March 28, 2009

To My Fellow Stockholders,

On behalf of the Directors and employees of Sturgis Bancorp, Inc. and Sturgis Bank & Trust Company, I am pleased to provide a copy of our 2008 Annual Report. In this Annual Report you will find many key ratios and measures of performance. I encourage you to study this information and participate as a shareholder. If you do not understand information contained in this Annual Report, or have suggestions, do not hesitate to contact me or our CFO, Brian Hoggatt at (269)651-9345.

Many stockholders, customer and community members are asking if we are impacted by all they are hearing on the news. This is not an easy question to answer. Certainly we are impacted by economic cycles. Our business revolves around credit risk. When the economy contracts, there is more risk in the loan portfolio. However, we did not own any Freddie Mac or Fannie May stock. We did not participate in "sub-prime" lending. We have not purchased any of the "toxic assets" that are weighing down larger bank balance sheets. In short, we are not experiencing the difficulties of many banks. We stayed true to traditional bank underwriting standards and have carefully managed our loan portfolio so we are not concentrated in one loan category. We have a relatively modest number of land development loans. These are some of the most troubling loans for community banks in Michigan. Our exposure is limited and at the present time we have only one of these loans that is not performing as expected. I am happy to report the customer is committed to working out of this loan and it is secured. Hopefully the economy will recover as our Federal Reserve Chairman predicts.

Our net income for 2008 was $2.3 million, or $1.13 per share, compared with net income of $3.3 million, or $1.43 per share, for the record year in 2007. Management continues to focus on diversifying the sources of income in an effort to reduce our reliance on only interest margin. This has been accomplished with the addition of a full service Trust Department and Investment Services subsidiary. Despite the downturn in the economy, noninterest income decreased only $112,000. Mortgage banking activities increased for 2008, especially in the fourth quarter, as mortgage rates decreased.

Total assets increased to $383.4 million at December 31, 2008 from $347.2 million at December 31, 2007. The growth included $31.9 million in securities and $10.7 million in loans. The growth in securities was in the highest credit quality available, backed by the full faith and credit of the U.S. Government. Loan growth was primarily in commercial loans. Asset quality remains relatively strong, despite a weak Michigan economy.

Management has focused on continued asset quality measures and balance sheet composition. Over the last twelve months, the Company increased deposit accounts by $17.4 million, including $7.1 million of non-interest bearing accounts. The Bank continues to focus on commercial banking relationships and increasing the number of checking accounts. Commercial deposit accounts and consumer checking accounts typically generate higher fee income and are a lower cost source of funding, compared to brokered CDs and borrowed funds. This focus continues in 2009.

Equity appreciation, preservation and management are especially important in weak economic times. During the year ended December 31, 2008, the Company successfully concluded its stock redemption program with $3.8 million of additional stock repurchased. The Bank plans to maintain its "well capitalized" position, while continuing to focus on growth in the deposit base and quality loans.

While the economic forecasts for Michigan and the real estate markets remain pessimistic for 2009, Management is committed to holding its course. We believe the adjustments we have made over the last few years are gaining momentum. Our primary market is a diversified business environment. We are well diversified in our loan portfolio and focused on continuing our emphasis on credit quality. As investments mature, we will seek to redeploy those funds in quality local lending relationships.

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

Although net income decreased from our 2007 record year, I am still proud of the 2008 performance. The decrease was primarily due to lower market interest rates, rather than credit losses. We expect 2009 will continue challenging times for the banking industry. We do not believe our Bank will be an exception, although we also believe we are well positioned to weather the storm and participate in the recovery. We understand the challenges in our markets, and Management is prepared to address those challenges. Management is confident we have implemented a strong strategic plan and is committed to long-term financial performance. The Bank is staffed with a very strong branch team and experienced lending staff. We continue to evaluate growth opportunities, although profitable growth through branch acquisition or de novo branching is rare in a weak economy.

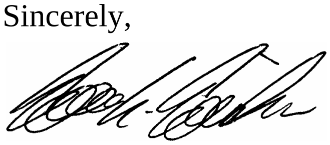
In summary, our Bank continues to produce sound core earnings and we are focused on growing shareholder value, being a responsible corporate citizen and providing a work environment based on integrity and service. We look forward to our continuing role as the leading financial institution in St. Joseph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

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

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

I hope to see you at our annual meeting.

Sincerely,



Eric L. Eishen President/CEO

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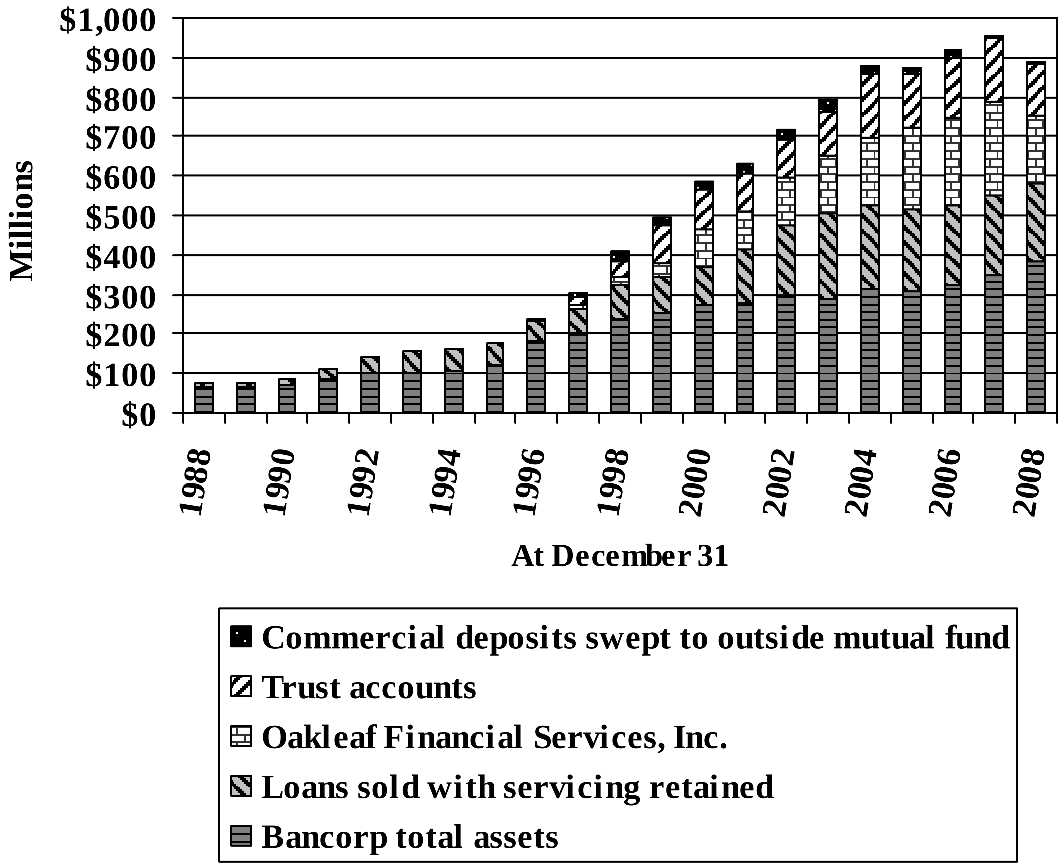
SELECTED FINANCIAL DATA

	At December 31,				
	2008	2007	2006	2005	2004
Total assets	$383,394	$347,202	$320,858	$307,515	$313,561
Cash and investment securities	17,539	28,191	29,463	22,085	25,628
Loans and loans held for sale	282,445	270,845	241,751	236,749	236,496
Mortgage -backed securities	49,407	15,880	19,590	18,337	22,685
Allowance for loan losses	2,838	2,699	2,523	2,287	2,616
Deposits	237,517	220,122	216,134	213,593	211,164
Short-term borrowings	7,287	-	-	-	9,259
Long-term borrowings	79,000	83,000	61,000	51,000	46,903
Repurchase agreements	30,500	13,000	13,000	13,400	15,000
Stockholders' equity	25,750	27,680	27,549	26,608	28,663
Book Value per share	12.76	12.20	11.40	10.65	10.53
Shares outstanding (actual number)	2,017,245	2,268,607	2,416,511	2,498,064	2,723,260

	Year Ended December 31,				
	2008	2007	2006	2005	2004
Interest income	$20,483	$21,703	$19,610	$16,904	$14,896
Interest expense	10,239	10,267	8,425	7,181	6,338
Provision for loan losses	489	513	493	371	812
Noninterest income	4,775	4,885	4,438	4,394	4,283
Noninterest expense	11,626	10,983	10,599	9,907	9,450
Federal income tax	598	1,481	1,380	1,137	865
Net income	2,306	3,344	3,151	2,702	1,715
Earnings per share (basic)	1.13	1.43	1.29	1.06	0.62
Earnings per share (diluted)	1.13	1.43	1.29	1.06	0.62
Cash dividends per share	0.48	0.53	0.45	0.38	0.36
Dividend payout ratio	37.33%	36.97%	34.93%	35.39%	58.06%
Equity/Assets ratio	6.72%	7.97%	8.59%	8.65%	9.14%
Return on assets	0.62%	1.00%	1.02%	0.86%	0.56%
Return on equity	9.14%	12.04%	11.66%	10.16%	5.93%
Weighted average shares					
outstanding (actual number):					
Basic	2,047,114	2,340,269	2,466,823	2,546,648	2,762,294
Diluted	2,047,114	2,340,554	2,449,643	2,550,030	2,767,603

Gross Assets Managed



This graph illustrates the growth of relationships for the Company since 1988. Each of these relationships indicates a point of contact with customers. The account values for Trust accounts and accounts at Oakleaf Financial Services, Inc. both decreased in 2008 with the recession.

Branch acquisitions with related deposits assumed are shown below:

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

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

CORPORATE YEAR IN REVIEW

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

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

Although the Bank's primary business has historically been and will continue to be the origination of first mortgage loans on 1-4 family unit homes, it has implemented strategies in the last few years that have increased commercial real estate and small business loans within its primary market area. Commercial loan growth remained strong during 2008. In 2008 and 2007, the Bank supplemented commercial loan growth by purchasing commercial nonmortgage loans from other financial institutions. The purchased loans have credit guarantees backed by the full faith and credit of the U.S. Government (USDA).

In 2008, the Bank began operations at an additional branch location in South Haven. The Bank also added additional ATM locations in Mendon and Three Rivers MI.

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

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

Forward Looking Statements

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

Results of Operations

Bancorp reported net income of $2.3 million and $3.3 million for the years ended December 31, 2008 and 2007, respectively. Earnings per share were $1.13, and $1.43 for the years ended December 31, 2008 and 2007, respectively. Net interest income decreased $1.2 million, and was the primary component of the decrease in net income. The increase in noninterest expense to $11.6 million in 2008 from $11.0 million in 2007 is primarily due to salaries and employee benefits, including commission-based compensation.

Interest Income

Interest income decreased $1.2 million to $20.5 million from $21.7 million. This decrease is primarily due to the decrease in market interest rates, with adjustable rate loans resetting lower throughout 2008. Average interest-earning assets increased to $336.6 million in 2008 from $294.9 million in 2007, primarily due to investment and loan growth. The average interest rate earned on loans decreased to 6.43% in 2008 from 7.72% in 2007. This decrease in the average interest rate earned is primarily due to adjustable rate loans repricing lower through 2008. Most commercial loans are priced on a variable basis and the expansion of non-interest bearing commercial deposit accounts will help to reduce the average funding costs. The average yield on interest-earning assets decreased to 6.09% in 2008 from 7.36% in 2007.

Interest Expense

Interest expense decreased $28,000 to $10.2 million in 2008 from $10.3 million in 2007. This was primarily due to the decrease in average interest rates on interest-bearing liabilities to 3.17% in 2008 from 3.65% in 2007. The average rate paid on interest-bearing deposits was 2.66% in 2008, compared to 3.14% in 2007. The average rate paid on borrowed funds decreased to 4.22% in 2008 from 4.99% in 2007. Average interest-bearing liabilities increased to $322.5 million in 2008 from $280.9 million in 2007.

Net Interest Income

Net interest income for the year ended December 31, 2008 was $10.2 million compared to $11.4 million for the year ended December 31, 2007, a decrease of $1.2 million. This decrease was caused primarily by a decrease in net interest margin, which decreased to 3.04% in 2008 from 3.88% in 2007

Average Balances, Interest Rates and Yields. Net interest income is affected by the difference ("interest rate spread") between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities and the relative amounts of interest-bearing liabilities and interest-earning assets. When the total of interest-earning assets approximates or exceeds the total of interest-bearing liabilities, any positive interest rate spread will generate net interest income. Financial institutions have traditionally used interest rate spreads as a measure of net interest income. Another indication of an institution's net interest income is its "net yield on interest-earning assets" or "net interest margin," which is net interest income divided by average interest-earning assets. The Bank's net interest margin for 2008 and 2007 was, 3.04% and 3.88%, respectively. The Bank has generally positioned itself for net interest income to increase with rising interest rates, with most loans adjusting with changes in related indices. The Bank's interest-earning assets reprice at a faster pace than interest-bearing liabilities. A benefit to the positive gap strategy is the protection from unusually high market interest rates. The most significant risk to the positive gap strategy is decreases in market interest rates.

(In thousands)

Average Balances and Interest Rates
Year Ended December 31,

	2008			2007		
	Average Outstanding Balance	**Interest Earned/ Paid**	**Yield/ Rate**	**Average Outstanding Balance**	**Interest Earned/ Paid**	**Yield/ Rate**
Interest-Earning Assets:						
Loans (1)	$ 277,052	$ 17,817	6.43%	$ 252,369	$ 19,493	7.72%
Mortgage-backed securities	31,984	1,606	5.02%	17,612	926	5.26%
Investment securities (2)	6,496	224	3.45%	7,056	320	4.54%
Interest-bearing deposits	21,067	836	3.97%	17,843	964	5.40%
Total interest-earning assets	$ 336,599	$ 20,483	6.09%	$ 294,880	$ 21,703	7.36%
Interest-Bearing Liabilities:						
Deposits	$ 216,887	$ 5,779	2.66%	$ 202,925	$ 6,374	3.14%
FHLB advances and repurchase agreements	105,660	4,460	4.22%	78,003	3,893	4.99%
Total interest-bearing liabilities	$ 322,547	$ 10,239	3.17%	$ 280,928	$ 10,267	3.65%
Net interest income		$ 10,244			$ 11,436	
Interest rate spread			2.92%			3.71%
Net interest-earning assets	$ 14,051			$ 13,952		
Net interest margin			3.04%			3.88%

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

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

	December 31,	
	2008	**2007**
Weighted average rate:		
Loans	5.86%	7.46%
Mortgage-backed securities	5.39%	5.56%
Investments(1)	4.47%	4.51%
Interest-bearing deposits	4.28%	5.24%
All interest-earning assets	5.72%	7.20%
Weighted average cost:		
Deposits (interest-bearing)	2.27%	3.18%
FHLB advances other borrowings	3.40%	4.87%
All interest-bearing liabilities	2.67%	3.72%
Interest rate spread	3.05%	3.48%

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

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

	(In thousands)					
	Year Ended December 31, 2008 vs 2007 Increase (Decrease) Due To:			Year Ended December 31, 2007 vs 2006 Increase (Decrease) Due To:		
Interest Income:	Volume	Rate	Total	Volume	Rate	Total
Loans	$ 1,789	$ (3,465)	$ (1,676)	$ 1,081	$ 430	$ 1,511
Mortgage-backed securities	723	(43)	680	(32)	124	92
Investment securities	(24)	(72)	(96)	(15)	(39)	(54)
Interest-bearing deposits	155	(283)	(125)	481	63	544
Total interest-earning assets	2,643	(3,863)	(1,220)	1,515	578	2,093
Interest Expense:						
Deposits	418	(1,013)	(595)	195	807	1,002
FHLB advances and borrowings	1,232	(665)	567	688	152	840
Total interest-bearing liabilities	1,650	(1,678)	(28)	883	959	1,842
Net Interest Income	$ 993	$ (2,185)	$ (1,192)	$ 632	$ (381)	$ 251

Provision for Loan Losses

The provision for loan losses was $489,000 for the year ended December 31, 2008 and $513,000 for the year ended December 31, 2007, a decrease of $24,000. The provision for loan losses was based upon management's assessment of relevant factors, including types and amounts of non-performing loans, historical and anticipated loss experience on such types of loans, and economic conditions. Loans charged off during 2008, net of recoveries, were $350,000, compared to $337,000 during 2007.

Nonperforming loans increased to $3.6 million at December 31, 2008 from $3.0 million at December 31, 2007. This increase in nonperforming loans includes one residential land development loan for $1.6 million, which is well-secured.

The allowance for loan losses as a percentage of total (gross) loans increased to 1.00% in 2008 from 0.99% in 2007. This increase is primarily due to a change in the mix of the Bank's loan portfolio. Management monitors the increasing exposure to commercial lending and economic developments the Bank's market area, among other factors, in determining appropriate provisions to the allowance for loan losses.

Noninterest Income

Noninterest income was $4.8 million in 2008, compared to $4.9 million in 2007. The primary components of the decrease in noninterest income were gain on sale of real estate owned and service charges. Mortgage banking activities increased $257,000 to $892,000 in 2008 from $635,000 in 2007. This increase is related to the increase in loan sales to $23.3 million in 2008 from $17.5 million in 2007. The increase in loan sales is due to lower market interest rates, which accelerated refinance activity. Commission income from brokerage activities continue to grow at the Company. Commission income, which is influenced by the U.S. economy and stock market values, was 33.2% of noninterest income in 2008, compared to 32.9% of non-interest income for 2007. Management expects brokerage commissions will continue to be a large component of noninterest income.

Noninterest Expense

Noninterest expense was $11.6 million in 2008, compared to $11.0 million in 2007, an increase of $668,000. The largest component of the increase was compensation and related expenses, which increased $203,000 to $7.0 million in 2008 from $6.8 million in 2007. Annual salary adjustments and staffing for the new South Haven branch office contributed to the increase in compensation. The service bureau data processing expenses increased $134,000 to $818,000 in 2008 from $684,000 in 2007, which supported the new South Haven branch office and two new ATM locations. The FDIC deposit insurance premiums paid in 2008 were $171,000, compared to $26,000 in 2007. During 2008, Bancorp realized $42,000 loss on sale of $11.5 million of available-for-sale securities, with the proceeds reinvested at market rates. At December 31, 2008, goodwill was not impaired. Management actively minimizes noninterest expense, although certain noninterest expenses are outside of Management's direct control. Management expects salaries and employee benefits to increase by approximately 3% annually.

The effective federal income tax rate was 20.6% in 2008 and 30.7% in 2007.

Financial Condition

General. Bancorp's total assets at December 31, 2008 were $383.4 million compared to $347.2 million at December 31, 2007, an increase of $36.2 million or 10.4%. Most of the increase in total assets was in available for sale securities.

Loans. Net loans increased to $280.9 million at December 31, 2008 from $270.2 million at December 31, 2007. Residential mortgages and residential construction loans decreased $3.8 million, as residential borrowers preferred fixed-rate loans in the lower market rates of 2008. The Bank sells long-term, fixed rate, residential mortgages in the secondary market. The major buyers of these loans are Federal Home Loan Mortgage Corporation (FHLMC) and FHLB. Commercial loans, including net commercial construction loans, increased to $123.5 million, or 43.6% of gross loans at December 31, 2008 from $108.5 million, or 39.8% of gross loans, at December 31, 2007. The proceeds from sales of loans (fixed-rate, residential mortgages) were $23.3 million and $17.5 million for the years ended December 31, 2008 and 2007, respectively.

The mortgage loans originated for sale ($23.9 million in 2008 and $17.8 million in 2007) were primarily funded by the secondary mortgage market sales. The decision to sell fixed-rate mortgages with original maturities of 10-years or greater protects the Bank from the interest rate risk inherent in holding these longer term, fixed-rate loans and provides a source of liquidity to fund loan demand. Reductions in market interest rates generally increase the pace of refinance activity in the residential loan portfolio.

At December 31, 2008, outstanding commitments to originate loans were $8.0 million and $75.9 million on fixed and variable-rate loans, respectively. Of these loan commitments, Management expects $3.9 million to be disbursed for new loans during the first half of 2009. The additional loan commitments are unused lines of credit, which may be drawn at any time by the borrower. These loan commitments will be funded by interest-bearing deposits, maturing assets, and additional FHLB borrowings, if needed.

Loans serviced for others was $194.8 million and $199.8 million at December 31, 2008 and 2007, respectively. This servicing portfolio consists of loan originated by the Bank and sold in the secondary mortgage market with servicing retained by the Bank. Management believes retaining servicing provides the Bank with a competitive advantage in its market. The retention of servicing requires the Bank to keep a higher staffing level than if the servicing would be sold. But many consumers have discovered the difficulties encountered when loan servicing is sold. The retention of servicing also allows the Bank to cross-sell other banking products and services to these customers. The value of the right to service is appraised quarterly and any temporary impairment of the value of servicing rights is recognized quarterly. The originated mortgage servicing rights asset required a valuation allowance of $35,000 at December 31, 2008. The Bank will continue to monitor the valuation of the servicing rights asset. If subsequent analysis shows changes in the appraised impairment, the valuation allowance will be adjusted to match the impairment.

Bancorp has no purchased mortgage servicing portfolio.

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

	(Dollars in thousands) Year Ended December 31,	
	2008	2007
Balance at the beginning of the period	$ 2,699	$ 2,523
Charge-offs:		
Residential mortgages	117	143
Commercial mortgages	206	75
Commercial nonmortgage loans	49	85
Other consumer and installment loans	11	133
Total charge-offs	383	436
Recoveries		
Residential mortgages	7	-
Commercial mortgages	-	-
Commercial nonmortgage loans	5	62
Other consumer and installment loans	21	37
Total recoveries	33	99
Net charge-offs	350	337
Provision for loan losses	489	513
Balance at the end of the period	$ 2,838	$ 2,699
Ratio of net charge-offs during the period to average loans outstanding during the period	0.13%	0.13%
Allowance for loan losses to total (gross) loans	1.00%	0.99%
Nonperforming assets to total assets	1.43%	1.21%
Allowance for loan losses to nonperforming assets	51.68%	63.98%

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

	(Dollars in thousands) As of December 31, 2008		2007	
	Amount	Percent of Loans in Each Category To Total Loans	Amount	Percent of Loans in Each Category To Total Loans
Residential mortgages	$1,199	53.24%	$ 849	57.18%
Commercial loans	1,493	43.98%	1,670	39.80%
Other consumer and installment	146	2.78%	180	3.02%
Total allowance for loan losses	$2,838	100.00%	$2,699	100.00%

Loans in nonaccrual status at December 31, 2008 were $3.2 million, up from $2.2 million at December 31, 2007. The increase in nonaccrual loans was primarily due to one residential land development loan, which is well secured. The following table presents the aggregate amount of troubled asset categories as of the dates indicated:

	(Dollars in thousands) December 31, 2008	2007
Past due – 90 days or greater	$ 391	$ 874
Nonaccrual loans	3,188	2,193
Real estate owned	1,913	1,702
Total nonperforming assets	5,492	4,769
Restructured assets	-	-
Total troubled assets	$5,492	$4,769
Ratio of troubled assets to total loans	1.96%	1.75%
Ratio of troubled assets to total assets	1.43%	1.37%

Interest-earning Deposits in Banks. Interest-bearing deposits in banks were $9.3 million at December 31, 2008, compared to $11.2 million at December 31, 2007, a decrease of $1.9 million. This decrease was invested in loans and securities.

Securities – Available for sale. Investment securities available for sale of $41.9 million at December 31, 2008 and $14.4 million at December 31, 2007 consisted primarily of mortgage-backed securities issued by the GNMA, FNMA, and FHLMC. The Bank's investment strategy has historically been to carry its mortgage-backed securities in the held-to-maturity portfolio. Management has changed this strategic decision, so that a balanced investment portfolio can more directly contribute to future liquidity needs, by being carried as available-for-sale. During 2007, the Bank sold $11.5 million of its available-for-sale securities at a loss of $42,000. Proceeds of the sale were reinvested in available-for-sale securities at market rates.

Securities – Held-to-maturity. At December 31, 2008 and December 31, 2007, investment securities held-to-maturity consist of U.S agency mortgage-backed securities and municipal obligations. The investment securities held-to-maturity were $8.8 million at December 31, 2008 compared to $4.4 million at December 31, 2007, an increase of $4.4 million. The increase was in mortgage-backed securities guaranteed by the Small Business Association (full faith and credit of the U. S. Government).

Deposits and Borrowed Funds. Deposits were $237.5 million at December 31, 2008 compared to $220.1 million at December 31, 2007, an increase of $17.4 million or 7.9%. Interest-bearing deposits increased to $211.8 million at December 31, 2008 from $201.5 million at December 31, 2007. Certificates of deposit with balances greater than or equal to $100,000 (commonly referred to as jumbo certificates), which carry greater interest rate sensitivity, decreased by $5.1 million to $21.5 million at December 31, 2008 from $26.6 at December 31, 2007. Other certificates of deposit, including brokered certificates of deposit parsed into $1,000 increments, increased to $85.4 million at December 31, 2008 from $80.0 million at December 31, 2007. Brokered certificates of deposit, mostly included in the certificates under $100,000, decreased to $37.3 million at December 31, 2008 from $29.8 million at December 31, 2007. The Bank uses brokered and jumbo certificates as sources of liquidity. Transaction savings accounts and checking accounts increased $9.9 million, or 9.5%, from December 31, 2007 to December 31, 2008. Transaction savings accounts and checking accounts represent 44.15% of deposits at December 31, 2008, compared to 51.58% of deposits at December 31, 2007. Bank management is actively attempting to increase these core deposit account relationships. Transaction savings accounts and checking accounts provide relatively inexpensive funding for future growth, compared to alternative certificates of deposit and borrowed funds at higher interest rates. The Bank offers competitive rates on its time deposits and uses jumbo certificates or borrowed funds, when that strategy enhances net interest income.

The Bank has an available line of credit with FHLB which provides for advances up to $5.0 million and matures annually in March. The Bank anticipates renewal of the line of credit at maturity in March 2009. All borrowings from FHLB are collateralized by substantially all mortgage loans and securities backed by the US Government.

Long-term advances were $79.0 million at December 31, 2008 compared to $83.0 million at December 31, 2007, a decrease of $4.0 million. No short-term advances were outstanding at December 31, 2008 or 2007. The Bank also had $5.1 million of fed funds purchased at December 31, 2008.

At December 31, 2008, Bancorp had $2.2 million outstanding on a closed-end line of credit with another financial institution. The line of credit matures in August 2009.

Capital Resources

The stockholders' equity of the Bancorp was $25.8 million at December 31, 2008 compared to $27.7 million at December 31, 2007, a decrease of $1.9 million, or 6.97%. The primary components of this decrease was the stock repurchase program, which successfully concluded in the first quarter of 2008. Bancorp repurchased $3.8 million of common stock in 2008 and $2.2 million in 2007. Cash dividends of $970,000, or $0.48 per share, were paid in 2008, out of the $2.3 million of net income. The stockholders' equity was 6.72% of total assets at December 31, 2008. Management continues to monitor and evaluate the best capital structure of Bancorp. A structure that provides sufficient capital to fund future growth, yet maximizes earnings per share, is deemed optimal. Management does not project a need for capital beyond what can be provided by retained earnings.

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

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

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

Management deems the current capitalization level adequate for current and anticipated strategies. Management does not expect Bancorp to grow in the foreseeable future to the $500 million asset level.

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

		December 31, 2008	December 31, 2007
Equity to assets		6.7%	8.0%
Tier I leverage		5.5%	6.7%
Risk-based:	Tier I capital	8.8%	9.6%
	Total capital	9.9%	10.8%

The change in capital ratios of Bancorp from December 31, 2007 to December 31, 2008 is primarily the result of the common stock repurchased.

Asset/Liability Management

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

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

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

The Bank measures its exposure to interest rate fluctuations primarily by using a computer modeling software designed for financial institutions, such as the Bank. The model uses assumptions which Management believes are reasonable for the analysis. These assumptions include (but are not limited to) prepayment and decay rates. Because of the Bank's smaller loan population, these assumptions are based on national statistics and may not reflect the Bank's own experience. It allows the Bank to simulate its asset-liability sensitivity based on the interest rate risk identified. The analysis estimates the changes in the market value of the Bank's equity using immediate and permanent interest rate change scenarios ranging from +4% to –4%, in 1% increments from current market rates. The software also allows simulation for unlimited additional market interest rate scenarios. At December 31, 2008, the following table illustrates the interest rate sensitivity of the Bank's consolidated equity to immediate and permanent changes in market interest rates.

(in Thousands of Dollars)	
Book value of Bank's equity	$28,210
4% increase in market rates	33,057
3% increase in market rates	34,812
2% increase in market rates	37,149
1% increase in market rates	38,048
No change (current market value of equity)	39,175
1% decrease in market rates	N/A
2% decrease in market rates	N/A
3% decrease in market rates	N/A
4% decrease in market rates	N/A

As the table shows, the Bank's estimated market value of equity exceeds book value in most of the relevant scenarios (market rates can not drop below 0%). That indicates that the Bank is able to withstand fluctuations in market interest rates without posting a significant threat to either the Bank's stockholders' equity or the federal deposit insurance system, and therefore, the Bank can be deliberate in its actions to adjust the asset-liability mix. The Bank would meet the regulatory minimum capital requirements in all of the interest-rate scenarios.

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

Effect of Interest Rate Fluctuations

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

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

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

Liquidity

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

As equity markets decreased through 2008, deposit customers have been attracted to Bank deposits from uninsured alternatives, such as money market accounts or other investments. If market interest rates remain historically low, Management expects depositors might unwisely look to more risky investments than Bank deposits to increase their return.

Contractual Obligations

The long-term debt obligations consist of certificates of deposit and advances from the Federal Home Loan Bank. The following schedule represents only scheduled principal payments as of December 31, 2008.

	Payments Due by Period (in thousands)				
	Total	Less than 1 year	1 – 3 years	4 – 5 Years	After 5 years
Certificates of deposit	$106,947	$61,054	$37,726	$ 7,952	$ 215
FHLB advances	79,000	25,500	33,500	12,500	7,500
Total contractual obligations	$185,947	$86,554	$71,226	$20,452	$ 7,715

Off-balance Sheet Activities

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

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

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

At December 31, 2008, the Bank had total commitments to originate loans of $8.0 million and $75.9 million on fixed rate and variable rate loans, respectively.

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

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

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

Impact of Inflation

The majority of assets and liabilities of financial institutions are monetary in nature. Generally, changes in interest rates have a more significant impact on earnings of the Bank than inflation. Although influenced by inflation, changes in rates do not necessarily move in either the same magnitude or direction as changes in the price of goods and services. Inflation could impact the growth of total assets, creating a need to increase equity capital at a higher rate to maintain an adequate equity to assets ratio, which in turn reduces the amount of earnings available for cash dividends. Through 2008 and 2007, inflation did not have a material impact on the Bancorp.

DIRECTORS OF BANCORP – December 31, 2008

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

OFFICERS OF BANCORP

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

DIRECTORS OF THE BANK – DECEMBER 31, 2008

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

OFFICERS OF THE BANK – DECEMBER 31, 2008

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

BANK CORPORATE INFORMATION

Location	Address	City, ST ZIP	Telephone	Fax
Sturgis (Main Office)	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5512
				(269) 651-8263
				(269) 865-5902
Sturgis–Trust Dept.	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-1380	(269) 659-6848
Branch Offices				
Bronson	863 West Chicago Road	Bronson, MI 49028	(517) 369-7322	(517) 369-2347
Centreville	158 West Main	Centreville, MI 49032	(269) 467-8525	(269) 467-4180
Climax	125 North Main	Climax, MI 49034	(269) 746-4256	(269) 746-4108
Coldwater	390 East Chicago Road	Coldwater, MI 49036	(517) 278-5634	(517) 278-5613
Colon	110 South Blackstone Street	Colon, MI 49040	(269) 432-3229	(269) 432-2971
South Haven	1121 LaGrange Street	South Haven, MI 49090	(269) 637-8444	(269) 637-5560
South Haven	365 Center Street	South Haven, MI 49090	(269)-637-6644	(269) 637-6645
Sturgis	1001 South Centerville Road	Sturgis, MI 49091	(269) 651-9379	(269) 651-1514
Sturgis	1501 East Chicago Road	Sturgis, MI 49091	(269) 651-9345	(269) 651-5609
Three Rivers	115 North Main Street	Three Rivers, MI 49093	(269) 273-8481	(269) 273-1732
White Pigeon	122 West Chicago Road	White Pigeon, MI 49099	(269) 483-9668	(269) 483-2725

Oakleaf Financial Services	113-125 East Chicago Road	Sturgis, MI 49091	(269) 651-2475	(269) 651-7273

MARKET INFORMATION

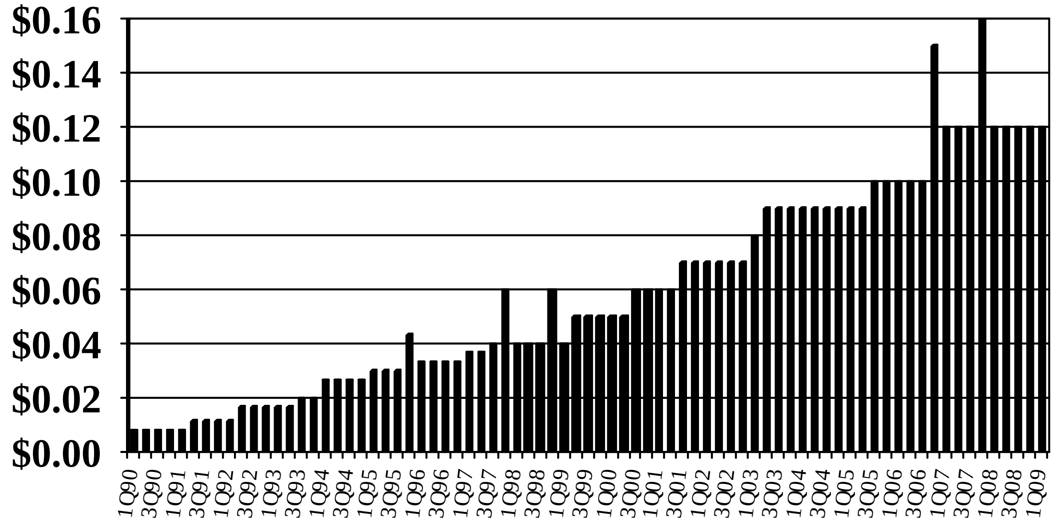
Shares of common stock of Bancorp were held by approximately 160 shareholders as of December 31, 2008. Bancorp's shares are traded on the OTC Bulletin Board under the symbol of "STBI". Trading activity has been infrequent.

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

	Year ended December 31,			
	2008		2007	
	High	Low	High	Low
First quarter	$15.50	$13.15	$13.15	$12.70
Second quarter	14.97	12.90	14.25	12.90
Third quarter	12.75	8.80	15.00	13.95
Fourth quarter	10.05	7.00	15.90	14.75

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

Cash Dividends Per Share



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

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

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

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

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

INDEPENDENT ACCOUNTANTS

Bancorp employed the accounting firm of Crowe Horwath LLP as Independent Accountants for the years ended December 31, 2008 and December 31, 2007. There have been no disagreements on accounting or financial disclosure matters within these time periods.

Crowe Horwath LLP
Member Horwath International

REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying consolidated balance sheets of Sturgis Bancorp, Inc. as of December 31, 2008 and 2007 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 financial position of Sturgis Bancorp. Inc, as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Crowe Horwath LLP

Crowe Horwath LLP

Grand Rapids, Michigan
March 23, 2009

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2008 and 2007
(Dollar amounts in thousands, except share and per share data)

	2008	2007
ASSETS		
Cash and due from banks	$ 6,930	$ 11,781
Other short-term investments	9	2,349
Total cash and cash equivalents	6,939	14,130
Interest-earning deposits in banks	9,334	11,160
Securities - Available for sale	41,896	14,380
Securities – Held to maturity (fair value 2008 - $8,439, 2007 - $4,420)	8,777	4,401
Federal Home Loan Bank stock, at cost	4,784	4,611
Loans held for sale	1,578	645
Loans, net of allowance of $2,838 and $2,699	280,867	270,200
Premises and equipment, net	8,710	7,404
Goodwill	5,109	5,109
Originated mortgage servicing rights	1,409	1,367
Real estate owned	1,913	1,702
Bank-owned life insurance	8,072	7,748
Accrued interest receivable	2,286	2,313
Investment in limited partnerships	618	759
Other assets	1,102	1,273
Total assets	$ 383,394	$ 347,202
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	$ 25,710	$ 18,598
Interest bearing	211,807	201,524
Total Deposits	237,517	220,122
Federal Home Loan Bank advances and other borrowings	86,287	83,000
Repurchase agreements	30,500	13,000
Accrued interest payable	868	1,150
Other liabilities	2,472	2,250
Total liabilities	357,644	319,522
Stockholders' equity		
Preferred stock - $1 par value: authorized - 1,000,000 shares issued and outstanding – 0 shares		
Common stock – $1 par value: authorized – 9,000,000 shares issued and outstanding 2,017,245 shares and 2,268,607 shares at December 31, 2008 and 2007	2,017	2,269
Additional paid-in capital	6,872	10,377
Retained earnings	16,470	15,134
Accumulated other comprehensive income (loss)	391	(100)
Total stockholders' equity	25,750	27,680
Total liabilities and stockholders' equity	$ 383,394	$ 347,202

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2008 and 2007
(Dollar amounts in thousands, except share and per share data)

	2008	2007
Interest income		
Loans	$ 17,817	$ 19,493
Investment securities:		
Taxable	2,403	1,909
Tax-exempt	49	111
Dividends	214	190
Total interest income	20,483	21,703
Interest expense		
Deposits	5,779	6,374
Borrowed funds	4,460	3,893
Total interest expense	10,239	10,267
Net interest income	10,244	11,436
Provision for loan losses	489	513
Net interest income after provision for loan losses	9,755	10,923
Noninterest income:		
Service charges and other fees	1,555	1,728
Investment brokerage commission income	1,587	1,606
Mortgage banking activities	892	635
Trust fee income	380	430
Increase in value of bank owned life insurance	324	319
Other income	37	167
Total noninterest income	4,775	4,885
Noninterest expenses:		
Salaries and employee benefits	7,039	6,836
Occupancy and equipment	1,414	1,329
Data processing	818	684
Professional services	332	289
Real estate owned expense	233	250
Advertising	197	191
Loss on sale of securities	42	-
Other	1,551	1,379
Total noninterest expenses	11,626	10,958
Income before income tax expense	2,904	4,850
Provision for income tax	598	1,506
Net income	$ 2,306	$ 3,344
Basic earnings per share	$ 1.13	$ 1.43
Diluted earnings per share	$ 1.13	$ 1.43

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years ended December 31, 2008 and 2007
(Dollar amounts in thousands, except share and per share data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance – January 1, 2007	$ 2,417	$ 12,341	$ 13,058	$ (267)	$ 27,549
Stock options exercised, net of 2,567 shares exchanged, including tax benefit	5	39	-	-	44
Adjustment to initially apply FASB Interpretation No. 48	-	-	(32)	-	(32)
Stock redemption	(153)	(2,003)	-	-	(2,156)
Net income for the year ended December 31, 2007	-	-	3,344	-	3,344
Other comprehensive income	-	-	-	167	167
Total comprehensive income	-	-	-	-	3,511
Cash dividends ($.53 per share)	-	-	(1,236)	-	(1,236)
Balance – December 31, 2007	2,269	10,377	15,134	(100)	27,680
Stock options exercised, net of 40,593 shares exchanged, including tax benefit	2	8	-	-	10
Stock redemption	(254)	(3,513)	-	-	(3,767)
Net income for the year ended December 31, 2008	-	-	2,306	-	2,306
Other comprehensive income	-	-	-	491	491
Total comprehensive income	-	-	-	-	2,797
Cash dividends ($.48 per share)	-	-	(970)	-	(970)
Balance – December 31, 2008	$ 2,017	$ 6,872	$ 16,470	$ 391	$ 25,750

See accompanying notes to consolidated financial statements.

STURGIS BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2008 and 2007
(Dollar amounts in thousands)

	2008	2007
Cash flows from operating activities		
Net income	$ 2,306	$ 3,344
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	517	491
Amortization of mortgage servicing rights	375	360
Provision for loan losses	489	513
Deferred income taxes	231	(100)
Accretion and amortization of securities	(139)	55
Recovery of impairment from investment	-	(75)
Gain on sale of loans held for sale	(819)	(422)
Proceeds from the sale of loans held for sale	23,282	17,528
Loans originated for sale	(23,814)	(17,821)
Gain on real estate owned	(34)	(81)
Loss of equity in limited partnership	141	130
Loss on sale of available for sale securities	42	-
Increase in cash value of bank-owned life insurance	(324)	(318)
Changes in assets and liabilities:		
Decrease (increase) in accrued interest and other assets	201	(189)
(Decrease) increase in accrued interest and other liabilities	(535)	226
Net cash provided by operating activities	1,919	3,641
Cash flows from investing activities		
Net change in interest-earning deposits in banks	1,826	(2,272)
Proceeds from maturities of securities held to maturity	1,645	615
Principal reductions of mortgage-backed securities held to maturity	1,703	791
Principal reductions of mortgage-backed securities available for sale	3,163	3,101
Purchase of securities held-to-maturity	(7,572)	-
Purchase of securities available-for-sale	(41,503)	(525)
Proceeds from sales of securities available-for-sale	11,503	-
Purchase of loans	(510)	(10,873)
Net increase in loans	(12,354)	(19,873)
Purchase of Federal Home Loan Bank stock	(173)	(476)
Proceeds from sale of real estate owned	1,529	939
Additions to premises and equipment, net	(1,822)	(1,235)
Net cash used in investing activities	(42,565)	(29,808)

(Continued)

(Dollar amounts in thousands)

	2008	2007
Cash flows from financing activities		
Net increase in deposits	$ 17,395	$ 3,988
Repayment of FHLB advances and other borrowings	(46,580)	(8,000)
Proceeds from FHLB advances and other borrowings	49,867	30,000
Net change in repurchase agreements	17,500	-
Cash dividends paid on common stock	(970)	(1,236)
Stock options exercised	10	44
Stock redemption	(3,767)	(2,156)
Net cash provided by financing activities	33,455	22,640
Net change in cash and cash equivalents	(7,191)	(3,527)
Cash and cash equivalents - beginning of year	14,130	17,657
Cash and cash equivalents - end of year	$ 6,939	$ 14,130
Supplemental information		
Cash paid for:		
Interest	$ 10,521	$ 9,988
Income taxes	755	1,515
Noncash investing and financing activities		
Loans transferred to real estate owned	$ 1,706	$ 1,602

See accompanying notes to consolidated financial statements.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at fair value at December 31, 2008, and at the lower of cost or estimated fair value in the aggregate at December 31, 2007. Net unrealized losses, if any, are recognized in a valuation allowance by charges to income.

Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loans sold. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right.

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

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

Purchased Loans: During 2008 and 2007, the Bank purchased four and 21 individual commercial nonmortgage loans, respectively, from other financial institutions, all of which are fully guaranteed by the U.S. Government (USDA). After acquisition, any incurred losses are recognized by an increase in the allowance for loan losses.

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

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

The allowance consists of specific, general and unallocated components. The specific components relate to loans that are classified as substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for quantitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

Servicing: Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. The Company compares the valuation model inputs and results to published industry data in order to validate the model results and assumptions. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for individual groupings, to the extent that fair value is less than the carrying amount. Changes in valuation allowances are reported with mortgage banking activities on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from Bancorp, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and Bancorp does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

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

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

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

Bank-Owned Life Insurance: Bancorp has purchased life insurance policies on certain key officers. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Investment in Limited Partnership: Bancorp has investments in limited partnerships that are structured to generate low-income housing tax credits, investments in two venture capital funds, and an investment in a Michigan partnership structured to generate commissions from the sale of title insurance. The low-income housing investment is accounted for at cost, net of amortization based on the effective yield method. The projected residual value in the underlying properties is periodically evaluated for impairment. Bancorp accounts for the other investments under the equity method, whereby Bancorp annually records its proportionate share of partnership profits and losses as an adjustment to the carrying value of the investment.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

Loan Commitments and Related Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

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

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

Bancorp is qualified under provisions of the Internal Revenue Code to deduct from taxable income a provision for bad debts in excess of such provision charged to income in the consolidated financial statements. Accordingly, retained earnings at December 31, 2008 and 2007 include approximately $918 for which no provision for federal income taxes has been made. Unrecognized deferred taxes on this amount are approximately $312. In the future, if this portion of retained earnings is used for any purpose other than to absorb bad debt losses, federal income taxes would be imposed at the then applicable rates.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Bancorp adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. Bancorp recorded approximately $31 of expense in 2007 and $32 as an adjustment to prior period retained earnings upon adoption of this standard.

Bancorp recognizes interest and/or penalties related to income tax matters in income tax expense.

Stock Compensation Plans: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. Future stock option grants will recognized as described, although there are currently no active stock option plans under which options may be granted.

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

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

	2008	2007
Net income	$ 2,306	$ 3,344
Weighted average number of common shares outstanding	2,047,114	2,340,269
Effect of dilutive options	-	285
Weighted average number of common shares outstanding used to calculate diluted earnings per share	2,047,114	2,340,554

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock options for 750 shares and 93,900 shares for the years ended December 31, 2008 and 2007 were not considered in computing earnings per common share because they were antidilutive.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale and changes in funded status of pension plan, which are also recognized as separate components of equity.

Legal Contingencies: Loss contingencies, including claims and legal action arising in the normal course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are now such matters that will have a material effect on Bancorp's consolidated financial statements.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

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

Adoption of New Accounting Standards: In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (FAS 157). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard was effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157.* This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. In adoption of this standard, Bancorp added certain disclosures to its Notes to the financial statements. In October 2008, the FASB issued Staff Position (FSP) 157-3, *Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active.* This FSP clarifies the application of FAS 157 in a market that is not active. The impact of adoption was not material.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value through Earnings* ("SAB 109"). Previously, SAB 105, *Application of Accounting Principles to Loan Commitments*, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 was effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. Bancorp adopted this standard as of December 31, 2008 and as a result, approximately $88 was recorded to noninterest income.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard was effective for Bancorp on January 1, 2008. In adoption of this standard, Bancorp elected to report loans held for sale at fair value prospectively as of December 1, 2008.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 2 – SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2008				
Available-for-sale securities:				
Mortgage-backed securities	$ 40,475	$ 872	$ -	$ 41,347
Other securities	549	-	-	549
	$ 41,024	$ 872	$ -	$ 41,896
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 717	$ 8	$ (2)	$ 723
Mortgage-backed securities	8,060	13	(357)	7,716
	$ 8,777	$ 21	$ (359)	$ 8,439
2007				
Available-for-sale securities:				
Mortgage-backed securities	$ 13,718	$ 137	$ -	$ 13,855
Other securities	525	-	-	525
	$ 14,243	$ 137	$ -	$ 14,380
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 2,376	$ 9	$ (7)	$ 2,378
Mortgage-backed securities	2,025	17	-	2,042
	$ 4,401	$ 26	$ (7)	$ 4,420

Securities with a carrying value of $49,528 (market value of $49,185) and $15,810 (market value of $15,962) were pledged at December 31, 2008 and 2007, respectively, to secure U.S. Treasury tax and loan payments, FHLB advances, and repurchase agreements.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 2 – SECURITIES (Continued)

The amortized cost and fair value of securities by contractual maturity at December 31, 2008 are shown below. Actual and expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Held-to-Maturity		Available-for-Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 416	$ 423	$ -	$ -
Due after one through five years	301	300	-	-
Due after five through ten years	-	-	-	-
Due after ten years	-	-	-	-
	717	723		
Mortgage-backed securities	8,060	7,716	40,475	41,347
Other securities	-	-	549	549
	$ 8,777	$ 8,439	$ 41,024	$ 41,896

For the years ended December 31, 2008 and 2007, proceeds from sales of securities available for sale amounted to $11,503 and $0, respectively. Realized losses, net of applicable tax benefits, amounted to $28 and $0 for the years ended December 31, 2008 and 2007, respectively. Gross realized gains, net of applicable tax expense, amounted to $0 and $50 for the years ended December 31, 2008 and 2007, respectively. The gain recognized in 2007 related to a recovery on a trust preferred security redemption for which an other than temporary impairment loss had been recognized in prior years.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 2 – SECURITIES (Continued)

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

	Less than 12 months		12 months or More		Total	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Gross Fair Value	Unrealized Losses	Fair Value
2008						
Available-for-sale securities:						
Mortgage backed	$ -	$ -	$ -	$ -	$ -	$ -
Held-to-maturity securities:						
Obligations of states and political subdivisions	$ -	$ -	$ (2)	$ 302	$ (2)	$ 302
Mortgage-backed securities	(336)	6,146	(21)	352	(357)	6,498
	$ (336)	$ 6,146	$ (23)	$ 654	$ (359)	$ 6,800
2007						
Available-for-sale securities:						
Mortgage backed	$ -	$ -	$ -	$ -	$ -	$ -
Held-to-maturity securities:						
Obligations of states and political subdivisions	$ (3)	$ 1,408	$ (4)	$ 601	$ (7)	$ 2,009
Mortgage-backed securities	-	-	-	-	-	-
	$ (3)	$ 1,408	$ (4)	$ 601	$ (7)	$ 2,009

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

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 3 – LOANS

A summary of the balances of loans follows:

	2008	2007
Mortgage loans:		
Residential 1-4 family	$ 148,747	$ 141,736
Commercial	82,854	71,675
Construction loans – residential	3,397	14,176
Construction loans – commercial	2,938	4,168
Total mortgage loans	237,936	231,755
Commercial nonmortgage loans	37,743	32,677
Consumer and installment loans:		
Consumer and installment	7,069	7,729
Other	732	505
Total consumer and installment loans	7,801	8,234
	283,480	272,666
Less:		
Allowance for loan losses	2,838	2,699
Unearned interest	-	1
	280,642	269,966
Add:		
Deferred loan origination and other costs, net of fees	225	234
Loans, net	$ 280,867	$ 270,200

An analysis of the allowance for loan losses follows:

	2008	2007
Balance – Beginning of year	$ 2,699	$ 2,523
Provision for loan losses	489	513
Loans charged off	(383)	(436)
Recoveries of loans previously charged off	33	99
Balance – End of year	$ 2,838	$ 2,699

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 3 – LOANS (Continued)

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

	2008	2007
Impaired loans with a valuation allowance	$ 1,653	$ 1,398
Impaired loans without a valuation allowance	2,068	690
Total impaired loans	$ 3,721	$ 2,088
Valuation allowance related to impaired loans	$ 142	$ 327
Average investment in impaired loans	2,064	2,667
Interest income recognized on impaired loans	160	97
Interest income recognized on a cash basis on impaired loans	160	97

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

Nonperforming loans were as follows:

	2008	2007
Total non-accrual loans	$ 3,188	$ 2,193
Total loans past due 90 days or more and still accruing	391	874

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

During 2008 and 2007, the Bank invested $511 and $10,873, respectively, of principal and accrued interest to purchase commercial nonmortgage loans from other financial institutions. The balance of these loans at December 31, 2008 was $10,512. These loans are serviced by other financial institutions and have credit guarantees backed by the full faith and credit of the U.S. Department of Agriculture (USDA).

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 4 – PREMISES AND EQUIPMENT

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

	2008	2007
Land	$ 1,846	$ 814
Land improvements	164	84
Office buildings	8,224	6,802
Furniture, fixtures and equipment	4,881	4,294
Construction in progress	-	1,322
Total premises and equipment	15,115	13,316
Less accumulated depreciation	(6,405)	(5,912)
Net carrying amount	$ 8,710	$ 7,404

Depreciation expense for the years ended December 31, 2008 and 2007 amounted to $517 and $491, respectively.

NOTE 5 – SERVICING

Loans serviced for others are not included in the accompanying consolidated balance sheet. The unpaid principal balance of mortgages and other loans serviced for others approximated $194.8 million and $199.8 million at December 31, 2008 and 2007, respectively.

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

	2008	2007
Mortgage servicing rights:		
Balance at beginning of year	$ 1,367	$ 1,476
Mortgage servicing rights capitalized	416	252
Mortgage servicing rights amortized	(376)	(363)
Provision for gain (loss) in fair value	2	2
Balance at end of year	$ 1,409	$ 1,367
Valuation allowance:		
Balance at beginning of year	$ 37	$ 39
Additions	87	-
Reductions	(89)	(2)
Write-downs	-	-
Balance at end of year	$ 35	$ 37

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 6 – REAL ESTATE INVESTMENT – LIMITED PARTNERSHIP

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

Bancorp's share of tax credits generated by the investee partnership totaled $108 in both 2008 and 2007.

NOTE 7 – DEPOSITS

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

	2008	2007
Passbook and savings deposits	$ 57,916	$ 47,538
NOW accounts	46,945	47,412
Time:		
$100,000 and over	21,545	26,563
Under $100,000	85,401	80,011
	$ 211,807	$ 201,524

At December 31, 2008, the scheduled maturities of time deposits are as follows:

Maturing in the Year Ending December 31,	Under $100,000	$100,000 and Over
2009	$ 46,075	$ 14,978
2010	18,526	2,753
2011	14,381	2,066
2012	4,755	1,070
2013	1,449	678
Thereafter	215	-
	$ 85,401	$ 21,545

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS

The Bank has advances from the Federal Home Loan Bank of Indianapolis (FHLB) of $79,000 and $83,000 at December 31, 2008 and 2007, respectively, which mature through 2016. At December 31, 2008 and 2007, the interest rates ranged from 2.46% to 5.31% and from 3.75% to 5.50%, respectively. The advances are subject to prepayment penalties as defined in the credit policy of FHLB.

Included in the above advances are three advances from FHLB totaling $21,000 at December 31, 2008, which mature through 2012. These advances have put options which allow FHLB to convert the interest rates to the three-month LIBOR with quarterly resets through maturity. The interest rate may only be converted by FHLB if the three-month LIBOR exceeds certain rates.

At December 31, 2008, another advance for $15,000, maturing February 22, 2011, may be put at any time by FHLB.

The advances are collateralized by securities held in safekeeping at FHLB, performing residential and commercial non-employee mortgage loans. The unpaid principal balance of pledged loans was approximately $141,300 and $136,400 at December 31, 2008 and 2007, respectively. Mortgage-backed securities with a carrying value of $7,868 (market value $7,525) were held in safekeeping at FHLB and were pledged at December 31, 2008. Mortgage-backed securities with a carrying value of $1,800 (market value $1,800) were held in safekeeping at FHLB and were pledged at December 31, 2007.

Annual payments of FHLB advances are as follows:

2009	$ 25,500
2010	5,000
2011	28,500
2012	10,000
2013	2,500
2014 and thereafter	7,500
	$ 79,000

The Bank also had $5.1 million and $0 of fed funds purchased from a financial institution at December 31, 2008 and 2007, respectively. The interest rate on fed funds purchased at December 31, 2008 was 0.26%.

During 2008, Bancorp obtained a closed-end line of credit with another financial institution for $3.0 million to repurchase common stock. The outstanding balance on the line of credit was $2.2 million at December 31, 2008. The line of credit matures in August 2009. The variable interest rate on the line of credit at December 31, 2008 was 4.50%.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 9 – REPURCHASE AGREEMENTS

Repurchase agreements are secured by available for sale mortgage-backed securities held by a third-party trustee with a market value of $41,347 and $13,854 at December 31, 2008 and 2007, respectively. In addition to these securities, repurchase agreements are also secured by short term investments with a market value of $0 and $610 at December 31, 2008 and 2007, respectively.

These agreements at December 31, 2008 included a $5,500 fixed rate financing arrangement that matures in 2009, and $25,000 variable rate financing arrangements that mature in 2013. At maturity, the securities underlying the agreements are returned to Bancorp.

Information concerning repurchase agreements is summarized as follows:

	2008	2007
Average daily balance during the year	$ 20,256	$ 13,000
Average interest rate during the year	3.95%	4.82%
Maximum month-end balance during the year	35,784	13,000
Weighted average interest rate at year end	1.50%	5.23%

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

NOTE 10 – FEDERAL INCOME TAXES

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

	2008	2007
Current expense	$ 400	$ 1,482
Deferred expense	198	24
	$ 598	$ 1,506

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 10 – FEDERAL INCOME TAXES (Continued)

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

	2008	2007
Amount computed at statutory rate	$ 988	$ 1,649
Tax-exempt income from Bank-owned life insurance	(110)	(108)
Tax-exempt interest income	(38)	(58)
Low-income housing tax credits	(108)	(108)
Other, net	(134)	131
	$ 598	$ 1,506

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

	2008	2007
Deferred tax assets:		
Allowance for loan losses	$ 859	$ 804
Unfunded pension liability	135	112
Deferred compensation	191	168
Other	115	145
	1,300	1,229
Deferred tax liabilities:		
Deferred loan fees	-	(80)
Mortgage servicing rights	(479)	(465)
Amortization	(975)	(818)
Depreciation	(391)	(256)
FHLB stock dividends	(139)	(139)
Unrealized gain on available-for-sale securities	(296)	(46)
Other	(211)	(191)
	(2,491)	(1,995)
Net deferred tax liability	$ (1,191)	$ (766)

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 10 – FEDERAL INCOME TAXES (Continued)

Unrecognized Tax Benefits

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2008	2007
Balance at January 1	$ 63	$ 32
Additions based on tax positions related to the current year	-	31
Settlements	(63)	-
	$ -	$ 63

During 2008, the Company settled an outstanding issue with the State of Indiana, and recorded a $63 decrease in unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the states of Indiana and Florida. The Company is no longer subject to examination by taxing authorities for years before 2005.

NOTE 11 – RETIREMENT BENEFITS

Bancorp is a participant in the multi-employer Financial Institutions Retirement Fund (FIRF or the Plan), which covers substantially all of the officers and employees of the Bank and its Subsidiaries. The defined benefit plan provides benefits to all full-time employees with one year of service, based on basic compensation and years of service. Bancorp contributions are determined by FIRF and generally represent the normal cost of the Plan. Specific Plan assets and accumulated benefit information for Bancorp's portion of the fund are not available. Under the Employee Retirement Income Security Act (ERISA), a contributor to a multi-employer pension plan may be liable in the event of complete or partial withdrawal for the benefit payments guaranteed under ERISA. Bancorp has no present intention to withdraw from the fund. The expenses of the Plan allocated to Bancorp for the years ended December 31, 2008 and 2007 were $375 and $503, respectively.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 11 – RETIREMENT BENEFITS (Continued)

The Bank sponsors a non-qualified defined benefit (DB) to provide supplemental retirement benefits for certain executives. These benefits include pre-retirement disability and death benefits, as well as post-retirement payments for 15 years. The following table sets forth the DB activity and other information as of and for the years ended December 31, 2008 and 2007.

	2008	2007
Plan assets at fair value	$ -	$ -
Projected benefit obligation	562	493
Underfunded status	$ (562)	$ (493)
Accumulated benefit obligation	$ 255	$ 215
Intangible assets	-	-
Net periodic pension cost	$ 75	$ 68
Change included in other comprehensive income	$ (6)	$ (13)
Actuarial assumptions:		
Weighted average discount rate	6.50%	6.50%
Increase in future compensation levels	4.00	4.00

The estimated net loss and prior service cost for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost during the year December 31, 2009 are not significant.

To fund the DB obligation and other employee benefits, the Bank has purchased insurance policies on the lives of certain officers of the Bank. The Bank is owner and beneficiary of these policies. At December 31, 2008 and 2007, the cash value of all bank-owned life insurance policies was $8,072 and $7,748, respectively. The cash value is available to fund future benefit obligations. There were no supplemental retirement benefits paid by the DB during 2008 or 2007. The Bank does not anticipate paying benefits in connection with this plan over the next 10 years.

(Continued)

NOTE 12 – COMMON STOCK AND OPTIONS

In September 2005, Bancorp entered into an agreement with a shareholder to repurchase up to 197,200 shares of common stock. The agreement was an irrevocable right and option to purchase the shares upon the death of the shareholder at market price as quoted on the OTC Bulletin Board or such similar quotation service on which Bancorp's shares trade. The stockholder died in October 2007 and Bancorp exercised the entire option agreement in November 2007. In February 2008, Bancorp obtained a $3.0 million line of credit with another financial institution and settled the option agreement to repurchase the shares totaling $2,928 on February 14, 2008.

Bancorp has two stock option plans under which grants have been extended to employees and directors.

Employee Plan – Options granted under the Employee Plan expired 10 years after the date of the grant for active and retired employees. If employment was terminated prior to that time for reasons other than death or disability, the options expired 30 days after termination of employment. If employment with the Bank was terminated by reason of death or disability, the options expired 90 days after termination of employment. All unexercised stock option grants under the Employee Plan expired in 2008. Unexercised stock option grants under the Employee Plan were 90,300 shares at December 31, 2007, all of which became fully vested in 2001. Because the Employee Plan expired in May 1998, no new stock options will be granted under the Employee Plan.

New Director Plan – The New Director Plan provided active directors with stock options that expire 10 years and one day after the grant date. If a grantee ceases to be a director prior to that time for reasons other than death or disability, the options expire 30 days after cessation of director status. If cessation of director status results from death or disability, the options expire 90 days after cessation of director status. Unexercised stock option grants under the New Director Plan were 750 and 4,725 at December 31, 2008 and 2007. Because the New Director Plan expired in December 1999, no new stock options will be granted under the New Director Plan. All unexercised stock option grants under the New Director Plan expire in 2009.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 12 – COMMON STOCK AND OPTIONS (Continued)

The following is a summary of the activity with respect to Bancorp's stock option plans for the years ended December 31, 2008:

	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding – January 1, 2008	95,025	$ 14.31
Granted	-	-
Cancelled	(51,801)	14.38
Exercised	(42,474)	14.29
Outstanding – December 31, 2008	750	$ 10.50

For options outstanding at December 31, 2008, the exercise price was $10.50 and the weighted average remaining contractual life of the options was approximately 4 months. The intrinsic value of options exercised in 2008 was $28. The aggregate intrinsic value of options outstanding at December 31, 2008 was $0.

NOTE 13 – MINIMUM REGULATORY CAPITAL REQUIREMENTS

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

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 13 – MINIMUM REGULATORY CAPITAL REQUIREMENTS (Continued)

Quantitative measures established by regulation to ensure capital adequacy require Bancorp and the Bank to maintain minimum amounts and ratios, as set forth in the following table. Total capital, Tier 1 capital, risk-weighted assets and average assets are measures used to analyze capital adequacy. These measures are defined in federal banking regulations. Ratios must be met regarding total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. At December 31, 2008 and 2007, Bancorp and the Bank met all minimum capital requirements to which they are subject.

At December 31, 2008, the Federal Deposit Insurance Corporation categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since December 31, 2008 that management believes have changed the Bank's well-capitalized status.

The Bank's actual capital amounts and ratios at December 31, 2008 and 2007 were as follows:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2008						
Total capital (to risk weighted assets)	$ 26,523	11.0	$ 19,360	8.0%	$ 24,200	10.0%
Tier 1 capital (to risk weighted assets)	23,685	9.8	9,680	4.0	14,520	6.0
Tier 1 capital (to adjusted total assets)	23,685	6.1	15,505	4.0	19,381	5.0
December 31, 2007						
Total capital (to risk weighted assets)	$ 25,279	10.8	$ 18,705	8.0%	$ 23,381	10.0%
Tier 1 capital (to risk weighted assets)	22,581	9.7	9,352	4.0	14,029	6.0
Tier 1 capital (to adjusted total assets)	22,581	6.8	13,380	4.0	16,725	5.0

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 14 – OFF-BALANCE-SHEET ACTIVITIES

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

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

At December 31, 2008 and 2007, the following financial instruments with credit risk were outstanding:

	2008	2007
Commitments to grant loans	$ 8,018	$ 8,379
Unfunded commitments under lines of credit	75,903	38,674
Commercial and standby letters of credit	1,765	270

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

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

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

(Continued)

(Dollar amounts in thousands, except share and per share data)

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

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

If the counterparty does not have the right or ability to redeem the collateral or Bancorp is permitted to sell or repledge the collateral on short notice, Bancorp records the collateral in its balance sheet at fair value with a corresponding obligation to return it.

NOTE 15 – RELATED PARTY TRANSACTIONS

In the ordinary course of business, Bancorp has granted loans to principal officers, directors and affiliates. A summary of the related party loan transactions for the years ended December 31, 2008 and 2007 is as follows:

	2008	2007
Related party loans - beginning of the year	$ 2,500	$ 2,388
Advances	-	130
Principal repayments	(139)	(18)
Related party loans – end of the year	$ 2,361	$ 2,500

Deposits from related parties held by the Bank at December 31, 2008 and 2007 approximated $1,285 and $1,354, respectively.

A director of Bancorp is a stockholder in a law firm that provides legal counsel to Bancorp and its subsidiaries. Legal fees and disbursements to the law firm totaled $172 and $93 for 2008 and 2007, respectively.

(Continued)

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs).

The fair value of loans held for sale is based upon binding quotes from 3rd party investors. (Level 2 inputs)

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis at December 31, 2008 were available for sale securities and loans held for sale. The fair value, using Quoted Prices in Active Markets for Identical Assets (or Level 1 measurements), was $41,896 for available for sale securities. Loans held for sale, using Significant Other Observable Inputs (or Level 2 measurement), had a fair value of $1,578. There were no Level 3 inputs used for measuring fair values on a recurring basis.

(Continued)

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis at December 31, 2008 were impaired loans. The fair value, using Significant Unobservable Inputs (or Level 3 measurements), was $3,579.

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $3,721, with a valuation allowance of $142, resulting in an additional provision for loan losses of $115 for the period.

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

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

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

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

FHLB stock: It was not practicable to estimate the fair value of FHLB stock due to restrictions on its transferability.

(Continued)

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

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

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

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

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

Off-Balance-Sheet Instruments: Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 16 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 6,939	$ 6,939	$ 14,130	$ 14,130
Interest-earning deposits in banks	9,334	9,812	11,160	11,553
Available for sale securities	41,896	41,896	14,380	14,380
Held to maturity securities	8,777	8,439	4,401	4,420
FHLB stock	4,784	N/A	4,611	N/A
Loans held for sale	1,578	1,578	645	654
Loans in portfolio, net	280,867	269,511	270,200	276,629
Accrued interest receivable	2,286	2,286	2,313	2,313
Financial liabilities:				
Deposits	$ 237,517	$ 237,091	$ 220,122	$ 215,646
Accrued interest payable	868	868	1,150	1,150
FHLB advances and other borrowings	86,287	85,957	83,000	83,845
Repurchase agreements	30,500	27,761	13,000	13,095

NOTE 17 – RESTRICTIONS ON DIVIDENDS

Banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to Bancorp. The total amount of dividends that may be paid at any date is generally limited to the retained earnings of the Bank. However, dividends paid by the Bank would be prohibited, if the effect thereof would cause the Bank's capital to be reduced below applicable minimum standards. At December 31, 2008, the Bank's retained earnings available for the payment of dividends was $3,819. Accordingly, approximately $24,391 of Bancorp's investment in the Bank was restricted at December 31, 2008.

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

(Continued)

(Dollar amounts in thousands, except share and per share data)

NOTE 18 – OTHER COMPREHENSIVE INCOME (LOSS)

	2008	2007
Unrealized holding gains on available for sale securities	$ 777	$ 234
Reclassification adjustment for losses (gains) realized in income	42	-
Net unrealized gains	735	234
Tax effect	(250)	(80)
Net-of-tax amount	485	154
Change in funded status of postretirement benefit obligation	9	20
Tax effect	(3)	(7)
Net-of-tax amount	6	13
	$ 491	$ 167

The following is a summary of the accumulated other comprehensive income balances, net of tax:

	2008	2007
Unrealized gains (losses) on securities available for sale	$ 575	$ 90
Unrealized loss on pension benefits	(184)	(190)
	$ 391	$ (100)

NOTE 19 – SUBSEQUENT EVENT (Unaudited)

On March 16, 2009, Bancorp's Board of Directors accepted management's recommendation to sell available for sale securities and reinvest the proceeds. Accordingly, on March 17, 2009 and March 18, 2009, Bancorp sold $26.4 million and $11.0 million, respectively, of available for sale securities. Bancorp realized gains, net of tax expense, of $727,000 on the sales. The transactions were part of Bancorp's ongoing asset and liability management strategy.