpose of this section is to provide a brief summary of the 2010 results of operations and financial condition. A more detailed analysis of the results of operations and financial condition follows this summary.

The Corporation reported a loss available to common shareholders in 2010 of $1.160 million, or $.34 per share, compared to net income of $1.907 million, $.56 per share, in 2009 and net income in 2008 of $1.872 million, $.55 per share.

Total assets of the Corporation at December 31, 2010, were $478.696 million, a decrease of $36.681 million, or 7.12% from total assets of $515.377 million reported at December 31, 2009. In 2010, the Corporation reduced excess liquidity and reliance on wholesale funding.

At December 31, 2010, the Corporation's loans stood at $383.086 million, a decrease of $1.224 million, or .32%, from 2009 year-end balances of $384.310 million. Loan balances were impacted by normal amortization and paydowns. A good portion of these payoffs pertained to loan relationships that no longer met our pricing or credit standards. Total loan production in 2010 amounted to $113.8 million, which included $36.7 million of secondary market mortgage loans. The Corporation also sold $12.6 million of SBA/USDA guaranteed loans.

Nonperforming loans totaled $10.563 million, or 2.76% of total loans at December 31, 2010. Nonperforming assets at December 31, 2010, were $16.125 million, 3.37% of total assets, compared to $21.041 million or 4.08% of total assets at December 31, 2009.

Total deposits decreased from $421.389 million at December 31, 2009, to $386.779 million at December 31, 2010, a decrease of 8.21%. The decrease in deposits in 2010 was comprised of a decrease in wholesale deposits of $115.396 million and an increase in core deposits of $80.786 million.

Shareholders' equity totaled $53.882 million at December 31, 2010, compared to $55.299 million at the end of 2009, a decrease of $1.417 million. This decrease reflects the consolidated net loss of $1.160 million, the $32,000 capital contribution impact of stock options, the decrease in the market value of available-for-sale investments, which amounted to $.481 million and the decrease from the accretion of the discount on preferred stock of $.192 million. The book value per common share at December 31, 2010, amounted to $12.63 compared to $13.10 at the end of 2009.

## *RESULTS OF OPERATIONS*

| (dollars in thousands, except per share data) | For the Years Ended December 31, **2010** | 2009 | 2008 |
|---|---|---|---|
| Taxable-equivalent net interest income | **$ 16,496** | $ 16,446 | $ 13,074 |
| Taxable-equivalent adjustment | **111** | 159 | 210 |
| Net interest income | **16,385** | 16,287 | 12,864 |
| Provision for loan losses | **6,500** | 3,700 | 2,300 |
| Other income | **2,795** | 4,751 | 4,653 |
| Other expense | **16,598** | 13,802 | 12,558 |
| Income before provision for income taxes | **(3,918)** | 3,536 | 2,659 |
| Provision for (benefit of) income taxes | **(3,500)** | 1,120 | 787 |
| Net income (loss) | **$ (418)** | $ 2,416 | $ 1,872 |
| Preferred dividend expense | **742** | 509 | - |
| Net income (loss) available to common shareholders | **$ (1,160)** | $ 1,907 | $ 1,872 |
| Earnings (loss) per common share | | | |
| Basic | **$ (.34)** | $ .56 | $ .55 |
| Diluted | **$ (.34)** | $ .56 | $ .55 |
| Return on average assets | **(.23) %** | .39 % | .44 % |

### Summary

The Corporation reported a net loss available to common shareholders of $1.160 million in 2010, compared to net income of $1.907 million in 2009 and a net income of $1.872 million in 2008. The 2010 results include elevated costs associated with nonperforming assets, including loan loss provisions of $6.500 million and OREO write-downs and gains/losses of $2.753 million. Also included in the 2010 results are security gains of $.215 million. The 2009 results include $1.208 million of gains related to branch office sales and $1.471 million of security gains. The 2008 operating results include the positive effect, $3.475 million of a lawsuit settlement, and the negative effect, $.425 million of a severance agreement.

### Net Interest Income

Net interest income is the Corporation's primary source of core earnings. Net interest income represents the difference between the average yield earned on interest-earning assets and the average rate paid on interest-bearing funding sources. Net interest revenue is the Corporation's principal source of revenue, representing 89% of total revenue in 2010. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest income on a taxable equivalent basis increased $.098 million from $16.287 in 2009 to $16.385 million, in 2010. Attributing to the overall decrease in net interest income was a reduction in investment securities which were sold late in 2009 in order to reduce excess liquidity and lower market interest rate risk. The proceeds from these sales were used to repay maturing wholesale deposits. In 2010, interest rates were somewhat stable with the prime rate at 3.25% for the entire year. The Corporation experienced a modest reduction, 14 basis points, in the overall rates on earnings assets from 5.26% in 2009 to 5.12% in 2010. Interest bearing funding sources also declined, by 22 basis points, from 1.82% in 2009 to 1.60% in 2010. The combination of these rate reductions resulted in an improved net interest margin from 3.62% in 2009 to 3.68% in 2010.

In 2009, the Corporation realized an increase of $3.423 million in net interest income. A portion of this increase was attributed to higher levels of investment securities which were funded by lower cost wholesale funding sources. In 2009, the Corporation benefited from low interest rates prevalent on wholesale deposit instruments. The interest rates in the

wholesale environment were significantly more attractive than offering rates by competitors in local markets. In addition to the benefits derived from lower rates or wholesale deposit instruments a number of new or rewritten loans were structured with interest rate floors that locked in a near term favorable interest rate spread.

The following table details sources of net interest income for the three years ended December 31 (dollars in thousands):

| | 2010 | Mix | 2009 | Mix | 2008 | Mix |
|---|---|---|---|---|---|---|
| Interest Income | | | | | | |
| Loans | $ 21,279 | 93.17 % | $ 20,813 | 87.79 % | $ 22,959 | 93.48 % |
| Funds sold | 58 | .25 | - | - | 96 | .39 |
| Taxable securities | 1,406 | 6.16 | 2,783 | 11.74 | 1,293 | 5.26 |
| Nontaxable securities | 28 | .12 | 19 | .08 | 5 | .02 |
| Other interest-earning assets | 69 | .30 | 93 | .39 | 209 | .85 |
| Total earning assets | 22,840 | 100.00 % | 23,708 | 100.00 % | 24,562 | 100.00 % |
| Interest Expense | | | | | | |
| NOW, money markets, checking | 1,218 | 18.87 % | 809 | 10.90 % | 1,284 | 10.98 % |
| Savings | 97 | 1.50 | 142 | 1.91 | 193 | 1.65 |
| CDs <$100,000 | 1,756 | 27.20 | 1,857 | 25.02 | 3,181 | 27.19 |
| CDs >$100,000 | 449 | 6.96 | 633 | 8.53 | 1,037 | 8.86 |
| Brokered deposits | 2,087 | 32.33 | 2,990 | 40.30 | 4,420 | 37.79 |
| Borrowings | 848 | 13.14 | 990 | 13.34 | 1,583 | 13.53 |
| Total interest-bearing funds | 6,455 | 100.00 % | 7,421 | 100.00 % | 11,698 | 100.00 % |
| Net interest income | $ 16,385 | | $ 16,287 | | $ 12,864 | |
| Average Rates | | | | | | |
| Earning assets | 5.10 % | | 5.22 % | | 6.16 % | |
| Interest-bearing funds | 1.60 | | 1.82 | | 3.32 | |
| Interest rate spread | 3.50 | | 3.40 | | 2.84 | |

As shown in the table above, income on loans provides more than 90% of the Corporation's interest revenue. The Corporation's loan portfolio has approximately 71% of variable rate loans that predominantly reprice with changes in the prime rate and 29% of fixed rate loans. A majority of the variable rate loans, 60%, or $160 million, have interest rate floors. These loans will not reprice until the prime rate increases to the extent necessary to surpass the interest rate floor. A prime rate increase of 100 basis points or more will reprice $66 million of these loans with floors, while the remainder will reprice with a 200 basis point increase in the prime rate.

The majority of interest bearing liabilities do not reprice automatically with changes in interest rates, which provides flexibility to manage interest income. Management monitors the interest sensitivity of earning assets and interest bearing liabilities to minimize the risk of movements in interest rates.

The following table presents the amount of taxable equivalent interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

| (dollars in thousands) | Years ended December 31, 2010 Average Balance | 2010 Interest | 2010 Average Rate | 2009 Average Balance | 2009 Interest | 2009 Average Rate | 2008 Average Balance | 2008 Interest | 2008 Average Rate |
|---|---|---|---|---|---|---|---|---|---|
| **ASSETS:** | | | | | | | | | |
| Loans [1,2,3] | $ 384,347 | $ 21,376 | 5.56 % | $ 374,796 | $ 20,964 | 5.59 % | $ 361,324 | $ 23,166 | 6.41 % |
| Taxable securities | 35,475 | 1,406 | 3.96 | 74,005 | 2,782 | 3.76 | 28,766 | 1,293 | 4.49 |
| Nontaxable securities [2] | 853 | 42 | 4.92 | 571 | 28 | 4.90 | 69 | 8 | 11.59 |
| Federal Funds sold | 22,934 | 58 | .25 | 74 | - | - | 4,101 | 96 | 2.34 |
| Other interest-earning assets | 4,448 | 69 | 1.55 | 4,415 | 93 | 2.11 | 4,318 | 209 | 4.84 |
| Total earning assets | 448,057 | 22,951 | 5.12 | 453,861 | 23,867 | 5.26 | 398,578 | 24,772 | 6.22 |
| Reserve for loan losses | (5,539) | | | (4,337) | | | (3,747) | | |
| Cash and due from banks | 29,291 | | | 19,397 | | | 6,901 | | |
| Fixed assets | 10,002 | | | 10,839 | | | 11,453 | | |
| Other real estate owned | 6,196 | | | 3,374 | | | 1,048 | | |
| Other assets | 14,986 | | | 10,518 | | | 11,110 | | |
| | 54,936 | | | 39,791 | | | 26,765 | | |
| TOTAL ASSETS | $ 502,993 | | | $ 493,652 | | | $ 425,343 | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY:** | | | | | | | | | |
| NOW and Money Markets | $ 99,411 | $ 943 | .95 % | $ 73,003 | $ 665 | 0.91 % | $ 77,997 | $ 1,245 | 1.60 % |
| Interest checking | 18,987 | 275 | 1.45 | 7,735 | 143 | 1.85 | 1,501 | 39 | 2.60 |
| Savings deposits | 19,503 | 97 | .50 | 20,179 | 142 | 0.70 | 15,963 | 193 | 1.21 |
| CDs <$100,000 | 84,841 | 1,756 | 2.07 | 67,356 | 1,858 | 2.76 | 78,755 | 3,181 | 4.04 |
| CDs >$100,000 | 26,273 | 449 | 1.71 | 26,906 | 633 | 2.35 | 27,079 | 1,037 | 3.83 |
| Brokered deposits | 118,615 | 2,087 | 1.76 | 176,017 | 2,990 | 1.70 | 111,482 | 4,420 | 3.96 |
| Borrowings | 36,116 | 848 | 2.35 | 36,338 | 990 | 2.72 | 39,248 | 1,583 | 4.03 |
| Total interest-bearing liabilities | 403,746 | 6,455 | 1.60 % | 407,534 | 7,421 | 1.82 | 352,025 | 11,698 | 3.32 |
| Demand deposits | 39,704 | | | 31,864 | | | 29,348 | | |
| Other liabilities | 3,372 | | | 3,723 | | | 3,340 | | |
| Shareholders' equity | 56,171 | | | 50,531 | | | 40,630 | | |
| | 99,247 | | | 86,118 | | | 73,318 | | |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ 502,993 | | | $ 493,652 | | | $ 425,343 | | |
| Rate spread | | | 3.52 | | | 3.44 % | | | 2.90 % |
| Net interest margin/revenue, tax equivalent basis | | $ 16,496 | 3.68 % | | $ 16,446 | 3.62 % | | $ 13,074 | 3.28 % |

(1) For purposes of these computations, non-accruing loans are included in the daily average loan amounts outstanding.
(2) The amount of interest income on nontaxable securities and loans has been adjusted to a tax equivalent basis, using a 34% tax rate.
(3) Interest income on loans includes loan fees.

The following table presents the dollar amount, in thousands, of changes in taxable equivalent interest income and interest expense for major components of interest-earning assets and interest-bearing obligations. It distinguishes between changes related to higher or lower outstanding balances and changes due to the levels and fluctuations in interest rates. For each category of interest-earning assets and interest-bearing obligations, information is provided for changes attributable to (i) changes in volume (i.e. changes in volume multiplied by prior period rate) and (ii) changes in rate (i.e. changes in rate multiplied by prior period volume). For purposes of this table, changes attributable to both rate and volume are shown as a separate variance.

| | Years ended December 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | **2010 vs. 2009** | | | | 2009 vs. 2008 | | | |
| | **Increase (Decrease) Due to** | | | | Increase (Decrease) Due to | | | |
| | **Volume** | **Rate** | **Volume and Rate** | **Total Increase (Decrease)** | Volume | Rate | Volume and Rate | Total Increase (Decrease) |
| **Interest earning assets:** | | | | | | | | |
| Loans | **$ 534** | **$ (119)** | **$ (3)** | **$ 412** | $ 863 | $ (2,955) | $ (110) | $ (2,202) |
| Taxable securities | **(1,448)** | **151** | **(79)** | **(1,376)** | 2,033 | (212) | (332) | 1,489 |
| Nontaxable securities | **13** | **-** | **1** | **14** | 58 | (5) | (33) | 20 |
| Federal funds sold | **58** | **-** | **-** | **58** | (94) | (96) | 94 | (96) |
| Other interest earning assets | **1** | **(25)** | **-** | **(24)** | 5 | (118) | (3) | (116) |
| Total interest earning assets | **$ (842)** | **$ 7** | **$ (81)** | **$ (916)** | $ 2,865 | $ (3,386) | $ (384) | $ (905) |
| **Interest bearing obligations** | | | | | | | | |
| NOW and money market deposits | **$ 241** | **$ 27** | **$ 10** | **$ 278** | $ (80) | $ (535) | $ 35 | $ (580) |
| Interest checking | **208** | **(31)** | **(45)** | **132** | 162 | (11) | (47) | 104 |
| Savings deposits | **(5)** | **(41)** | **1** | **(45)** | 51 | (81) | (21) | (51) |
| CDs <$100,000 | **482** | **(464)** | **(120)** | **(102)** | (460) | (1,010) | 147 | (1,323) |
| CDs >$100,000 | **(15)** | **(173)** | **4** | **(184)** | (7) | (400) | 3 | (404) |
| Brokered deposits | **(975)** | **107** | **(35)** | **(903)** | 2,559 | (2,526) | (1,463) | (1,430) |
| Borrowings | **(6)** | **(137)** | **1** | **(142)** | (117) | (514) | 38 | (593) |
| Total interest bearing obligations | **$ (70)** | **$ (712)** | **$ (184)** | **$ (966)** | $ 2,108 | $ (5,077) | $ (1,308) | $ (4,277) |
| **Net interest income, tax equivalent basis** | | | | **$ 50** | | | | $ 3,372 |

## Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During 2010, the Corporation recorded a provision for loan loss of $6.500 million, compared to a provision of $3.700 million in 2009. The higher provision for 2010 was due in large part to an elevated level of charge-offs which totaled $5.112 million, or 1.33% of average loans compared to $2.752 million or .73% on average loans in 2009.

## Noninterest Income

Noninterest income was $2.795 million, $4.751 million, and $4.653 million in 2010, 2009, and 2008, respectively. The principal recurring sources of noninterest income are the gains on the sale of secondary market loans and fees for services related to deposit and loan accounts. In 2010, the Corporation expanded its efforts to generate increased income from secondary market loans by adding additional staff and centralizing processing activities. In 2009, the Corporation recorded a gain on the sale of two branch offices, $1.208 million, and a gain on security sales of $1.471 million.

The following table details noninterest income for the three years ended December 31 (dollars in thousands):

| | 2010 | 2009 | 2008 | % Increase (Decrease) 2010-2009 | 2009-2008 |
|---|---|---|---|---|---|
| Deposit service charges | **$ 128** | $ 116 | $ 101 | **10.34 %** | 14.85 % |
| NSF Fees | **862** | 907 | 737 | **(4.96)** | 23.07 |
| Gain on sale of secondary market loans | **445** | 224 | 107 | **98.66** | 109.35 |
| Secondary market fees generated | **94** | 93 | 34 | **1.08** | 173.53 |
| SBA Fees | **868** | 513 | 12 | **69.20** | 4,175.00 |
| Proceeds from settlement of lawsuits | **-** | - | 3,475 | **-** | (100.00) |
| Gain on sale of branch offices | **-** | 1,208 | - | **(100.00)** | 100.00 |
| Other | **183** | 219 | 123 | **(16.44)** | 78.05 |
| Subtotal | **2,580** | 3,280 | 4,589 | **(21.34)** | (28.52) |
| Net security gains | **215** | 1,471 | 64 | **(85.38)** | 2,198.44 |
| Total noninterest income | **$ 2,795** | $ 4,751 | $ 4,653 | **(41.17) %** | 2.11 % |

Total revenues from the loan sale activities amounted to $1.407 million in 2010, $.830 million in 2009 and $.153 million in 2008. The Corporation anticipates increased revenues from these activities in future periods. As stated, we increased our capacity for secondary market activities with several key staff additions. We are also increasing our SBA and USDA lending activities as these types of government sponsored programs become more advantageous to borrowers. Deposit related income totaled $.990 million in 2010 compared to $1.023 million in 2009 and $.838 million in 2008. The current regulatory environment may limit the Corporation's ability to grow these revenue sources.

**Noninterest Expense**

Noninterest expense was $16.598 million in 2010, compared to $13.802 million and $12.558 million in 2009 and 2008, respectively. In 2010, the increase in noninterest expense totaled $2.796 million, or 20.26%. The largest increase in noninterest expense for 2010 occurred in OREO write-downs and gains/losses on the sale of OREO, which increased from $.208 million in 2009 to $2.753 million in 2010. In 2008 the Corporation had net gains of $80,000 on the sale of OREO. Management expects that costs associated with carrying nonperforming loans will continue to be above historical norms. Salaries and benefits, at $6.918 million, increased by $.335 million, 5.09%, from the 2009 expenses of $6.583 million and compared to $6.886 million in 2008. The other most significant loan and deposit expense increase was in FDIC insurance assessment premiums which totaled $.839 million in 2009 and increased to $.957 million in 2010. FDIC insurance costs are also expected to increase in future periods based upon the need to replenish the deposit insurance fund for charges due to increased bank failures.

Management will continue to review all areas of noninterest expense in order to evaluate where opportunities may exist which could reduce expenses without compromising service to customers.

The following table details noninterest expense for the three years ended December 31 (dollars in thousands):

| | 2010 | 2009 | 2008 | % Increase (Decrease) 2010 - 2009 | 2009 - 2008 |
|---|---|---|---|---|---|
| Salaries and benefits | **$ 6,918** | $ 6,583 | $ 6,886 | **5.09** % | (4.40) % |
| Occupancy | **1,313** | 1,385 | 1,374 | **(5.20)** | .80 |
| Furniture and equipment | **806** | 805 | 771 | **0.12** | 4.41 |
| Data processing | **740** | 862 | 844 | **(14.15)** | 2.13 |
| Professional service fees: | | | | | |
| Accounting | **269** | 261 | 254 | **3.07** | 2.76 |
| Legal | **98** | 95 | 41 | **3.16** | 131.71 |
| Consulting and other | **260** | 247 | 213 | **5.26** | 15.96 |
| Total professional service fees | **627** | 603 | 508 | **3.98** | 18.70 |
| Loan and deposit | **910** | 746 | 488 | **21.98** | 52.87 |
| OREO writedowns and (gains) losses on sale | **2,753** | 208 | (80) | **1,223.56** | (360.00) |
| FDIC insurance premiums | **957** | 839 | 81 | **14.06** | 935.80 |
| Telephone | **193** | 187 | 170 | **3.21** | 10.00 |
| Advertising | **297** | 322 | 305 | **(7.76)** | 5.57 |
| Amortization of intangibles | **-** | 46 | 78 | **(100.00)** | (41.03) |
| Other operating expenses | **1,084** | 1,216 | 1,133 | **(10.86)** | 7.33 |
| Total noninterest expense | **$ 16,598** | $ 13,802 | $ 12,558 | **20.26** % | 9.91 % |

**Federal Income Taxes**

A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and contain tax carryforwards including past net operating losses and tax credits. For example, a temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized based on the weight of available evidence. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. Judgment must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized.

*Current Federal Tax Provision*

The Corporation recorded a current period federal tax benefit of $3.500 million in 2010, compared to a $1.120 million provision in the same period a year earlier. In the first quarter of 2010, management evaluated the deferred tax assets associated with the net operating loss and tax credit carryforwards based upon the Corporation's foreseen ability to utilize the benefits of these carryforwards prior to their expiration. At that time, the Corporation had net deferred tax assets of approximately $13.4 million and a valuation allowance of $8.1 million against these assets. As a part of this analysis, management considered, among other things, current asset levels and projected loan and deposit growth, current interest rate spreads and projected net interest income levels, and noninterest income and expense, along with management's ability to control expenses and the potential for increasing contributions of noninterest income. Management also considered the impact of nonperforming assets and future period charge-off activity relative to projected provisions. Based upon the analysis of projected taxable income and the probability of achieving these projected taxable income levels, the Corporation reduced the valuation allowance on its deferred tax assets by $3.500 million. Among the criteria that management considered in evaluating the deferred tax asset was taxable income for the three most recent taxable years ending December 31, 2009 which totaled $8.2 million. This taxable income allowed the Corporation to utilize NOL carryforwards. At 2010 year end, management, in recognition of the net operating loss before taxes of $3.918 million and based upon additional analysis of deferred tax balances and future taxable income projections, made the determination to increase the valuation allowance by approximately $1.364 million, resulting in a net decrease in the valuation allowance of $2.136 million for the year.

*Deferred Tax Benefit – Historical Commentary*

The Corporation recognized a federal deferred tax benefit of $7.500 million in the third quarter of 2007. The recognition of this deferred tax benefit relates to the generally accepted accounting principles applicable to the probability of utilizing the NOL and tax credit carryforwards of the Corporation. The Corporation, based upon current profitability trends largely supported by expansion of the net interest margin and controlled expenses, determined that a portion, $7.500 million, of the NOL carryforward was probable. The $7.500 million recognition was based upon assumptions of a sustained level of taxable income within the NOL carryforward period and took into account Section 382, annual limitations. This tax benefit was recorded by reducing the valuation allowance that was recorded against the deferred tax assets of the Corporation. In 2006, the Corporation recognized a portion of this benefit, $.500 million, based upon the then current probabilities.

The table below details the Corporation's deferred tax assets and liabilities (dollars in thousands):

| | 2010 | 2009 |
|---|---|---|
| Deferred tax assets: | | |
| NOL carryforward | $ 9,342 | $ 9,520 |
| Allowance for loan losses | 2,248 | 1,776 |
| Alternative Minimum Tax Credit | 1,463 | 1,463 |
| OREO Tax basis > book basis | 1,081 | 80 |
| Tax credit carryovers | 672 | 672 |
| Deferred compensation | 247 | 273 |
| Stock option compensation | 204 | 196 |
| Depreciation | 118 | 72 |
| Intangible assets | 95 | 112 |
| Other | 11 | 49 |
| Total deferred tax assets | 15,481 | 14,213 |
| Valuation allowance | $ (6,010) | $ (8,146) |
| Deferred tax liabilities: | | |
| FHLB stock dividend | (128) | (128) |
| Unrealized gain (loss) on securities | (315) | (563) |
| Other | - | (95) |
| Total deferred tax liabilities | (443) | (786) |
| Net deferred tax asset | $ 9,028 | $ 5,281 |

As shown in the table above, the NOL and tax credit carryforwards comprise the majority of the deferred tax asset, which is reduced by the $6.010 million valuation adjustment.

As of December 31, 2010, the Corporation had an NOL carryforward of approximately $27.5 million along with various credit carryforwards of $2.1 million. This NOL and credit carryforward benefit is dependent upon the future profitability of the Corporation. A portion of the NOL, approximately $17.0 million, and all of the tax credit carryforwards are also subject to the use limitations of Section 382 of the Internal Revenue Code since they originated prior to the December 2004 recapitalization of the Corporation. These carryforwards, if not utilized, will begin to expire in the year 2023. The annual limitation is $1.4 million for the NOL carryforwards and the equivalent value of tax credits, which is approximately $.477 million.

The Corporation will continue to evaluate the utilization of the NOL and credit carryforwards in subsequent periods to determine if any further adjustment to the valuation allowance is necessary. The determination criteria for recognition of deferred tax benefits will include the assumption of future period taxable income based upon the projected profitability of the Corporation.

Management believes that the Corporation will ultimately utilize all of the NOL carryforwards and a portion of the tax credit carryforwards. The valuation allowance, which stands at $6.0 million as of December 31, 2010 is a conservative measurement of the uncertainty related to the current economy and level of profitability the Corporation will attain in the near term.

## *FINANCIAL POSITION*

| (dollars in thousands) | December 31, 2010 Balance | 2010 Mix | | 2009 Balance | 2009 Mix | | 2008 Balance | 2008 Mix | |
|---|---|---|---|---|---|---|---|---|---|
| **Sources of funds:** | | | | | | | | | |
| Deposits: | | | | | | | | | |
| Non-interest bearing transactional deposits | **$ 41,264** | **8.62** | % | $ 35,878 | 6.96 | % | $ 30,099 | 6.67 | % |
| Interest-bearing transactional depopsits | **152,373** | **31.83** | | 113,997 | 22.12 | | 91,314 | 20.23 | |
| CD's <$100,000 | **96,977** | **20.26** | | 59,953 | 11.63 | | 73,752 | 16.34 | |
| Total core deposit funding | **290,614** | **60.71** | | 209,828 | 40.71 | | 195,165 | 43.23 | |
| CD's >$100,000 | **22,698** | **4.74** | | 36,385 | 7.06 | | 25,044 | 5.55 | |
| Brokered deposits | **73,467** | **15.35** | | 175,176 | 33.99 | | 150,888 | 33.42 | |
| Total noncore deposit funding | **96,165** | **20.09** | | 211,561 | 41.05 | | 175,932 | 38.97 | |
| FHLB and other borrowings | **36,069** | **7.53** | | 36,140 | 7.01 | | 36,210 | 8.02 | |
| Other liabilities | **1,966** | **.41** | | 2,549 | .49 | | 2,572 | .57 | |
| Shareholders' equity | **53,882** | **11.26** | | 55,299 | 10.74 | | 41,552 | 9.21 | |
| Total | **$ 478,696** | **100.00** | % | $ 515,377 | 100.00 | % | $ 451,431 | 99.57 | % |
| **Uses of Funds:** | | | | | | | | | |
| Net Loans | **$ 376,473** | **78.64** | % | $ 379,085 | 73.54 | % | $ 366,003 | 81.08 | % |
| Securities available for sale | **33,860** | **7.07** | | 46,513 | 9.03 | | 47,490 | 10.52 | |
| Federal funds sold | **12,000** | **2.51** | | 27,000 | 5.24 | | - | - | |
| Federal Home Loan Bank Stock | **3,423** | **.72** | | 3,794 | .74 | | 3,794 | .84 | |
| Interest-bearing deposits | **713** | **.15** | | 678 | .13 | | 582 | .13 | |
| Cash and due from banks | **22,719** | **4.75** | | 18,433 | 3.58 | | 10,112 | 2.24 | |
| Other assets | **29,508** | **6.16** | | 39,874 | 7.74 | | 23,450 | 5.19 | |
| Total | **$ 478,696** | **100.00** | % | $ 515,377 | 100.00 | % | $ 451,431 | 100.00 | % |

### Securities

The securities portfolio is an important component of the Corporation's asset composition to provide diversity in its asset base and provide liquidity. Securities decreased $12.653 million in 2010, from $46.513 million at December 31, 2009 to $33.860 million at December 31, 2010. This decrease in 2010 was largely attributable to paydowns on mortgage backed securities. The Corporation also sold $5 million of investments early in 2010 to reduce excess liquidity. In 2009, a net gain of $1.471 million was recorded in connection with the sale of approximately $45 million of investments. These investments were purchased early in 2009 as a short-term "leveraging" program in the deployment of a portion of the proceeds from the issuance of preferred stock in conjunction with the Corporation's participation in TARP. This "leveraging" program to increase investment securities was intended to offset the relatively high cost of the preferred stock. Management, along with the concurrence of the Board of Directors, deleveraged this position late in 2009.

The carrying value of the Corporation's securities is as follows at December 31 (dollars in thousands):

| | **2010** | 2009 |
|---|---|---|
| US Agencies - MBS | **$ 27,710** | $ 45,238 |
| US Agencies | **4,973** | - |
| Obligations of states and political subdivisions | **1,177** | 1,275 |
| Total securities | **$ 33,860** | $ 46,513 |

The Corporation's policy is to purchase securities of high credit quality, consistent with its asset/liability management strategies. The majority of the bank's current investments, $32.683 million or 97%, are highly marketable investments guaranteed by the U.S. government. The Corporation classifies all securities as available for sale, in order to maintain adequate liquidity and to maximize its ability to react to changing market conditions. At December 31, 2010, investment securities with an estimated fair market value of $14.462 million were pledged.

## Loans

The Bank is a full service lender and offers a variety of loan products in all of its markets. The majority of its loans are commercial, which represents approximately 78% of total loans outstanding at December 31, 2010.

The Corporation continued to experience strong loan demand in 2010 with approximately $114 million of new loan production, including $37 million of mortgage loans sold in the secondary market. At 2010 year-end, the Corporation's loans stood at $383.086 million, a slight decrease from the 2009 year-end balances of $384.310 million. The total outstanding loans declined by $1.2 million after reductions for loans sales, (both SBA/USDA and secondary market) amortization and payoffs, some associated with the elimination of problem assets. In 2010, the secondary mortgage loans that were produced and sold totaled $36.7 million while the SBA/USDA loan sales amounted to $12.6 million. The production of loans was distributed among the regions, with the Upper Peninsula at $81 million, $22 million in the Northern Lower Peninsula and $11 million in Southeast Michigan where the market has been hit the hardest by the recession.

Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with changes to the loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing. The Corporation is highly competitive in structuring loans to meet borrowing needs and satisfy strong underwriting requirements.

Following is a table that illustrates the balance changes in the loan portfolio from 2008 through 2010 year end (dollars in thousands):

| | | | | Percent Change | |
|---|---|---|---|---|---|
| | **2010** | 2009 | 2008 | **2010-2009** | 2009-2008 |
| Commercial real estate | **$ 194,859** | $ 208,895 | $ 185,241 | **(6.72)** % | 12.77 % |
| Commercial, financial, and agricultural | **68,858** | 72,184 | 79,734 | **(4.61)** | (9.47) |
| One-to-four family residential real estate | **75,074** | 67,232 | 65,595 | **11.66** | 2.50 |
| Construction | | | | | |
| Consumer | **5,682** | 7,118 | 4,852 | **(20.17)** | 46.70 |
| Commercial | **33,330** | 24,591 | 31,113 | **35.54** | (20.96) |
| Consumer | **5,283** | 4,290 | 3,745 | **23.15** | 14.55 |
| Total | **$ 383,086** | $ 384,310 | $ 370,280 | **(0.32)** % | 3.79 % |

Our commercial real estate loan portfolio predominantly relates to owner occupied real estate, and our loans are generally secured by a first mortgage lien. Commercial real estate market conditions continued to be under stress in 2010, and we expect this trend to continue. These conditions may negatively affect our commercial real estate loan portfolio in future periods. We make commercial loans for many purposes, including: working capital lines, which are generally renewable annually and supported by business assets, personal guarantees and additional collateral. Commercial business lending is generally considered to involve a higher degree of risk than traditional consumer bank lending.

Following is a table showing the composition of loans by significant industry types in the commercial loan portfolio as of December 31 (dollars in thousands):

| | **2010** | | | 2009 | | | 2008 | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Balance** | **% of Loans** | **% of Capital** | Balance | % of Loans | % of Capital | Balance | % of Loans | % of Capital |
| Real estate - operators of nonres bldgs | **$ 58,114** | **19.56 %** | **107.85 %** | $ 48,689 | 15.93 % | 88.05 % | $ 41,299 | 13.95 % | 99.39 % |
| Hospitality and tourism | **37,737** | **12.70** | **70.04** | 45,315 | 14.82 | 81.95 | 35,086 | 11.85 | 84.44 |
| Commercial construction | **33,330** | **11.22** | **61.86** | 24,591 | 8.04 | 44.47 | 31,113 | 10.51 | 74.88 |
| Operators of nonresidential buildings | **16,598** | **5.59** | **30.80** | 12,619 | 4.13 | 22.82 | 13,352 | 4.51 | 32.13 |
| Real estate agents and managers | **15,857** | **5.34** | **29.43** | 24,242 | 7.93 | 43.84 | 29,292 | 9.89 | 70.50 |
| Other | **135,411** | **45.59** | **251.31** | 150,214 | 49.15 | 271.64 | 145,946 | 49.29 | 351.24 |
| Total commercial loans | **$ 297,047** | **100.00 %** | | $ 305,670 | 100.00 % | | $ 296,088 | 100.00 % | |

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation's highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of 2010 year-end. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner-occupied developments.

Our residential real estate portfolio predominantly includes one-to-four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of December 31, 2010, our residential loan portfolio totaled $80.756 million, or 21.08% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from $3.184 million at the end of 2009 to $2.471 million at 2010 year-end. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

Due to the seasonal nature of many of the Corporation's commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer's business cycle. The lending staff evaluates the collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

## Credit Quality

The table below shows balances of nonperforming assets for the three years ended December 31 (dollars in thousands):

| **Nonperforming Assets:** | **2010** | 2009 | 2008 |
|---|---|---|---|
| Nonaccrual loans | **$ 5,921** | $ 14,368 | $ 4,887 |
| Accruing loans past due 90 days or more | **-** | - | - |
| Restructured Loans | **4,642** | 869 | - |
| Total nonperforming loans | **10,563** | 15,237 | 4,887 |
| Other real estate owned | **5,562** | 5,804 | 2,189 |
| Total nonperforming assets | **$ 16,125** | $ 21,041 | $ 7,076 |
| Nonperforming loans as a % of loans | **2.76 %** | 3.96 % | 1.32 % |
| Nonperforming assets as a % of assets | **3.37 %** | 4.08 % | 1.57 % |
| **Reserve for Loan Losses:** | | | |
| At period end | **$ 6,613** | $ 5,225 | $ 4,277 |
| As a % of loans | **1.73 %** | 1.36 % | 1.16 % |
| As a % of nonperforming loans | **62.61 %** | 34.29 % | 87.52 % |
| As a % of nonaccrual loans | **111.69 %** | 36.37 % | 87.52 % |

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and the bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes a loan review consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the 2010 independent review provided findings similar to management on the overall adequacy of the reserve. The Corporation will again utilize a consultant for loan review in 2011.

The following table details the impact of nonperforming loans on interest income for the three years ended December 31 (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| Interest income that would have been recorded at original rate | **$ 583** | $ 700 | $ 377 |
| Interest income that was actually recorded | **141** | 40 | 60 |
| Net interest lost | **$ 442** | $ 660 | $ 317 |

## Allowance for Loan Losses

Management analyzes the allowance for loan losses on a quarterly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs in 2010 amounted to $5.112 million, or 1.33% of average loans outstanding, compared to $2.752 million, or .73% of loans outstanding in 2009. In 2010, $2.342 million of the charge-offs resulted from three credit relationships in Southeast Michigan. The current reserve balance is representative of the relevant risk inherent within the Corporation's loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

A three year history of the Corporation's credit quality is displayed in the following table (dollars in thousands):

| **Allowance for Loan Losses** | **2010** | 2009 | 2008 |
|---|---|---|---|
| Balance at beginning of period | **$ 5,225** | $ 4,277 | $ 4,146 |
| Loans charged off: | | | |
| Commercial, financial & agricultural | **5,027** | 2,465 | 2,062 |
| One-to-four family residential real estate | **410** | 282 | 157 |
| Consumer | **48** | 71 | 71 |
| Total loans charged off | **5,485** | 2,818 | 2,290 |
| Recoveries of loans previously charged off: | | | |
| Commercial, financial & agricultural | **346** | 38 | 114 |
| One-to-four family residential real estate | **11** | 16 | - |
| Consumer | **16** | 12 | 7 |
| Total recoveries of loans previously charged off | **373** | 66 | 121 |
| Net loans charged off | **5,112** | 2,752 | 2,169 |
| Provision for loan losses | **6,500** | 3,700 | 2,300 |
| Balance at end of period | **$ 6,613** | $ 5,225 | $ 4,277 |
| Total loans, period end | **$ 383,086** | $ 384,310 | $ 370,280 |
| Average loans for the year | **384,347** | 374,796 | 361,324 |
| Allowance to total loans at end of year | **1.73 %** | 1.36 % | 1.16 % |
| Net charge-offs to average loans | **1.33** | .73 | .60 |
| Net charge-offs to beginning allowance balance | **97.84** | 64.34 | 52.32 |

The computation of the required allowance for loan losses as of any point in time is one of the critical accounting estimates made by management in the financial statements. As such, factors used to establish the allowance could change significantly from the assumptions made and impact future earnings positively or negatively. The future of the national and local economies and the resulting impact on borrowers' ability to repay their loans and the value of collateral are examples of areas where assumptions must be made for individual loans, as well as the overall portfolio.

The Corporation's computation of the allowance for loan losses follows the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations issued by the Federal Financial Institutions Examination Council (FFIEC) in July 2001. The computation of the allowance for loan losses considers prevailing local and national economic conditions as well as past and present underwriting practices.

At the end of 2010, the allowance for loan losses represented 1.73% of total loans. In management's opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of real estate collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate (dollars in thousands):

| | |
|---|---|
| **Balance at January 1, 2009** | $ 2,189 |
| Other real estate transferred from loans due to foreclosure | 4,879 |
| Reclassification of redemption ORE | (475) |
| Other real estate transferred to premises and equipment | - |
| Other real estate sold | (581) |
| OREO writedowns | (187) |
| Loss on OREO | (21) |
| **Balance at December 31, 2009** | 5,804 |
| Other real estate transferred from loans due to foreclosure | 5,373 |
| Reclassification of redemption ORE | - |
| Other real estate transferred to premises and equipment | - |
| Other real estate sold | (2,862) |
| OREO writedowns | (2,703) |
| Loss on OREO | (50) |
| **Balance at December 31, 2010** | $ 5,562 |

During 2010, the Corporation received real estate in lieu of loan payments of $5.373 million. In determining the carrying value of other real estate, the Corporation generally starts with a third party appraisal of the underlying collateral and then deducts estimated selling costs to arrive at a net asset value. After the initial receipt, management periodically re-evaluates the recorded balance and records any additional reductions in the fair value as a write-down of other real estate.

### Deposits

Total deposits at December 31, 2010 were $386.779 million, a decrease of $34.610 million, or 8.21% from December 31, 2009 deposits of $421.389 million. The table below shows the deposit mix for the periods indicated (dollars in thousands):

| | **2010** | **Mix** | 2009 | Mix | 2008 | Mix |
|---|---|---|---|---|---|---|
| Non-interest-bearing | **$ 41,264** | **10.67 %** | $ 35,878 | 8.51 % | $ 30,099 | 8.11 % |
| NOW, money market, checking | **134,703** | **34.83** | 95,790 | 22.73 | 70,584 | 19.02 |
| Savings | **17,670** | **4.57** | 18,207 | 4.32 | 20,730 | 5.59 |
| Certificates of Deposit <$100,000 | **96,977** | **25.07** | 59,953 | 14.23 | 73,752 | 19.87 |
| Total core deposits | **290,614** | **75.14** | 209,828 | 49.79 | 195,165 | 52.59 |
| Certificates of Deposit >$100,000 | **22,698** | **5.87** | 36,385 | 8.64 | 25,044 | 6.75 |
| Brokered CDs | **73,467** | **18.99** | 175,176 | 41.57 | 150,888 | 40.66 |
| Total non-core deposits | **96,165** | **24.86** | 211,561 | 50.21 | 175,932 | 47.41 |
| Total deposits | **$ 386,779** | **100.00 %** | $ 421,389 | 100.00 % | $ 371,097 | 100.00 % |

The decrease in deposits, as illustrated above, is composed of a decrease in noncore deposits of $115.396 million, while core deposits increased by $80.786 million.

Historically the Corporation's loan growth outpaced core deposit growth, which resulted in more reliance on brokered deposits as a source of funding. Management has increased its efforts to grow core deposits in recent years by introducing several new deposit products and implementing a bank-wide deposit incentive program. In 2010, the Corporation grew core deposits by $81 million with most of this growth occurring in lower cost transactional deposits.

During 2009, the increase in wholesale brokered deposits were in part utilized to enhance balance sheet liquidity and to fund the acquisition of investments purchased in the TARP leveraging program discussed earlier in this management discussion. At the end of 2009, the Corporation initiated the sale of approximately $39 million of its investment portfolio

to deleverage the balance sheet. Proceeds from the sale of these investments were used to pay off matured brokered deposits. In August 2009, the Bank sold two branch offices with core deposits of approximately $29 million. This strategic decision was in conjunction the bank's overall strategy to tighten its existing geographical footprint and concentrate its resources in the commercial hubs of the Upper Peninsula.

Management continues to monitor existing deposit products in order to stay competitive, both as to terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional accounts.

**Borrowings**

The Corporation also utilizes FHLB borrowings as a source of funding. At 2010 year end, this source of funding totaled $35 million, of which $20 million matured early in 2011 and was refinanced into longer term FHLB borrowings. Subsequent to the refinancing, the $25 million of FHLB borrowings had a weighted average maturity of 3.5 years.

**Shareholders' Equity**

Changes in shareholders' equity are discussed in detail in the "Capital and Regulatory" section of this report.

## *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

### Interest Rate Risk

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation's safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices, such as the prime rate or rates paid on various government issued securities. When loans are made with longer-term fixed rates, the Corporation attempts to match these balances with sources of funding with similar maturities in order to mitigate interest rate risk. In addition, the Corporation prices loans so it has an opportunity to reprice the loan within 12 to 36 months.

At December 31, 2010 the Bank had $33.860 million of securities, with a weighted average maturity of 15.8 months. The investment portfolio is intended to provide a source of liquidity to the Corporation with limited interest rate risk. The Corporation may also elect to sell monies as investments in federal funds sold to correspondent banks, and has other interest bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation offers deposit products with a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer-term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken, since the speed of change affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and, at the same time, maximize income.

Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/ liability ("ALCO") meetings, whose membership includes senior management, board representation and third party investment consultants. During these monthly meetings, we review the current ALCO position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following timeframes. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1 to 90 day timeframe. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following is the Corporation's repricing opportunities at December 31, 2010 (dollars in thousands):

| | 1-90 Days | 91-365 Days | >1-5 Years | Over 5 Years | Total |
|---|---|---|---|---|---|
| Interest-earning assets: | | | | | |
| Loans | $ 276,547 | $ 7,157 | $ 25,210 | $ 74,172 | $ 383,086 |
| Securities | 970 | 17,318 | 14,706 | 866 | 33,860 |
| Other [(1)] | 12,713 | - | - | 3,423 | 16,136 |
| Total interest-earning assets | 290,230 | 24,475 | 39,916 | 78,461 | 433,082 |
| Interest-bearing obligations: | | | | | |
| NOW, money market, savings and interest checking | 152,373 | - | - | - | 152,373 |
| Time deposits | 26,845 | 41,006 | 51,507 | 317 | 119,675 |
| Brokered CDs | 10,125 | 60,614 | - | 2,728 | 73,467 |
| Borrowings | 20,000 | 5,000 | 10,000 | 1,069 | 36,069 |
| Total interest-bearing obligations | 209,343 | 106,620 | 61,507 | 4,114 | 381,584 |
| Gap | $ 80,887 | $ (82,145) | $ (21,591) | $ 74,347 | $ 51,498 |
| Cumulative gap | $ 80,887 | $ (1,258) | $ (22,849) | $ 51,498 | |

[(1)] includes Federal Home Loan Bank stock

The above analysis indicates that at December 31, 2010, the Corporation had a cumulative liability sensitivity gap position of $1.258 million within the one-year timeframe. The Corporation's cumulative liability sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn less net interest income since more liabilities would reprice at higher rates than assets. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation's net interest income would increase. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or unexpected prepayments. In addition, the gap analysis treats savings, NOW and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2010, the Corporation had $276.547 million of variable rate loans that reprice primarily with the prime rate index. Approximately $160 million of these variable rate loans have interest rate floors. This means that the prime rate will have to increase above the floor rate before these loans will reprice. At year end, $66 million of these floor-rate loans would reprice with a 100 basis point prime rate increase, with $94 million repricing with an additional 100 basis point prime rate increase.

At December 31, 2009, the Corporation had a cumulative liability sensitivity gap position of $17.977 million within the one-year time frame.

The borrowings in the gap analysis include $20 million of FHLB advances that were refinanced early in 2011 into fixed rate advances. Subsequent to this refinancing, the $35 million total of FHLB borrowings then carried a weighted average maturity of 3.5 years.

The Corporation's primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets, and therefore, has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation's interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to

maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality. In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

The table below measures current maturity levels of interest-earning assets and interest-bearing obligations, along with average stated rates and estimated fair values at December 31, 2010 (dollars in thousands). Nonaccrual loans of $5.921 million are included in the table at an average interest rate of 0.00% and a maturity greater than five years.

| | Principal/Notional Amount Maturing/Repricing In: | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2014 | 2015 | Thereafter | Total | Fair Value 12/31/2010 |
| **Rate Sensitive Assets** | | | | | | | | |
| Fixed interest rate securities | $ 23,261 | $ 2,906 | $ 6,198 | $ 334 | $ 295 | $ 866 | $ 33,860 | $ 33,860 |
| Average interest rate | 3.85 % | 4.49 % | 5.55 % | 8.07 % | 3.13 % | 3.98 % | 4.25 % | |
| Fixed interest rate loans | 36,552 | 23,566 | 15,769 | 14,752 | 4,736 | 15,565 | 110,940 | 108,441 |
| Average interest rate | 6.00 | 6.68 | 6.57 | 5.62 | 6.33 | 6.14 | 6.16 | |
| Variable interest rate loans | 272,146 | - | - | - | - | - | 272,146 | 274,885 |
| Average interest rate | 5.08 | - | - | - | - | - | 5.08 | |
| Other assets | 12,713 | - | - | - | - | 3,423 | 16,136 | 16,136 |
| Average interest rate | .25 | - | - | - | - | 2.50 | .73 | |
| Total rate sensitive assets | $ 344,672 | $ 26,472 | $ 21,967 | $ 15,086 | $ 5,031 | $ 19,854 | $ 433,082 | $ 433,322 |
| Average interest rate | 4.90 % | 6.44 % | 6.28 % | 5.67 % | 6.14 % | 5.42 % | 4.88 % | |
| **Rate Sensitive Liabilities** | | | | | | | | |
| Interest-bearing savings, NOW, MMAs, interest checking | $ 152,373 | $ - | $ - | $ - | $ - | $ - | $ 152,373 | $ 152,373 |
| Average interest rate | .88 % | - % | - % | - % | - % | - % | - % | |
| Time deposits | 138,596 | 34,256 | 9,248 | 6,163 | 1,840 | 3,039 | 193,142 | 194,248 |
| Average interest rate | 1.86 | 2.06 | 2.76 | 3.01 | 3.14 | 3.45 | 2.01 | |
| Fixed interest rate borrowings | 5,000 | - | - | 10,000 | - | 1,069 | 16,069 | 16,230 |
| Average interest rate | .61 | - | - | 2.10 | - | 1.00 | 1.56 | |
| Variable interest rate borrowings | 20,000 | - | - | - | - | - | 20,000 | 20,004 |
| Average interest rate | .31 | - | - | - | - | - | .31 | |
| Total rate sensitive liabilities | $ 315,969 | $ 34,256 | $ 9,248 | $ 16,163 | $ 1,840 | $ 4,108 | $ 381,584 | $ 382,855 |
| Average interest rate | 1.27 % | 2.06 % | 2.76 % | 2.45 % | 3.14 % | 2.81 % | 1.42 % | |

## Foreign Exchange Risk

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking office in Sault Ste. Marie. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. As of December 31, 2010, the Corporation had excess Canadian liabilities of .106 million, which equated to approximately the same valuation in U.S. dollars. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation. Management intends to limit the Corporation's foreign exchange risk by acquiring deposit liabilities approximately equal to its Canadian assets.

### Off-Balance-Sheet Risk

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps or options. However, the Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised. See Note 17 to the consolidated financial statements for additional information.

### *LIQUIDITY*

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank's principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

During 2010, the Corporation decreased cash and cash equivalents by $10.714 million. As shown on the Corporation's consolidated statement of cash flows, liquidity was primarily impacted by cash provided by operating activities, resulting primarily from a reduction in other assets due to a settlement from the prior year sale of investment securities recorded as a receivable at 2009 year end. The net change in investing activities included a net increase in loans of $9.355 million and a "net" decrease in securities available for sale of $11.788 million. The net increases in assets were offset by a similar decrease in deposit liabilities of $34.610 million. This decrease in deposits was composed of a decrease in non-core deposits of $115.386 million combined with an increase in bank deposits of $80.776 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30 to 90 day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

The Bank's investment portfolio, most of which are guaranteed by the U.S. government, provide added liquidity during periods of market turmoil and overall liquidity concerns in the financial markets. As of December 31, 2010, $19.398 million of the Bank's investment portfolio was unpledged, which makes them readily available for sale to address any short term liquidity needs.

It is anticipated that during 2011, the Corporation will fund anticipated loan production with a combination of core-deposit growth and noncore funding, primarily brokered CDs.

The Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. The Bank is currently prohibited from paying dividends because of a deficit in retained earnings. The Bank, in order to pay dividends in future periods, will need regulatory approval. The Corporation is currently exploring alternative opportunities for longer term sources of liquidity and permanent equity to support projected asset growth.

Liquidity is managed by the Corporation through its Asset and Liability Committee ("ALCO"). The ALCO Committee meets monthly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank's liquidity is best illustrated by the mix in the Bank's core and non-core funding dependency ratio, which explains the degree of reliance on non-core liabilities to fund long-term assets. Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $100,000. Non-core funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and other borrowings. At December 31, 2010, the Bank's core deposits in relation to total funding were 68.73% compared to 45.86% in 2009. These ratios indicated at December 31, 2010, that the Bank has decreased its reliance on non-core deposits and borrowings to fund the Bank's long-term assets, namely loans and investments. The Bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate

liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of December 31, 2010, the Bank had $15.875 million of unsecured lines available and another $2.500 million available if secured. Management believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank's liquidity.

From a long-term perspective, the Corporation's liquidity plan for 2011 includes strategies to increase core deposits in the Corporation's local markets and will continue to augment local deposit growth efforts with wholesale CD funding, to the extent necessary.

The Corporation is considering whether or not to participate in the U.S. Treasury's Small Business Lending Fund program ("SBLF"). The Corporation has applied for funding under the SBLF, but has not yet received approval, nor has the Corporation determined if it will participate if approved. This SBLF program would allow the Corporation to pay off the TARP preferred and also requires an injection of capital into the Bank which is dependent upon the amount of the total SBLF funding less the $11 million of TARP preferred.

*CONTRACTUAL OBLIGATIONS AND COMMITMENTS*

As disclosed in the Notes to the Consolidated Financial Statements, the Corporation has certain obligations and commitments to make future payments under contracts. At December 31, 2010, the aggregate contractual obligations and commitments are (dollars in thousands):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| Contractual Obligations | Less than 1 Year | 1 to 3 Years | 4 to 5 Years | After 5 Years | Total |
| Total deposits | $ 332,233 | $ 43,504 | $ 8,003 | $ 3,039 | $ 386,779 |
| Federal Home Loan Bank borrowings | 25,000 | - | 10,000 | - | 35,000 |
| Preferred stock [1] | - | - | 11,000 | - | 11,000 |
| Other borrowings | - | - | - | 1,069 | 1,069 |
| Directors' deferred compensation | 123 | 246 | 216 | 323 | 908 |
| Annual rental / purchase commitments under noncancelable leases / contracts | 90 | 29 | - | - | 119 |
| TOTAL | $ 357,446 | $ 43,779 | $ 29,219 | $ 4,431 | $ 434,875 |
| Other Commitments | | | | | |
| Letters of credit | $ 2,192 | $ - | $ - | $ - | $ 2,192 |
| Commitments to extend credit | 31,126 | - | - | - | 31,126 |
| Credit card commitments | 2,737 | - | - | - | 2,737 |
| TOTAL | $ 36,055 | $ - | $ - | $ - | $ 36,055 |

**[1]The Corporation issued preferred stock in April of 2009 as part of its participation in TARP. The initial term of this preferred stock is five years with an interest rate of 5%, which increases to 9% after the initial term. Although there is no contractual obligation to do so, the Corporation intends to repay this obligation within the initial term.**

*CAPITAL AND REGULATORY*

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital, and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of December 31, 2010, the Corporation and the Bank were well capitalized. The Corporation is currently exploring its alternatives for the possible issuance of equity or debt in order to provide a broader base to support future asset growth. During 2010, total capitalization decreased by $1.417 million. Other changes in total capital occurred from recognition of net income and market value decrease of the Corporation's investment securities. During 2010, risk based capital decreased by $5.455 million, while Tier 1 Capital decreased by $5.164 million.

The decrease in capital was also impacted by the disallowed portion of the Corporation's deferred tax asset. The portion of the deferred tax asset which is allowed to be included in regulatory capital is only that portion that can be utilized within the next 12-month period. At December 31, 2010, the Corporation did not include any of the deferred tax asset in its Tier 1 or Total Risk Based Capital.

The following table details sources of capital for the three years ended December 31 (dollars in thousands):

| | **2010** | 2009 | 2008 |
|---|---|---|---|
| **Capital Structure** | | | |
| Common shareholders' equity | **$ 43,176** | $ 44,785 | $ 41,552 |
| Preferred stock | **10,706** | 10,514 | - |
| Total shareholders' equity | **53,882** | 55,299 | 41,552 |
| Total capitalization | **$ 53,882** | $ 55,299 | $ 41,552 |
| Tangible capital | **$ 53,882** | $ 55,299 | $ 41,506 |
| | | | |
| **Intangible Assets** | | | |
| Subsidiaries: | | | |
| Core deposit premium | **$ -** | $ - | $ 46 |
| Other identifiable intangibles | **-** | - | - |
| Total intangibles | **$ -** | $ - | $ 46 |
| | | | |
| **Risk-Based Capital** | | | |
| Tier 1 capital: | | | |
| Total shareholders' equity | **$ 53,882** | $ 55,299 | $ 41,552 |
| Net unrealized (gains) losses on available for sale securities | **(612)** | (1,093) | (445) |
| Less: disallowed deferred tax asset | **(9,028)** | (4,800) | (6,200) |
| Less: intangibles | **-** | - | (46) |
| Total Tier 1 capital | **$ 44,242** | $ 49,406 | $ 34,861 |
| Tier 2 Capital: | | | |
| Allowable reserve for loan losses | **$ 4,890** | $ 5,181 | $ 4,277 |
| Qualifying long-term debt | **-** | - | - |
| Total Tier 2 capital | **4,890** | 5,181 | 4,277 |
| Total risk-based capital | **$ 49,132** | $ 54,587 | $ 39,138 |
| **Risk-weighted assets** | **$ 389,468** | $ 414,440 | $ 376,986 |
| **Capital Ratios:** | | | |
| Tier 1 Capital to average assets | **9.25%** | 9.75% | 8.01% |
| Tier 1 Capital to risk-weighted assets | **11.36%** | 11.92% | 9.25% |
| Total Capital to risk-weighted assets | **12.62%** | 13.17% | 10.38% |

Regulatory capital is not the same as shareholders' equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes. The Corporation's acquisition intangibles and a portion of the deferred tax asset are examples of such assets, which was discussed earlier.
Presented below is a summary of the Corporation's and Bank's capital position in comparison to generally applicable regulatory requirements:

| | Equity to Year-end Assets | Tangible Equity to Year-end Assets | Tier 1 Capital to Average Assets | Tier 1 Capital to Risk Weighted Assets | Total Capital to Risk Weighted Assets |
|---|---|---|---|---|---|
| Regulatory minimum for capital adequacy purposes | N/A | N/A | 4.00% | 4.00% | 8.00% |
| Regulatory defined well capitalized guideline | N/A | N/A | 5.00% | 6.00% | 10.00% |
| **The Corporation:** | | | | | |
| **December 31, 2010** | **11.26%** | **11.26%** | **9.25%** | **11.36%** | **12.62%** |
| December 31, 2009 | 10.73% | 10.73% | 9.75% | 11.92% | 13.17% |
| **The Bank:** | | | | | |
| **December 31, 2010** | **10.22%** | **10.22%** | **8.09%** | **9.92%** | **11.18%** |
| December 31, 2009 | 9.38% | 9.38% | 8.38% | 10.24% | 11.49% |

The Corporation intends to maintain the Bank's Tier I Capital at 8% and total capital to risk-weighted assets at a minimum of 10.00% in order to qualify for reduced FDIC deposit based insurance.

## *IMPACT OF INFLATION AND CHANGING PRICES*

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation's operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation's performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation's performance. Changes in interest rates do not necessarily move to the same extent as changes in the prices of goods and services.

**(PAGE INTENTIONALLY LEFT BLANK)**

# Directors and Officers

## *DIRECTORS*

### *Mackinac Financial Corporation and mBank*

**Walter J. Aspatore - Lead Director**
Chairman
Amherst Partners
*Director Since: 2004*

**Dennis B. Bittner**
Owner and President
Bittner Engineering, Inc.
*Director Since: 2001*

**Joseph D. Garea**
Managing Partner
Hancock Securities
*Director Since: 2007*

**Kelly W. George**
President, Mackinac Financial Corporation
President and CEO, mBank
*Director Since: 2006*

**Robert E. Mahaney**
Sole Proprietor
Veridea Group, LLC
*Director Since: 2008*

**Robert H. Orley**
Vice President and Secretary
Real Estate Interests Group, Inc.
*Director Since: 2004*

**L. Brooks Patterson**
County Executive
Oakland County
*Director Since: 2006*

**Randolph C. Paschke**
Chairman, Department of Accounting
Wayne State University, School of Business Administration
*Director Since: 2004*

**Paul D. Tobias**
Chairman and CEO, Mackinac Financial Corporation
Chairman, mBank
*Director Since: 2004*

## *OFFICERS*

### *Mackinac Financial Corporation*

| Name | Title | Location |
|---|---|---|
| Paul D. Tobias | Chairman and Chief Executive Officer | Birmingham |
| Kelly W. George | President | Manistique |
| Ernie R. Krueger | EVP - Chief Financial Officer | Manistique |

### *mBank*

| Name | Title | Location |
|---|---|---|
| Bernadette C. Beaudre | AVP - Deposit Compliance Officer | Manistique |
| Shelby J. Bischoff | AVP - Business Development Officer | Marquette |
| Linda K. Bolda | VP - Human Resources | Manistique |
| Jesse A. Deering | First VP - SEM Executive | Birmingham |
| Kevin D. Evans | SVP - Retail Sales Management | Newberry |
| Jeremy W. Flodin | VP - Sr. Credit Admin/Credit Risk Analyst | Manistique |
| Laura L. Garvin | VP - Commercial Banking Officer | Birmingham |
| Kelly W. George | President and CEO | Manistique |
| Clarice A. Ghiardi | VP - Mortgage/Consumer Banking Officer | Marquette |
| Robert C. Henry | VP - Commercial Banking Officer | Traverse City |
| Ernie R. Krueger | EVP - Chief Financial Officer | Manistique |
| David W. Leslie | VP - Commercial Banking Officer | Birmingham |
| Boris Martysz | SVP - Marquette Market Executive | Marquette |
| Tamara R. McDowell | EVP - Chief Credit and Operations Officer | Manistique |
| Jacquelyn R. Menhennick | SVP - Mortgage and Consumer Lending Manager | Marquette |
| Kevin J. Negri | VP - Commercial Banking Officer | Marquette |
| Barbara A. Parrett | AVP - Branch Sales Manager/Retail Banking Officer | Stephenson |
| Debra L. Peterson | VP - Branch Sales Manager/Mortgage-Consumer Banking Officer | Escanaba |
| Scott A. Ravet | VP - Commercial Banking Officer | Manistique/Escanaba |
| Andrew P. Sabatine | Regional President - NLP | Traverse City |
| Gregory D. Schuetter | First VP - Commercial Lending Manger | Manistique |
| Joanna B. Slaght | SVP - Compliance/Risk Manager | Manistique |
| Michael A. Slaght | VP - Branch Sales Manager/Commercial Banking Officer | Newberry |
| Jennifer A. Stempki | VP - Assistant Controller | Manistique |
| Ann M. Stepp | SVP - Branch Administration/Inc Program Officer | Gaylord |
| Daniel L. Stoudt | AVP - Mortgage Loan Officer | Traverse City |
| David R. Thomas | VP - Commercial Banking Officer | Sault Ste. Marie |
| Timothy J. Timmer | VP - Commercial Banking Officer | Gaylord |
| Paul D. Tobias | Chairman | Birmingham |
| Janet M. Willbee | AVP - Mortgage Loan Officer | Gaylord |

# Corporate Information

***CORPORATE HEADQUARTERS***
Mackinac Financial Corporation
130 South Cedar Street
Manistique, Michigan 49854
(888) 343-8147

***TRANSFER AGENT***
Registrar and Transfer Company
10 Commerce Drive
Cranford, NJ 07016
(800) 368-5948

***INVESTOR RELATIONS***
(888) 343-8147

***WEBSITE***
www.bankmbank.com

***INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM***
Plante and Moran, PLLC
Grand Rapids, Michigan

***STOCK LISTING AND SYMBOL***
NASDAQ Capital Market
Symbol: MFNC

***SHAREHOLDER INFORMATION***
Copies of the Corporation's 10-K and 10-Q reports as filed with the Securities and Exchange Commission are available upon request from the Corporation.

***ANNUAL SHAREHOLDERS' MEETING***
The 2011 Annual Meeting of the Shareholders of Mackinac Financial Corporation will be held on May 25, 2011.

***Visit our website, www.bankmbank.com, for updated news releases, financial reports, SEC filings, corporate governance and other investor information.***

Mackinac Financial

**130 South Cedar Street**
**Manistique, MI  49854**