

Fentura Financial, Inc.

Years Ended
December 31,
2012 and 2011

Consolidated
Financial
Statements

FENTURA FINANCIAL, INC.

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INDEPENDENT AUDITORS' REPORT

March 11, 2013

Shareholders and Board of Directors
Fentura Financial, Inc.
Fenton, Michigan

We have audited the accompanying consolidated financial statements of *Fentura Financial, Inc.* (the "Corporation"), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of *Fentura Financial, Inc.* as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.



FENTURA FINANCIAL, INC.

CONSOLIDATED BALANCE SHEETS

	December 31	
	2012	2011
ASSETS		
Cash and cash equivalents	\$ 45,712	\$ 18,634
Securities, available for sale	44,530	58,687
Securities, held to maturity	3,058	2,963
Total securities	47,588	61,650
Loans held for sale	782	123
Loans		
Commercial	43,305	33,956
Commercial real estate	103,179	118,984
Residential real estate	29,838	26,829
Consumer	23,422	25,998
Total loans	199,744	205,767
Less allowance for loan losses	4,962	8,164
Net loans	194,782	197,603
Bank owned life insurance	6,052	5,941
Premises and equipment, net	10,235	10,202
Federal Home Loan Bank ("FHLB") stock	661	661
Accrued interest receivable	902	1,039
Other real estate owned	2,579	1,949
Other assets	1,429	1,059
Total assets	\$ 310,722	\$ 298,861
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	\$ 80,550	\$ 62,713
Interest-bearing	195,289	203,168
Total deposits	275,839	265,881
Federal Home Loan Bank advances	891	923
Subordinated debentures	14,000	14,000
Accrued interest payable and other liabilities	3,789	3,397
Total liabilities	294,519	284,201
Shareholders' equity		
Common stock, no par value: 5,000,000 shares authorized, 2,444,161 (2,388,225 in 2011) shares issued and outstanding	43,310	43,191
Accumulated deficit	(27,290)	(28,554)
Accumulated other comprehensive income	183	23
Total shareholders' equity	16,203	14,660
Total liabilities and shareholders' equity	\$ 310,722	\$ 298,861

The accompanying notes are an integral part of these consolidated financial statements.

FENTURA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31	
	2012	2011
Interest and dividend income		
Loans, including fees	\$ 10,970	\$ 11,604
Investments		
Taxable	1,081	1,354
Tax-exempt	119	150
Federal funds sold	23	35
Total interest and dividend income	12,193	13,143
Interest expense		
Deposits	1,499	2,478
Borrowings	446	505
Total interest expense	1,945	2,983
Net interest income	10,248	10,160
Provision for loan losses	(508)	3,142
Net interest income, after provision for loan losses	10,756	7,018
Noninterest income		
Service charges on deposit accounts	1,030	1,157
Net gain on sale of mortgage loans	961	348
Trust and investment services income	1,071	960
Net gain on sale of premises and equipment	-	350
Net gain on sale of securities	25	5
Other income and fees	1,755	2,038
Total noninterest income	4,842	4,858
Noninterest expenses		
Salaries and employee benefits	6,775	6,763
Occupancy	1,079	1,117
Furniture and equipment	1,076	1,042
Loan and collection	944	1,217
Advertising and promotional	164	129
Telephone and communication services	167	237
Other professional services	1,049	1,165
Other general and administrative	3,007	2,157
Total noninterest expenses	14,261	13,827
Income (loss) from continuing operations before income tax	1,337	(1,951)
Federal income taxes	73	52
Income (loss) from continuing operations	1,264	(2,003)
Discontinued operations, net of tax		
Income from discontinued operations	-	22
Gain from sale of discontinued operations	-	469
Income from discontinued operations, net of tax	-	491
Net income (loss)	\$ 1,264	\$ (1,512)
Net income (loss) per share from continuing operations		
Basic and diluted	\$ 0.52	\$ (0.86)
Net income per share from discontinued operations		
Basic and diluted	\$ -	\$ 0.21
Net income (loss) per share		
Basic and diluted	\$ 0.52	\$ (0.65)

The accompanying notes are an integral part of these consolidated financial statements.

FENTURA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Year Ended December 31	
	2012	2011
Net income (loss)	\$ 1,264	\$ (1,512)
Other comprehensive income (loss)		
Unrealized holding gains (losses) on available-for-sale investment securities arising during the year	185	(53)
Reclassification adjustment for gains (losses) realized in income	(25)	(5)
Tax effect	-	20
Other comprehensive income (loss)	160	(38)
Comprehensive income (loss)	\$ 1,424	\$ (1,550)

The accompanying notes are an integral part of these consolidated financial statements.

FENTURA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balances, January 1, 2011	\$ 43,036	\$ (27,042)	\$ 61	\$ 16,055
Issurance of shares under stock purchase and dividend reinvestment plans (79,460 shares)	155	-	-	155
Comprehensive loss	-	(1,512)	(38)	(1,550)
Balances, December 31, 2011	43,191	(28,554)	23	14,660
Issurance of shares under stock purchase and dividend reinvestment plans (55,936 shares)	119	-	-	119
Comprehensive income	-	1,264	160	1,424
Balances, December 31, 2012	<u>\$ 43,310</u>	<u>\$ (27,290)</u>	<u>\$ 183</u>	<u>\$ 16,203</u>

The accompanying notes are an integral part of these consolidated financial statements.

FENTURA FINANCIAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31	
	2012	2011
Cash flows from operating activities		
Net income (loss)	\$ 1,264	\$ (1,512)
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation	677	679
Amortization and accretion on securities	(695)	(385)
Provision for loan losses	(508)	3,142
Loans originated for sale	(45,011)	(22,124)
Proceeds from sale of loans	45,313	23,199
Net gain on sales of loans	(961)	(348)
Net gain on sales of securities	(25)	(5)
Net loss (gain) on sale of other real estate owned	6	(10)
Provision for other real estate owned losses	159	480
Net gain on sale of premises and equipment	-	(350)
Net earnings from bank owned life insurance	(111)	(141)
Net (increase) decrease in interest receivable and other assets	(233)	1,080
Net increase in interest payable and other liabilities	392	355
Net change in discontinued operations operating activities	-	11,025
Net cash provided by operating activities	267	15,085
Cash flows from investing activities		
Proceeds from maturities of securities - HTM	-	1,385
Proceeds from maturities of securities - AFS	13,431	7,878
Proceeds from calls of securities - AFS	6,150	6,000
Proceeds from sales of securities - AFS	13,991	2,024
Purchases of securities - AFS	(18,535)	(32,380)
Purchase of securities - HTM	(95)	-
Origination of loans, net of principal payments	11,459	4,464
Purchases of loans	(10,530)	-
Repurchase of FHLB stock	-	79
Proceeds from sales of other real estate owned	1,605	2,686
Purchase of premises and equipment, net	(710)	(196)
Net change in discontinued operations investing activities	-	92,910
Net cash provided by investing activities	16,766	84,850
Cash flows from financing activities		
Net increase (decrease) in deposits	9,958	(10,096)
Net decrease in short-term borrowings	-	(879)
Repayments of advances from FHLB	(32)	(31)
Net proceeds from stock issuance	119	155
Net change in discontinued operations financing activities	-	(103,942)
Net cash provided by (used in) financing activities	10,045	(114,793)
Net increase (decrease) in cash and cash equivalents	27,078	(14,858)
Cash and cash equivalents, beginning of year	18,634	33,492
Cash and cash equivalents, end of year	\$ 45,712	\$ 18,634
Supplemental cash flows information		
Cash paid for interest	\$ 1,597	\$ 2,575
Cash paid for income taxes	\$ 198	\$ 1,028
Transfers from loans to other real estate	\$ 2,161	\$ 1,698
Loans provided for sales of other real estate owned	\$ 239	\$ -

The accompanying notes are an integral part of these consolidated financial statements.

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation

The consolidated financial statements include Fentura Financial, Inc. (the Corporation) and its wholly owned subsidiaries Fentura Holdings LLC ("FHLLC") and The State Bank ("the Bank") in Fenton, Michigan; and reported as discontinued operations, West Michigan Community Bank in Hudsonville, Michigan (sold in January 2011). Intercompany transactions and balances are eliminated in consolidation.

In 2009, the Corporation entered into an agreement to sell West Michigan Community Bank to a third-party investor group. This sale closed on January 31, 2011. This subsidiary is reported as discontinued operations. See Note 16 for further discussion.

Consolidated financial statements are presented with discontinued operations sequestered on the 2011 statements of operations and statements of cash flows. The presentations for 2011 reflect the discontinued operations results to the extent applicable.

The Corporation provides banking and trust services principally to individuals, small businesses and governmental entities through its eight community banking offices in Genesee, Livingston, and Oakland Counties in southeastern Michigan. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Commercial real estate loans are 51.7% of gross loans and other commercial loans are 21.7% of gross loans at December 31, 2012. As of December 31, 2011, the loan portfolio was composed as follows: commercial real estate 57.8%, of total loans and commercial loans were 16.5% of total loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets and real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by both residential and commercial real estate. The Corporation's exposure to credit risk is substantially affected by the economy in the Corporation's market area and by changes in commercial real estate values. While the loan portfolio is substantially commercial based, the Corporation is not dependent on any single borrower. Other financial instruments which potentially represent concentrations of credit risk in the normal course of business include deposit accounts in other financial institutions and federal funds sold.

The principal source of liquidity of the Corporation is dividends from its bank subsidiary and deposits in the subsidiary bank. The Corporation's access to liquidity from its banking subsidiary is subject to regulatory restrictions, as a result of the Consent Order entered into with various banking regulators further described in Note 13. The Bank is currently subject to restrictions on its ability to make dividend payments without prior regulatory approval. The Corporation currently believes that it has cash on hand to cover its financial obligations and expenses for the foreseeable future and is not reliant on new capital funding to meet such obligations. The Bank's primary sources of liquidity are time deposits and non-maturity deposits. At December 31, 2012 retail time deposits equal 22.8% of total deposits and there are no brokered deposits held by the Bank. This is compared to December 31, 2011 when time deposits consisted of 28.1% of total deposits and brokered deposits were 4.1% of total deposits. Details regarding deposits are further described in Note 7 of the consolidated financial statements.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the fair values of securities and other financial instruments, other than temporary impairment of securities, the carrying value of other real estate owned and deferred taxes are particularly subject to change.

Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents, includes cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions and short-term borrowings.

Investment Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income (loss), net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI management considers many factors, including: (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, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether the Corporation intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If the Corporation intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Corporation does not intend to sell the security and it is not more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the

amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loans held for sale are reported at the lower of cost or fair value, on an aggregate basis and are sold with servicing rights released.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Interest income is not reported when full loan repayment is in doubt, typically when the loan is impaired or payments are past due over 90 days (180 days for residential mortgages).

All interest accrued in the current year but not received for loans placed on non-accrual are reversed against current interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual loss history experienced by the Corporation over a range of the most recent 4 quarters to the most recent 12 quarters. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions;

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industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential mortgage, installment loans and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

Troubled Debt Restructurings

Under certain circumstances, the Corporation will provide borrowers relief through loan restructurings and modifications. A loan restructuring constitutes a troubled debt restructuring ("TDR") if for economic or legal reasons related to the borrower's financial difficulties the Corporation grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment as described above.

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance of which the provision is accounted for in the consolidated statements of operations.

Transfers of Financial Assets

Transfers of financial assets, including mortgage loans held-for-sale, as described above, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when 1) the assets have been legally isolated from the Bank, 2) 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 3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. The Bank has no substantive continuing involvement related to these loans. The Bank sold residential mortgage loans to an unrelated third party with proceeds of \$45,313,000 and \$23,199,000 in 2012 and 2011, respectively, which resulted in a net gain of \$961,000 and \$348,000 for 2012 and 2011, respectively.

Other Real Estate Owned and Foreclosed Assets

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

Bank Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 15 to 40 years. Furniture, fixtures and equipment

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are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Premises and equipment and other 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, if lower than carrying amount.

Federal Home Loan Bank (FHLB) stock

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Bank Owned Life Insurance

The Bank has purchased life insurance policies on certain key executives. 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. The change in cash surrender value is an adjustment of premiums paid in determining the net expense or income recognized under the contracts and is included in noninterest expenses.

Stock Based Compensation

Compensation cost is recognized for stock options, restricted stock awards issued to employees, and stock appreciation rights 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 and stock appreciation rights, 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.

Income Taxes

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance reduces deferred tax assets to the amount expected to be realized. Included within deferred tax liabilities are amounts related to unrealized gains on available for sale securities.

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 has a greater than 50% likelihood of being realized on examination including the appeals process. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense. Such interest or penalties recorded in 2012 or 2011 were not significant.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Loan Commitments and Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby 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.

Earnings (Loss) Per Common Share

Basic earnings or loss per common share are net income or net loss divided by the weighted average number of common shares outstanding during the period. Employee Stock Ownership Plan (ESOP) shares are considered outstanding for this calculation unless unearned. Stock options were not considered in computing diluted earnings per common share because they were antidilutive.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale, which are also recognized as separate components of equity.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary 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.

Restrictions on Cash

Cash on hand or on deposit with the Federal Reserve Bank of \$25,000 was required to meet regulatory reserve and clearing requirements at year-end 2012 and 2011.

Dividend Restrictions

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Corporation or by the Corporation to shareholders. The State Bank has been restricted from dividend payments due to the signing of Consent Order with the Federal Deposit Insurance Corporation (FDIC). The Holding Company has been placed under restrictions by the Federal Reserve regarding the declaration or payment of any dividends and the receipt of dividends from the subsidiary Bank (see Note 13).

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 12. 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.

Reclassifications

Certain items in the prior year consolidated financial statements were reclassified to conform to the current year presentation.

Subsequent Events

In preparing these consolidated financial statements, the Corporation has evaluated, for potential recognition or disclosure, significant events or transactions that occurred during the period subsequent to December 31, 2012, the most recent balance sheet

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presented herein, through March 11, 2013, the date these consolidated financial statements were available to be issued. No significant such events or transactions were identified.

2. EARNINGS PER SHARE

The factors in the earnings per share computation follow:

(000s omitted except share and per share data)	2012	2011
Basic		
Net income (loss)	\$ <u>1,264</u>	\$ <u>(1,512)</u>
Weighted average common shares outstanding	<u>2,422,261</u>	<u>2,337,140</u>
Basic income (loss) per common share	\$ <u>0.52</u>	\$ <u>(0.65)</u>
Diluted		
Net income (loss)	\$ <u>1,264</u>	\$ <u>(1,512)</u>
Weighted average common shares outstanding for basic earnings per common share	2,422,261	2,337,140
Add dilutive effects of assumed exercises of stock options	-	-
Average shares and dilutive potential common shares	<u>2,422,261</u>	<u>2,337,140</u>
Diluted income (loss) per common share	\$ <u>0.52</u>	\$ <u>(0.65)</u>

The factors in the earnings per share from continuing operations follow:

(000s omitted except share and per share data)	2012	2011
Basic		
Net income (loss) from continuing operations	\$ <u>1,264</u>	\$ <u>(2,003)</u>
Weighted average common shares outstanding	<u>2,422,261</u>	<u>2,337,140</u>
Basic income (loss) per common share from continuing operations	\$ <u>0.52</u>	\$ <u>(0.86)</u>
Diluted		
Net income (loss) from continuing operations	\$ <u>1,264</u>	\$ <u>(2,003)</u>
Weighted average common shares outstanding for basic earnings per common share	2,422,261	2,337,140
Add dilutive effects of assumed exercises of stock options	-	-
Average shares and dilutive potential common shares	<u>2,422,261</u>	<u>2,337,140</u>
Diluted income (loss) per common share from continuing operations	\$ <u>0.52</u>	\$ <u>(0.86)</u>

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Options for the purchase of 9,301 and 13,786 shares of common stock were not considered in computing diluted earnings per common share for 2012 and 2011 respectively, because they were antidilutive.

3. INVESTMENT SECURITIES

Year-end securities were as follows:

(000s omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2012				
Available-for-sale				
U.S. government and federal agency	\$ 4,992	\$ 19	\$ -	\$ 5,011
State and municipal	2,520	-	(14)	2,506
Mortgage-backed residential Collateralized mortgage obligations - agencies	11,374	197	-	11,571
Equity securities	23,306	198	(121)	23,383
	<u>2,155</u>	<u>93</u>	<u>(189)</u>	<u>2,059</u>
	<u>\$ 44,347</u>	<u>\$ 507</u>	<u>\$ (324)</u>	<u>\$ 44,530</u>
Held to Maturity				
State and municipal	<u>\$ 3,058</u>	<u>\$ 64</u>	<u>\$ (6)</u>	<u>\$ 3,116</u>
2011				
Available-for-sale				
U.S. government and federal agency	\$ 6,144	\$ 23	\$ (2)	\$ 6,165
Mortgage-backed residential Collateralized mortgage obligations - agencies	15,625	312	(15)	15,922
Collateralized mortgage obligations - private label	31,002	457	(5)	31,454
Equity securities	3,725	-	(702)	3,023
	<u>2,155</u>	<u>100</u>	<u>(132)</u>	<u>2,123</u>
	<u>\$ 58,651</u>	<u>\$ 892</u>	<u>\$ (856)</u>	<u>\$ 58,687</u>
Held to Maturity				
State and municipal	<u>\$ 2,963</u>	<u>\$ 90</u>	<u>\$ -</u>	<u>\$ 3,053</u>

Contractual maturities of securities at December 31, 2012 were as follows. Securities not due at a single maturity date, consisting of mortgage-backed, collateralized mortgage obligations and equity securities are shown separately.

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(000s omitted)	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. government and federal agency				
Due in one year or less	\$ -	\$ -	\$ 410	\$ 413
Due from one to five years	2,520	2,506	1,391	1,413
Due from five to ten years	2,000	2,008	1,257	1,290
Due after ten years	2,992	3,003	-	-
Mortgage backed residential	11,374	11,571	-	-
Collateralized mortgage obligations - agencies	23,306	23,383	-	-
Collateralized mortgage obligations - private label	-	-	-	-
Equity securities	2,155	2,059	-	-
	<u>\$ 44,347</u>	<u>\$ 44,530</u>	<u>\$ 3,058</u>	<u>\$ 3,116</u>

Securities pledged at December 31, 2012 and 2011 had a carrying amount of \$5,419,000 and \$10,764,000 and were pledged to secure public deposits and borrowings.

At December 31, 2011 two holdings totaling \$3,023,000 in securities issued by Wells Fargo and Bear Stearns exceeded 10% of stockholders' equity. These securities were sold during 2012.

Securities with unrealized losses at December 31, 2012 and 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

(000s omitted)	Less Than 12 Months		Over 12 Months		Fair Value	Total Gross Unrealized Losses
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss		
2012						
State and municipal	\$ 2,520	\$ (14)	\$ 491	\$ (6)	\$ 3,011	\$ (20)
Mortgage-backed residential	-	-	-	-	-	-
Collateralized mortgage obligations - agencies	12,597	(121)	-	-	12,597	(121)
Collateralized mortgage obligations - private label	-	-	-	-	-	-
Equity securities	-	-	916	(189)	916	(189)
Total	<u>\$ 15,117</u>	<u>\$ (135)</u>	<u>\$ 1,407</u>	<u>\$ (195)</u>	<u>\$ 16,524</u>	<u>\$ (330)</u>

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(000s omitted)	Less Than 12 Months		Over 12 Months		Fair Value	Total Gross Unrealized Losses
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss		
2011						
U.S. Government and federal agencies	\$ -	\$ -	\$ 1,498	\$ (2)	\$ 1,498	\$ (2)
Mortgage-backed residential	6,766	15	-	-	6,766	(15)
Collateralized mortgage obligations - agencies	-	-	4,985	(5)	4,985	(5)
Collateralized mortgage obligations - private label	-	-	3,023	(702)	3,023	(702)
Equity securities	-	-	772	(132)	772	(132)
Total	\$ 6,766	\$ (15)	\$ 10,278	\$ (841)	\$ 17,044	\$ (856)

As of December 31, 2012, the Corporation's security portfolio consisted of 77 securities, 17 of which were in an unrealized loss position.

The Corporation did not recognize other-than-temporary impairment on the investment portfolio during 2012 or 2011.

Collateralized Mortgage Obligations

During 2012 the Corporation sold two private label CMOs. These securities were sold at a combined loss of \$287,000. At December 31, 2011, the private label securities had an amortized cost of \$3,725,000 with an unrealized loss of \$702,000.

The Corporation has also been closely monitoring the performance of the agency CMO and mortgage backed securities ("MBS") portfolios. Management continues to monitor items such as payment streams and underlying default rates, and did not determine a significant change in these items. There were no other-than-temporary impairments recorded in 2011 or 2012.

Equity Securities

The Corporation's equity investments with unrealized losses are investments in non-public bank holding companies within Michigan. These securities receive a multi-faceted review utilizing call reports and other data. Management reviews such performance indicators as earnings, ROE, ROA, non-performing assets, brokered deposits and capital ratios. Management draws conclusions from this information, as well as any published information or trading activity received from the individual institutions, to assist in determining if any unrealized loss is other than temporary. Additionally, management considers the length of time the investments have been in an unrealized loss position.

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In evaluating OTTI, management additionally considers the factors presented in Note 1.

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The table below presents a roll forward of the credit losses recognized in earnings on debt securities for which a portion of OTTI was recognized in other comprehensive income for the periods ended December 31:

(000s omitted)	2012	2011
Beginning balance, January 1	\$ 507	\$ 507
Additions for credit losses on securities for which no previous other-than-temporary impairment was recognized	-	-
Increases to credit losses on securities for which no previous other-than-temporary impairment was recognized	-	-
Reduction for previous credit losses realized on securities sold during the year	<u>(209)</u>	<u>-</u>
Ending balance, December 31	<u>\$ 298</u>	<u>\$ 507</u>

No OTTI was indicated following analysis in 2012 or 2011. The reduction in OTTI shown in the table above related to the sales of the private label CMO's during 2012. The remaining balance relates to OTTI taken on the Corporation's equity securities recognized in 2010.

4. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Corporation originates primarily residential and commercial real estate loans, commercial, and installment loans. The Corporation estimates that the majority of their loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2012 is as follows:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Balance, January 1, 2012	\$ 892	\$ 5,993	\$ 501	\$ 214	\$ 475	\$ 89	\$ 8,164
Provision for loan losses	342	(1,326)	319	(92)	(21)	270	(508)
Loans charged off	(785)	(2,249)	(424)	(37)	(291)	-	(3,786)
Loan recoveries	<u>71</u>	<u>976</u>	<u>3</u>	<u>21</u>	<u>21</u>	<u>-</u>	<u>1,092</u>
Balance, December 31, 2012	<u>\$ 520</u>	<u>\$ 3,394</u>	<u>\$ 399</u>	<u>\$ 106</u>	<u>\$ 184</u>	<u>\$ 359</u>	<u>\$ 4,962</u>

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2011 is as follows:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Balance, January 1, 2011	\$ 871	\$ 9,187	\$ 411	\$ 233	\$ 508	\$ 14	\$ 11,224
Provision for loan Losses	104	2,619	200	129	15	75	3,142
Loans charged off	(178)	(6,066)	(114)	(179)	(74)	-	(6,611)
Loan recoveries	95	253	4	31	26	-	409
Balance, December 31, 2011	<u>\$ 892</u>	<u>\$ 5,993</u>	<u>\$ 501</u>	<u>\$ 214</u>	<u>\$ 475</u>	<u>\$ 89</u>	<u>\$ 8,164</u>

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment and based on impairment method at December 31, 2012:

(000s omitted) 2012	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Allowance for loan Losses							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	\$ 91	\$ 1,631	\$ 116	\$ 36	\$ 23	\$ -	\$ 1,897
Collectively evaluated for impairment	429	1,763	283	70	161	359	3,065
Total ending allowance balance	<u>\$ 520</u>	<u>\$ 3,394</u>	<u>\$ 399</u>	<u>\$ 106</u>	<u>\$ 184</u>	<u>\$ 359</u>	<u>\$ 4,962</u>
Loans							
Loans individually evaluated for impairment	\$ 1,476	\$ 13,534	\$ 1,126	\$ 52	\$ 340	\$ -	\$ 16,528
Loans collectively evaluated for impairment	41,829	89,645	28,712	4,751	18,279	-	183,216
Total ending loan balance	43,305	103,179	29,838	4,803	18,619	-	199,744
Accrued interest receivable	131	305	68	13	58	-	575
Total recorded Investment in loans	<u>\$ 43,436</u>	<u>\$ 103,484</u>	<u>\$ 29,906</u>	<u>\$ 4,816</u>	<u>\$ 18,677</u>	<u>\$ -</u>	<u>\$ 200,319</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment and based on impairment method at December 31, 2011:

(000s omitted) 2011	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Allowance for loan Losses							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	\$ 714	\$ 2,907	\$ 201	\$ 60	\$ 275	\$ -	\$ 4,157
Collectively evaluated for impairment	<u>178</u>	<u>3,086</u>	<u>300</u>	<u>154</u>	<u>200</u>	<u>89</u>	<u>4,007</u>
Total ending allowance balance	<u>\$ 892</u>	<u>\$ 5,993</u>	<u>\$ 501</u>	<u>\$ 214</u>	<u>\$ 475</u>	<u>\$ 89</u>	<u>\$ 8,164</u>
Loans							
Loans individually evaluated for impairment	\$ 3,823	\$ 24,797	\$ 844	\$ 133	\$ 494	\$ -	\$ 30,091
Loans collectively evaluated for impairment	<u>30,133</u>	<u>94,187</u>	<u>25,985</u>	<u>6,270</u>	<u>19,101</u>	<u>-</u>	<u>175,676</u>
Total ending loan balance	33,956	118,984	26,829	6,403	19,595	-	205,767
Accrued interest receivable	<u>143</u>	<u>341</u>	<u>75</u>	<u>47</u>	<u>61</u>	<u>-</u>	<u>667</u>
Total recorded investment in loans	<u>\$ 34,099</u>	<u>\$ 119,325</u>	<u>\$ 26,904</u>	<u>\$ 6,450</u>	<u>\$ 19,656</u>	<u>\$ -</u>	<u>\$ 206,434</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents loans individually evaluated for impairment by portfolio class of loans as of December 31, 2012:

(000s omitted) 2012	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
With no related allowances recorded					
Commercial	\$ 2,022	\$ 1,183	\$ -	\$ 1,193	\$ 51
Commercial real estate	12,693	7,316	-	9,552	569
Residential real estate	263	215	-	144	23
Consumer					
Installment loans	30	5	-	10	3
Home equity	367	258	-	204	24
With an allowance recorded					
Commercial	295	295	91	1,168	11
Commercial real estate	6,263	6,257	1,631	9,894	233
Residential real estate	1,300	913	116	283	34
Consumer					
Installment loans	48	48	36	35	3
Home equity	82	83	23	245	5
Total	\$ 23,363	\$ 16,573	\$ 1,897	\$ 22,728	\$ 956

The following table presents loans individually evaluated for impairment by portfolio class of loans as of December 31, 2011:

(000s omitted) 2011	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
With no related allowances recorded					
Commercial	\$ 2,280	\$ 2,116	\$ -	\$ 2,407	\$ 59
Commercial real estate	16,275	11,302	-	11,785	250
Residential real estate	279	168	-	170	7
Consumer					
Installment loans	13	13	-	-	-
Home equity	119	119	-	-	-
With an allowance recorded					
Commercial	1,903	1,715	714	1,874	120
Commercial real estate	15,814	13,532	2,907	13,733	788
Residential real estate	894	675	201	710	38
Consumer					
Installment loans	121	121	60	71	5
Home equity	377	379	275	444	22
Total	\$ 38,075	\$ 30,140	\$ 4,157	\$ 31,194	\$ 1,289

Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2012:

(000s omitted) 2012	Nonaccrual	Loans Past Due Over 90 Days Still Accruing ⁽¹⁾
Commercial	\$ 1,771	\$ -
Commercial real estate	3,182	-
Home equity	-	-
Installment loans	5	-
Residential real estate	625	102
Total	\$ 5,583	\$ 102

⁽¹⁾ Includes accrued interest receivable of \$2

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2011:

(000s omitted) 2011	Nonaccrual	Loans Past Due Over 90 Days Still Accruing ⁽¹⁾
Commercial	\$ 2,298	\$ 449
Commercial real estate	13,918	-
Home equity	88	39
Installment loans	13	-
Residential real estate	241	-
Total	\$ 16,558	\$ 488

⁽¹⁾ Includes accrued interest receivable of \$6

The following table presents the aging of the recorded investment in past due loans by class of loans as of December 31, 2012:

(000s omitted) 2012	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due ⁽¹⁾	Total Past Due
Commercial	\$ 83	\$ -	\$ 1,073	\$ 1,156
Commercial real estate	215	-	1,028	1,243
Installment loans	-	-	5	5
Home equity	30	-	-	30
Residential real estate	-	-	688	688
Total	\$ 328	\$ -	\$ 2,794	\$ 3,122

⁽¹⁾ Includes accrued interest receivable of \$2

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the aging of the recorded investment in past due loans by class of loans as of December 31, 2011:

(000s omitted) 2011	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due ⁽¹⁾	Total Past Due
Commercial	\$ 431	\$ 14	\$ 2,741	\$ 3,186
Commercial real estate	2,796	-	10,750	13,546
Installment loans	3	1	51	55
Home equity	73	-	85	158
Residential real estate	-	-	198	198
Total	\$ 3,303	\$ 15	\$ 13,825	\$ 17,143

⁽¹⁾Includes accrued interest receivable of \$15

Modifications

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of concessions when modifying a loan or lease, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Residential real estate loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs through a reduction of interest rate and/or extension of the maturity date. Installment loans modified in a TDR are primarily comprised of loans where the Corporation has lowered monthly payments by extending the term.

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Corporation may have the financial effect of increasing the specific allowance associated with the loan.

Modified loans totaled \$11,570,000 at December 31, 2012 compared to \$15,005,000 at December 31, 2011. The sizeable decrease was largely the result of receiving payoffs and restructuring credits.

The Corporation allocated \$1,690,000 and \$2,167,000 of specific reserves to customers whose loan terms have been modified in TDRs as of December 31, 2012 and December 31, 2011. Modified loans are also included with impaired loans. The Corporation has no additional amounts committed to these customers.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following presents by class, information related to loans modified in a TDR during the years ended December 31, 2012 and 2011:

(000s omitted)	Loans Modified as TDR for the Year Ended December 31, 2012		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	-	\$ -	\$ -
Commercial real estate	10	4,211	4,211
Residential real estate	2	187	187
Installment loans	-	-	-
Home equity	1	36	36
Total	13	\$ 4,434	\$ 4,434

(000s omitted)	Loans Modified as TDR for the Year Ended December 31, 2011		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	12	\$ 3,217	\$ 3,217
Commercial real estate	9	2,987	2,987
Residential real estate	1	201	201
Installment loans	1	34	34
Home equity	1	6	6
Total	24	\$ 6,445	\$ 6,445

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The following presents information on TDRs for which there was a payment default, (i.e. 30 days or more past due following a modification) that had been modified during the 12-month period prior to the default.

(000s omitted)	Loans with Payment Defaults December 31, 2012	
	Number of Contracts	Recorded Investment (as of Period End) (1)
Commercial	5	\$ 1,123
Commercial real estate	5	2,241
Installment loans	<u>1</u>	<u>5</u>
Total	<u>11</u>	<u>\$ 3,369</u>

(000s omitted)	Loans with Payment Defaults December 31, 2011	
	Number of Contracts	Recorded Investment (as of Period End) (1)
Commercial	3	\$ 789
Commercial real estate	3	1,151
Installment loans	<u>1</u>	<u>6</u>
Total	<u>7</u>	<u>\$ 1,946</u>

(1) The period-end balances are inclusive of all partial paydowns and charge-offs since the modifications date, if any. Loans modified in a TDR that were fully paid down, charged off, or foreclosed upon by period end are not reported.

Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs are analyzed in the same manner as other impaired loans within their respective loan segment.

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following presents by portfolio loan class, the type of modification made in a TDR:

(000s omitted)	Loans Modified Through Reduction of Interest Rate December 31, 2012		Loans Modified Through Extension of Term December 31, 2012	
	Number of Loans	Recorded Investment (as of Period End) (1)	Number of Loans	Recorded Investment (as of Period End) (1)
Commercial	-	\$ -	-	\$ -
Commercial real estate	7	3,755	3	456
Residential real estate	1	101	1	86
Installment loans	-	-	-	-
Home equity	1	36	-	-
Total	9	\$ 3,892	4	\$ 542

(000s omitted)	Loans Modified Through Reduction of Interest Rate December 31, 2011		Loans Modified Through Extension of Term December 31, 2011	
	Number of Loans	Recorded Investment (as of Period End) (1)	Number of Loans	Recorded Investment (as of Period End) (1)
Commercial	1	\$ 545	-	\$ -
Commercial real estate	1	174	11	2,672
Residential real estate	1	201	8	2,813
Installment loans	-	-	1	6
Home equity	1	34	-	-
Total	4	\$ 954	20	\$ 5,491

⁽¹⁾ The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

Credit Quality Indicators

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience; credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Corporation uses the following definitions for classified risk ratings:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Prime. Loans classified as prime are well seasoned borrowers displaying strong financial condition, consistently superior earning performance, and access to a range of financing alternatives. The borrower's trends and outlook, as well as those of its industry are positive.

Pass. Loans classified as pass have a moderate to average risk to established borrowers that display sound financial condition and operating results. The capacity to service debt is stable and demonstrated at a level consistent with or above the industry norms. Borrower and industry trends and outlook are considered good.

Watch. Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection nor liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The Corporation does not classify loans as doubtful. Loans that approach this status are charged-off.

Based on the most recent analysis performed, the recorded investment by risk category of loans by portfolio class is as follows at December 31:

(000s omitted) 2012	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 6,216	\$ 33,737	\$ 1,779	\$ 1,714	\$ 43,446
Commercial real estate	469	83,607	11,491	7,934	103,501
Total	\$ 6,685	\$ 117,344	\$ 13,270	\$ 9,648	\$ 146,947

(000s omitted) 2011	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 3,441	\$ 25,006	\$ 1,850	\$ 3,832	\$ 34,099
Commercial real estate	-	79,909	14,583	24,833	119,325
Total	\$ 3,441	\$ 104,915	\$ 16,433	\$ 28,665	\$ 153,424

FENTURA FINANCIAL, INC.

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The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity as of December 31, 2012 and 2011:

(000s omitted) 2012	Home Equity	Installment	Residential Real Estate	Total
Performing	\$ 18,346	\$ 4,768	\$ 28,788	\$ 51,902
Non-performing	<u>341</u>	<u>53</u>	<u>1,128</u>	<u>1,522</u>
Total	<u>\$ 18,687</u>	<u>\$ 4,821</u>	<u>\$ 29,916</u>	<u>\$ 53,424</u>

(000s omitted) 2011	Home Equity	Installment	Residential Real Estate	Total
Performing	\$ 19,162	\$ 6,317	\$ 26,060	\$ 51,539
Non-performing	<u>494</u>	<u>133</u>	<u>844</u>	<u>1,471</u>
Total	<u>\$ 19,656</u>	<u>\$ 6,450</u>	<u>\$ 26,904</u>	<u>\$ 53,010</u>

Loans to principal officers, directors, and affiliates at December 31, 2012 and 2011 were \$2,750,000 and \$3,119,000, respectively.

5. OTHER REAL ESTATE OWNED

Other real estate owned at December 31, included in continuing operations, was:

(000s omitted)	2012	2011
Beginning balance, January 1	\$ 1,949	\$ 3,407
Transfer into other real estate	2,400	1,708
Sales of other real estate owned	(1,611)	(2,686)
Write downs of other real estate owned	<u>(159)</u>	<u>(480)</u>
Ending balance	<u>\$ 2,579</u>	<u>\$ 1,949</u>

Net (losses) gains on sales of other real estate were (\$6,000) in 2012 and \$10,000 in 2011. Due primarily to declining real estate values, the Corporation experienced write-downs of other real estate owned of \$159,000 in 2012 and \$480,000 in 2011. Carrying costs associated with other real estate owned totaled \$353,000 in 2012 and \$514,000 in 2011.

FENTURA FINANCIAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. PREMISES AND EQUIPMENT, NET

Bank premises and equipment is comprised of the following at December 31:

(000s omitted)	2012	2011
Land and land improvements	\$ 2,452	\$ 2,455
Building and building improvements	11,107	11,194
Furniture and equipment	5,054	5,889
Construction in progress	<u>81</u>	<u>115</u>
	18,694	19,653
Less accumulated depreciation	<u>8,459</u>	<u>9,451</u>
Ending balance	<u>\$ 10,235</u>	<u>\$ 10,202</u>

Depreciation expense was \$677,000 and \$679,000 for 2012 and 2011.

The Corporation leases property for certain branches and ATM locations. Rent expense was \$60,000 for 2012 and \$81,000 for 2011. Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that generally are present at December 31, 2012 (000s omitted):

2013	\$ 60
2014	57
2015	46
2016	23
2017	<u>-</u>
	<u>\$ 186</u>

7. DEPOSITS

The following is a summary of deposits of at December 31:

(000s omitted)	2012	2011
Non-interest bearing		
Demand	<u>\$ 80,550</u>	<u>\$ 62,713</u>
Interest-bearing		
Savings	76,227	64,365
Money market demand	56,194	52,970
Time, \$100,000 and over	20,394	34,698
Time, \$100,000 and under	<u>42,474</u>	<u>51,135</u>
Total interest bearing	<u>195,289</u>	<u>203,168</u>
Total deposits	<u>\$ 275,839</u>	<u>\$ 265,881</u>

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Scheduled maturities of time deposits at December 31, were as follows:

(000s omitted)	2012	2011
2013	\$ 30,952	\$ 56,890
2014	16,391	17,944
2015	6,258	6,276
2016	2,983	2,619
2017	5,917	2,024
Thereafter	<u>367</u>	<u>80</u>
	<u>\$ 62,868</u>	<u>\$ 85,833</u>

The Corporation held no brokered deposits at December 31, 2012. Brokered deposits totaled approximately \$11,015,000 at December 31, 2011. At December 31, 2011, brokered deposits had interest rates ranging from 4.90% to 5.30%, respectively. Maturities ranged from four to ten months.

As a result of the Consent Order, the Bank is precluded from issuing or renewing brokered deposits.

Deposits from principal officers, directors, and affiliates at December 31, 2012 and 2011 were \$3,468,000 and \$3,343,000, respectively.

8. BORROWINGS

Federal Home Loan Bank Advance

At year-end, advances from the FHLB were as follows:

(000s omitted) Principal Term	Advance Amount	Maturity Date
<u>December 31, 2012</u>		
Single maturity fixed rate advance With rate of 7.34%	\$ <u>891</u>	May 2016
<u>December 31, 2011</u>		
Single maturity fixed rate advance With rate of 7.34%	\$ <u>923</u>	May 2016

The advance is payable at its maturity date, a prepayment penalty is assessed with early payoffs of advances. The advance is collateralized by securities totaling \$4,743,000 and \$5,975,000 at December 31, 2012 and 2011, respectively.

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Maturities over each of the next five years are (000s omitted):

2013	\$	35
2014		39
2015		42
2016		<u>775</u>
	\$	<u>891</u>

Subordinated Debentures and Trust Preferred Securities

A trust formed by the Corporation issued \$12,000,000 of trust preferred securities in 2003 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 3.00%) and the current rate at December 31, 2012 is 3.31%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2008 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2033.

A trust formed by the Corporation issued \$2,000,000 of trust preferred securities in 2005 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 1.60%) and the current rate at December 31, 2012 is 1.91%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2010 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2035.

The Corporation is not considered the primary beneficiary of these trusts, therefore the trusts are not consolidated in the Corporations' financial statements but rather the subordinated debentures are shown as a liability.

As the subsidiary banks are working to preserve capital and withholding the payment of dividends to the holding company, the Corporation elected in the first quarter of 2009 to defer interest payments for five years on the \$14,000,000 of subordinated debentures. The reason for the interest deferral was to maintain liquidity at the holding company and the Bank subsidiary. Accrued interest payable on the subordinated debentures was \$1,844,000 at December 31, 2012 compared to \$1,464,000 at December 31, 2011. The Corporation is not in default under either of the indentures. During this five year period, the Corporation is precluded from paying dividends on its outstanding common stock. The Corporation subsequently may give notice that it elects to shorten the deferral period, pay accrued interest and return to the normal course of dividend payments.

9. INCOME TAXES

The provision (benefit) for income taxes reflected in the consolidated statements of operations for the years ended December 31 consists of the following:

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(000s omitted)	2012	2011
Current expense of continuing operations	\$ 73	\$ 295
Deferred expense of continuing operations	-	(243)
Net tax from continuing operations	73	52
Net tax expense of discontinued operations	-	280
	<u>\$ 73</u>	<u>\$ 332</u>

Income tax expense for continuing operations was less than the amount computed by applying the statutory federal income tax rate to income (loss) before income taxes. The reasons for the difference are as follows:

(000s omitted)	2012	2011
Income tax at statutory rate	\$ 435	\$ (663)
Valuation allowance	(60)	321
IRS audit settlement	228	193
Tax exempt status	(61)	(77)
Other	(469)	278
	<u>\$ 73</u>	<u>\$ 52</u>

The net deferred tax asset recorded includes the following amounts of deferred tax assets and liabilities:

(000s omitted)	2012	2011
Deferred tax assets		
Allowance for loan losses	\$ 1,687	\$ 2,775
Alternative minimum tax credit	258	214
Compensation	293	299
Net operating loss	3,562	2,334
Non-accrual interest	137	98
Capital loss	1,149	1,149
ORE write downs	440	628
Other	295	281
	<u>7,821</u>	<u>7,778</u>
Deferred tax liabilities		
Depreciation	(689)	(575)
Other	(40)	(74)
	<u>(729)</u>	<u>(649)</u>
Valuation allowance	<u>(7,092)</u>	<u>(7,129)</u>
Net deferred taxes	<u>\$ -</u>	<u>\$ -</u>

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefit related to such assets may not be realized. Management has reviewed the deferred tax position for the Corporation at December 31, 2012 and 2011. The Corporation's evaluation of taxable events, losses in recent years and the deterioration of the Michigan economy led management to conclude that it was more likely than not that the benefit would not be realized. As a result, the Corporation maintained a full valuation allowance at December 31, 2012 and 2011, respectively. The federal net operating loss carry forwards of approximately \$10,477,000 will expire beginning in 2030 if not previously utilized.

An income tax expense associated with continuing operations in the amounts of \$73,000 and \$52,000 were recorded for the years ended December 31, 2012 and 2011 respectively. The expense recorded considers the results of current period adjustments to other comprehensive income and discontinued operations. Generally, the calculation for income tax expense (benefit) does not consider the tax effect of changes in other comprehensive income or loss, which is a component of shareholders' equity on the balance sheet. However, an exception is provided in certain circumstances when there is a pre-tax loss from continuing operations and income from other categories such as other comprehensive income or discontinued operations. In such case, pre-tax income from other categories is included in the tax expense (benefit) calculation for the current period.

In the ordinary course of business, the Corporation enters into certain transactions that have uncertain tax consequences. From time to time, the Internal Revenue Service (IRS) questions and/or challenges the tax position taken by the Corporation with respect to those transactions. The Corporation believes that its tax returns were filed based upon applicable statutes, regulations and case law in effect at the time of the transactions. The IRS, an administrative authority of a court, if presented with the transactions, could disagree with the Corporation's interpretation of the tax law. After evaluating the risks and opportunities, the best outcome may result in a settlement. The ultimate outcome for each position is not known.

At December 31, 2011, amounts payable to the IRS for the settlement of certain tax positions examined by the agency were \$193,000. There were no unrecognized or recognized tax benefits recorded in any previously reported periods presented. The increase of \$193,000 in amounts recorded for tax positions previously taken from December 31, 2010 was the result of the Corporation's IRS examination and ultimate settlement. Accrued interest and penalties were not considered to be significant. These amounts were paid during 2012.

At December 31, 2012, amounts payable to the IRS for the settlement of certain tax positions examined by the agency were \$230,000. There were no unrecognized or recognized tax benefits recorded in any previously reported periods presented. The increase of \$230,000 in amounts recorded for tax positions previously taken from December 31, 2011 was the result of the Corporation's IRS examination covering the 2009 tax year and ultimate settlement. The Corporation does not expect the total amount of unrecognized or recognized tax benefits to significantly change within the next twelve months. The aforementioned other positions taken would not be expected to have a significant impact on the Corporation's effective tax rate in any one reporting period if and when recognized.

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Based on current knowledge and probability of assessment of various potential outcomes, the Corporation believes that accrued tax liabilities and the valuation allowance are adequate to absorb the effect, if any, relating to the ultimate resolution of the uncertain tax position in the matter outlined above.

The Corporation and its subsidiaries are subject to U.S. federal income taxes as well as income tax of the state of Michigan. The Corporation is no longer subject to examination by taxing authorities for years before 2009.

10. BENEFIT PLANS

The Corporation has a noncontributory discretionary employee stock ownership plan (Plan) covering substantially all of its employees. It is a requirement of the plan to invest principally in the Corporation's common stock. No contributions were made to the Plan in 2012 or 2011.

The Corporation has also established a 401(k) Plan in which 50% of the employees' contribution can be matched with a discretionary contribution by the Corporation up to a maximum of 6% of gross wages. There were no contributions to the plan in 2012 or 2011.

The Corporation entered into Supplemental Executive Retirement Agreements (SERP Agreements) with certain executives. The SERP Agreements are designed to encourage executives to remain long term employees of the Corporation, and to provide specified benefits to certain key executives who contribute materially to the continued growth, development and future business success of the Corporation. The retirement benefits are an unsecured obligation of the Corporation. The Corporation and the Affiliate Bank have established other Non-Qualified Deferred Compensation arrangements for employees not covered under the SERP. The arrangements are designed to encourage certain officers to remain long-term employees of the Corporation and the Bank, and to provide the officers with supplemental retirement income. At year end 2012 and 2011, the accumulated liability for these plans totaled \$861,317, and \$878,731, respectively. The Corporation's contributions to the plans in 2012 and 2011 were \$171,527 and \$323,354, respectively. Certain executive officers are subject to post-employment payments for termination following a change in control.

11. COMMON STOCK PURCHASE AND OPTION PLANS

Director and Employee Plans

The Directors Stock Purchase Plan permits directors of the Corporation to purchase shares of common stock made available for purchase under the plan at the fair market value on the fifteenth day prior to the annual issuance date. The total number of shares issuable under this plan is limited to 9,600 shares in any calendar year.

The Retainer Stock Plan allows directors to elect to receive shares of common stock in full or partial payment of the director's retainer fees and fees for attending meetings. The number of shares is determined by dividing the dollar amount of fees to be paid in shares by the market value of the stock on the first business day prior to the payment date.

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The Executive Stock Bonus Plan permits the administrator of the plan to grant shares of the Corporation's common stock to eligible employees. Any executive or managerial level employee is eligible to receive grants under the plan. The Board of Directors administers the plan and the numbers of shares issued are at the sole discretion of the Board of Directors. No shares were granted under this plan during 2012 or 2011.

Dividend Investment Plan

The Automatic Dividend Reinvestment Plan ("DRIP") permits enrolled shareholders to automatically use dividends paid on common stock to purchase additional shares of the Corporation's common stock at the fair market value on the investment date. Any shareholder who is the beneficial or record owner of not more than 9.9% of the issued and outstanding shares of the Corporation's common stock is eligible to participate in the plan.

Pursuant to a separate agreement with a family who collectively holds more than 9.9% of the Corporation's stock on or prior to January 31 of each year beginning January 31, 1997, the Corporation is to advise the family, in a written notice, of the number of shares sold under the DRIP. Each family member will have the option, until February 28 of the same year, to purchase from the Corporation one-third of the total number of shares that would be sufficient to prevent the dilution to all family members as a group that result from the DRIP shares. The purchase price under this agreement is the fair market value on December 31 of the year immediately preceding the year in which the written notice is given. Similarly, a reverse agreement exists which allows the Corporation to redeem family shares to maintain the family ownership percentage in the event that stock repurchase activity more than offsets the shares available because of the DRIP.

The following summarizes shares issued under the various plans:

(000s omitted)	2012	2011
Automatic dividend reinvestment plan	\$ -	\$ -
Director stock purchase and retainer stock	54,146	73,668
Stock options	-	-
Other issuance of stock	<u>1,790</u>	<u>5,792</u>
	<u>\$ 55,936</u>	<u>\$ 79,460</u>

Stock Option Plans

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the fair market value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the Plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options were granted in 2012 or 2011.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other

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terms of the options, subject to consistency with the terms of the Plan. No options were granted in 2012 or 2011.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

The following table summarizes stock option activity:

(000s omitted)	Number of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2012	13,786	\$ 29.60		
Options forfeited during 2012	<u>(4,485)</u>	<u>26.92</u>		
Options outstanding and exercisable at December 31, 2012	<u>9,301</u>	<u>\$ 30.89</u>	<u>0.90</u>	<u>-</u>

(000s omitted)	Number of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2011	18,872	\$ 29.32		
Options forfeited during 2011	<u>(5,086)</u>	<u>28.57</u>		
Options outstanding at December 31, 2011	<u>13,786</u>	<u>\$ 29.60</u>	<u>1.73</u>	<u>-</u>

No options were exercised during 2012 or 2011. As of December 31, 2012 and 2011, there was no unrecognized compensation cost related to non-vested stock options granted under the Plan.

On February 24, 2011, the Corporation's board of directors granted 25,000 Stock Appreciation Rights ("SARs") to five executives. The terms of the Stock Appreciation Rights Agreements (the "SAR Agreements") provide that the SARs will be paid in cash on one or two fixed dates,

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which are determined as certain performance conditions are met. The conditions include the Corporation's wholly owned subsidiary, The State Bank, no longer being subject to terms, conditions and restrictions of the consent order dated December 31, 2009 (the "Consent Order") and the Corporation no longer being subject to terms, conditions and restrictions of the agreement between the Corporation and the Federal Reserve Board, which was effective November 4, 2010 (the "FRB Agreement"). The first payment date under the agreement is the later of February 24, 2014, the date on which the State Bank is no longer subject to the terms, conditions and restrictions of the Consent Order, and the date on which the Corporation is no longer subject to the terms, conditions and restrictions of the FRB Agreement. On the first SAR payment date a participant shall receive an amount equal to the product of the number of stock appreciation rights granted and the excess of the fair market value of one share of the Corporation's common stock over \$2.00. If the first SAR payment date does not occur prior to February 24, 2016, then the SARs shall be cancelled without any payment to the participant. If the first SAR payment date occurs prior to February 24, 2016, then the second SAR payment date shall be February 24, 2016. On the second payment date a participant shall receive an amount equal to the number of stock appreciation rights granted and the excess of the fair market value of one share of the Corporation's common stock on the second SAR payment date over the value of one share of the Corporation's common stock on the first SAR payment date. If the fair market value of one share of the Corporation's common stock on the second SAR payment date does not exceed the fair market value of one share of the Corporation's common stock on the first SAR payment date, then no payment shall be made to the participant on the second SAR payment date. There were 20,000 SAR's outstanding at December 31, 2012 as a result of this issuance as 5,000 SAR's were forfeited during 2012 as a result of one of the executive's departure.

On March 13, 2012, the Corporation's board of directors granted 10,000 Stock Appreciation Rights to a new executive officer. The terms of this Stock Appreciation Rights Agreement is the same as those previously discussed except that the first and second payment dates are March 12, 2015 and March 13, 2017, respectively.

On May 14, 2012, the Corporation's board of directors granted 5,000 Stock Appreciation Rights to a new executive officer. The terms of this Stock Appreciation Rights Agreement is the same as those previously discussed except that the first and second payment dates are May 14, 2015 and May 14, 2017, respectively. As a result of all issuances, 35,000 SARs were outstanding at December 31, 2012.

Generally accepted accounting principles require plans settled in cash to be accounted for as liabilities only when the liability is probable and reasonably estimable and to be re-measured at each reporting period. Management has determined that as of December 31, 2012, it is not probable that the performance criteria will be met and as such no liability for the compensatory element of the awards has been recorded in the consolidated financial statements.

12. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

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 and asset or liability.

Securities Available for Sale

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance. The Corporation reviews the performance of the securities that comprise level 3 on a quarterly basis.

Impaired Loans

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 usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned

Non-recurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available, which results in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

(000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2012				
Available-for-sale securities				
U.S. government and federal agency	\$ 5,011	\$ -	\$ 5,011	\$ -
State and municipal	2,506	-	2,506	-
Mortgage-backed residential Collateralized mortgage obligations - agencies	11,571	-	11,571	-
Equity securities	23,383	-	23,383	-
	2,059	-	1,394	665
	<u>\$ 44,530</u>	<u>\$ -</u>	<u>\$ 43,865</u>	<u>\$ 665</u>

(000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2011				
Available-for-sale securities				
U.S. government and federal agency	\$ 6,165	\$ -	\$ 6,165	\$ -
Mortgage-backed residential Collateralized mortgage obligations - agencies	15,922	-	15,922	-
Collateralized mortgage Obligations - private label	31,454	-	31,454	-
Equity securities	3,023	-	3,023	-
	2,123	-	1,051	1,072
	<u>\$ 58,687</u>	<u>\$ -</u>	<u>\$ 57,615</u>	<u>\$ 1,072</u>

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The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

(000s omitted)	Equity Securities	
	2012	2011
Beginning balance, January 1	\$ 1,072	\$ 1,147
Included in other comprehensive income	(63)	(75)
Transfers in and/or out of Level 3	<u>(344)</u>	<u>-</u>
Ending balance, December 31	<u>\$ 665</u>	<u>\$ 1,072</u>

During 2012, \$344,000 of equity securities were transferred from level 3 to level 2 due to observable trades during 2012.

Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

(000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2012				
Impaired loans				
Commercial	\$ 203	\$ -	\$ -	\$ 203
Commercial real estate	1,193	-	-	1,193
Residential real estate	796	-	-	796
Installment	12	-	-	12
Home equity	<u>27</u>	<u>-</u>	<u>-</u>	<u>27</u>
Total impaired loans	<u>\$ 2,231</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,231</u>
Other real estate owned				
Commercial real estate	<u>\$ 229</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 229</u>

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(000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2011				
Impaired loans				
Commercial	\$ 60	\$ -	\$ -	\$ 60
Commercial real estate	4,534	-	-	4,534
Residential real estate	474	-	-	474
Installment	55	-	-	55
Home equity	102	-	-	102
Total impaired loans	\$ 5,225	\$ -	\$ -	\$ 5,225
Other real estate owned				
Commercial real estate	\$ 301	\$ -	\$ -	\$ 301

The following represent impairment charges recognized during the year:

Impaired loans that are measured for impairment using the fair value of the collateral had a carrying amount of \$3,101,000, with a valuation allowance of \$870,000, which did not require additional provision for loan losses at December 31, 2012. At December 31, 2011 impaired loans had a carrying amount of \$7,105,000, with a valuation allowance of \$1,880,000, which did not require additional provision for loan losses at December 31, 2011.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,579,000, of which \$229,000 was at fair value at December 31, 2012, which resulted from write-downs totaling \$48,000. At December 31, 2011 other real estate owned had a net carrying amount of \$1,949,000, of which \$301,000 was at fair value at December 31, 2011, which resulted from write-downs totaling \$24,000.

Qualitative information about level 3 fair value instruments is as follows:

Instrument	Level 3 Instruments			
	Fair Value	Valuation Technique	Unobservable Input	Weighted Average
Equity Securities	\$ 665	Market Average	Price to book ratio	63%
Impaired Loans	\$ 2,231	Appraisal Value - Real Estate	Discount applied to appraisal	3%
		Appraisal Value - Accounts Receivable	Discount applied to appraisal	80%
		Appraisal Value - Vehicles/Equipment	Discount applied to appraisal	66%
Other Real Estate	\$ 229	Appraisal Value	Discount applied to appraisal	0%

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Carrying amount and estimated fair value of financial instruments, not previously presented, at year end were as follows:

(000s omitted)	2012		2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Cash and cash equivalents	\$ 45,712	\$ 45,712	\$ 18,634	\$ 18,634
Securities held to maturity	3,058	3,116	2,963	3,053
Loans held for sale	782	782	123	123
Net loans (including impaired loans)	194,782	198,737	197,603	205,647
FHLB stock	661	661	661	661
Accrued interest receivable	902	902	1,039	1,039
Liabilities				
Deposits	\$ 275,839	\$ 276,291	\$ 265,881	\$ 266,661
FHLB advances	891	1,072	923	1,142
Subordinated debentures	14,000	13,999	14,000	13,751
Accrued interest payable	1,920	1,920	1,572	1,572

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

Cash and Cash Equivalents

The carrying amounts reported in the consolidated balance sheets for cash and short-term instruments approximate their fair values.

Securities Held to Maturity

Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

Loans Held for Sale

The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

FHLB Stock

It was not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans

For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated using discounted cash flow analysis. The carrying amount of accrued interest receivable approximates its fair value.

Accrued Interest

The carrying amount of accrued interest approximates its fair value.

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Off-Balance-Sheet Instruments

The fair value of off-balance sheet items is not considered material.

Deposits

The fair values disclosed for demand deposits are, by definition equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using discounted cash flow calculation that applies interest rates currently being offered on similar certificates.

FHLB Advance

Rates currently available for FHLB advances with similar terms and remaining maturities are used to estimate the fair value of the existing obligation.

Subordinated Debentures

The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on management's judgments regarding future expected loss experience, current economic conditions, risk characteristics and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

13. REGULATORY MATTERS

The Corporation (on a consolidated basis) and its Bank subsidiary are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items that are calculated under regulatory accounting practices. The capital amounts and classifications 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.

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2012 and 2011, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action.

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators that contain provisions to foster improvement in The State Bank's earnings, lower nonperforming loan levels, increase capital, and require revisions to various policies. The Consent Order requires The State Bank to maintain a Tier 1 capital to average asset ratio of a minimum of 8.0%. It also requires The State Bank to maintain a total capital to risk weighted asset ratio of 12.0%. At December 31, 2012, The State Bank had a Tier 1 capital to average assets ratio of 8.7% and a total capital to risk-weighted assets ratio of 13.3%.

The Consent Orders restrict the Bank from issuing or renewing brokered deposits. The Consent Orders also restrict dividend payments from The State Bank to the Corporation. The Corporation, the Board of Directors and management continue to work on plans to come into compliance with the Consent Orders. Recent actions included the injection of \$900,000 of capital into The State Bank on January 31, 2011 resulting from the sale of West Michigan Community Bank. Additional capital injections were made on June 2, 2011 in the amount of \$2,862,000 and on July 27, 2011 in the amount of \$850,000. These injections were the result of the sale of non-performing assets from the subsidiary of the Corporation. Following these injections, the Bank has attained capital levels that can be considered well capitalized by regulatory standards. Future non-compliance with Consent Order requirements may cause the Bank to be subject to further enforcement actions by the FDIC.

Effective in November 2010, the Corporation received a notice from The Federal Reserve which defined restrictions being placed upon the holding company. The restrictions include the declaration or payment of any dividends, the receipt of dividends from subsidiary banks, the repayment of any principal or interest on subordinated debentures or Trust Preferred securities, restrictions on debt, any changes in Executive or Senior Management or change in the role of Senior Management. In addition, the notice provided an expectation that the Corporation "maintain sufficient capital" levels.

The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies.

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The tables below illustrate the regulatory capital amounts and ratios as of December 31, 2012 and 2011:

(000s omitted)	Actual		For Capital Adequacy Purposes		Regulatory Agreement Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2012						
Total Capital (to Risk Weighed Assets) The State Bank	28,829	13.3%	17,291	8.0%	25,937	12.0%
Tier 1 Capital (to Risk Weighed Assets) The State Bank	26,071	12.1%	8,646	4.0%	N/A	N/A
Tier 1 Capital (to Average Assets) The State Bank	26,071	8.7%	11,944	4.0%	23,888	8.0%
(000s omitted)	Actual		For Capital Adequacy Purposes		Regulatory Agreement Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2011						
Total Capital (to Risk Weighed Assets) The State Bank	26,448	12.3%	17,166	8.0%	\$ 25,749	12.0%
Tier 1 Capital (to Risk Weighed Assets) The State Bank	23,700	11.0%	8,583	4.0%	N/A	N/A
Tier 1 Capital (to Average Assets) The State Bank	23,700	8.1%	11,654	4.0%	\$ 23,307	8.0%

Management believes they have responded fully to the provisions of the Consent Order. Non-compliance with Consent Order requirements may cause the Bank to be subject to further enforcement actions by the FDIC.

14. LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES

Off-balance-Sheet Risk

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

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The contractual amount of financial instruments with off-balance-sheet risk was as follows at year-end:

(000s omitted)	2012	2011
Commitments to make loans (at market rate)	\$ 20,653	\$ 5,725
Unused lines of credit and letters of credit	31,994	28,420

Commitments to make loans are generally made for periods of 90 days or less. At December 31, 2012, loan commitments and unused lines of credit had interest rates ranging from 2.75% to 7.75% and maturities ranging from 1 month to 30 years.

15. CONTINGENCIES

Litigation

The Corporation is party to litigation arising during the normal course of business. In the opinion of management, based on consultation with legal counsel, the resolution of such litigation is not expected to have a material effect on the consolidated financial statements.

Environmental Issues

As a result of acquiring real estate from foreclosure proceedings, the Corporation is subject to potential claims and possible legal proceedings involving environmental matters. No such claims have been asserted as of December 31, 2012.

16. DISCONTINUED OPERATIONS

On April 28, 2010, at the Annual Shareholder Meeting, a formal announcement was made regarding the signing of a definitive agreement to sell West Michigan Community Bank ("WMCB"). The transaction was consummated on January 31, 2011, and the Corporation received \$10,500,000 from the sale of West Michigan Community Bank (a 10% premium over book value). As a condition of the sale, the Corporation assumed certain non-performing assets of West Michigan Community Bank which totaled \$9,900,000. The assets were housed in a newly formed real estate holding company subsidiary of the Corporation, FHLLC. In addition, The State Bank assumed \$2,900,000 of watch rated credits.

As of July 1, 2011, due to a change in management's intent, the remaining balances of the assets described above and previously classified as discontinued operations at June 30, 2011 were reclassified to continuing operations; therefore there are no assets or liabilities presented at December 31, 2011.

A condensed statement of income of discontinued operations is presented for the twelve months ended December 31, 2011. Due to the sale of West Michigan Community Bank at January 31, 2011, only one month of income and expense is presented. Due to management's change in intent in regard to loans and other real estate assumed, related to the sale of West Michigan Community Bank, which occurred July 1, 2011, only six months of income and expense are presented.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Condensed Statement of Discontinued Operations

(000s omitted)	Year Ended December 31, 2011		
	Assumed Loans and Other Real Estate	WMCB	Total
Interest income	\$ -	\$ 515	\$ 515
Interest expense	-	129	129
Net interest income	-	386	386
Provision for loan losses	-	(50)	(50)
Net interest income after Provision for loan losses	-	436	436
Non-interest income	-	121	121
Non-interest expense	82	415	497
Income (loss) before federal Income tax	(82)	142	60
Federal income tax expense (benefit)	-	38	38
Gain on sale of subsidiary	-	469	469
Net income (loss)	<u>\$ (82)</u>	<u>\$ 573</u>	<u>\$ 491</u>

In connection with the sale of West Michigan Community Bank, the Corporation recognized a gross gain of \$711,000. Net of tax the net gain amounted to \$469,000.

