

CHOICEONE FINANCIAL SERVICES INC  
Form 10-Q  
August 13, 2014  
**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2014

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: **000-19202**

**ChoiceOne Financial Services, Inc.**  
(Exact Name of Registrant as Specified in its Charter)

**Michigan**  
(State or Other Jurisdiction of  
Incorporation or Organization) **38-2659066**  
(I.R.S. Employer Identification No.)

**109 East Division**  
**Sparta, Michigan** **49345**  
(Address of Principal Executive Offices) (Zip Code)

**(616) 887-7366**  
(Registrant's Telephone Number, including Area Code)

Indicate by checkmark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes            No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes            No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer                      Accelerated filer

Non-accelerated filer                      Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes    No

As of July 31, 2014, the Registrant had outstanding 3,300,238 shares of common stock.

**PART I. FINANCIAL INFORMATION**Item 1. Financial Statements.

ChoiceOne Financial Services, Inc.

**CONSOLIDATED BALANCE SHEETS**

| (Dollars in thousands)  | June 30,<br>2014<br>(Unaudited) | December<br>31,<br>2013<br>(Audited) |
|---|---------------------------------|--------------------------------------|
| <b>Assets</b>   |                                 |                                      |
| Cash and due from banks   | \$ 20,741                       | \$ 20,479                            |
| Securities available for sale   | 139,354                         | 136,082                              |
| Federal Home Loan Bank stock  | 2,478                           | 2,478                                |
| Federal Reserve Bank stock  | 1,272                           | 1,272                                |
| Loans held for sale   | 1,323                           | 931                                  |
| Loans   | 329,694                         | 315,966                              |
| Allowance for loan losses   | (4,656 )                        | (4,735 )                             |
| Loans, net  | 325,038                         | 311,231                              |
| Premises and equipment, net   | 11,917                          | 11,995                               |
| Other real estate owned, net  | 349                             | 508                                  |
| Cash value of life insurance policies                                 | 10,412                          | 10,269                               |
| Intangible assets, net  | 1,051                           | 1,275                                |
| Goodwill  | 13,728                          | 13,728                               |
| Other assets  | 4,259                           | 4,327                                |
|   | <b>\$ 531,922</b>               | <b>\$ 514,575</b>                    |
| <b>Liabilities</b>  |                                 |                                      |
| Deposits – noninterest-bearing  | \$ 119,754                      | \$ 102,243                           |
| Deposits – interest-bearing   | 308,015                         | 315,884                              |
| Total deposits  | 427,769                         | 418,127                              |
| Repurchase agreements   | 22,361                          | 26,033                               |
| Advances from Federal Home Loan Bank                                  | 14,378                          | 6,392                                |
| Other liabilities   | 3,417                           | 2,465                                |
| Total liabilities   | 467,925                         | 453,017                              |
| <b>Shareholders' Equity</b>   |                                 |                                      |
| Preferred stock; shares authorized: 100,000; shares outstanding: none | —                               | —                                    |

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|  |            |            |
|--|------------|------------|
| Common stock and paid in capital, no par value; shares authorized: 7,000,000;<br>shares outstanding: 3,300,238 at June 30, 2014 and 3,295,463 at December 31, 2013 | 46,679     | 46,595     |
| Retained earnings  | 16,444     | 14,815     |
| Accumulated other comprehensive income, net  | 874        | 148        |
| Total shareholders' equity   | 63,997     | 61,558     |
| Total liabilities and shareholders' equity   | \$ 531,922 | \$ 514,575 |

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.

**CONSOLIDATED STATEMENTS OF INCOME** (Unaudited)

| (Dollars in thousands, except per share data)       | Three Months              |         | Six Months                |         |
|---|---------------------------|---------|---------------------------|---------|
|   | Ended<br>June 30,<br>2014 | 2013    | Ended<br>June 30,<br>2014 | 2013    |
| Interest income                                     |                           |         |                           |         |
| Loans, including fees                               | \$3,940                   | \$4,004 | \$7,764                   | \$8,008 |
| Securities:   |                           |         |                           |         |
| Taxable   | 454                       | 454     | 936                       | 917     |
| Tax exempt  | 343                       | 347     | 690                       | 693     |
| Other   | 1                         | 2       | 4                         | 5       |
| Total interest income                               | 4,738                     | 4,807   | 9,394                     | 9,623   |
| Interest expense                                    |                           |         |                           |         |
| Deposits  | 262                       | 338     | 541                       | 714     |
| Advances from Federal Home Loan Bank                | 15                        | 11      | 26                        | 15      |
| Other   | 12                        | 10      | 24                        | 19      |
| Total interest expense                              | 289                       | 359     | 591                       | 748     |
| Net interest income                                 | 4,449                     | 4,448   | 8,803                     | 8,875   |
| Provision for loan losses                           | —                         | —       | 100                       | 300     |
| Net interest income after provision for loan losses | 4,449                     | 4,448   | 8,703                     | 8,575   |
| Noninterest income                                  |                           |         |                           |         |
| Customer service charges                            | 963                       | 934     | 1,822                     | 1,772   |
| Insurance and investment commissions                | 206                       | 194     | 437                       | 343     |
| Gains on sales of loans                             | 304                       | 481     | 450                       | 974     |
| Gains on sales of securities                        | 27                        | 53      | 92                        | 76      |
| Losses on sales and write-downs of other assets     | (110 )                    | (231 )  | (111 )                    | (300 )  |
| Earnings on life insurance policies                 | 73                        | 75      | 143                       | 150     |
| Other   | 119                       | 126     | 235                       | 267     |
| Total noninterest income                            | 1,582                     | 1,632   | 3,068                     | 3,282   |
| Noninterest expense                                 |                           |         |                           |         |
| Salaries and benefits                               | 2,076                     | 2,101   | 4,160                     | 4,117   |
| Occupancy and equipment                             | 596                       | 592     | 1,213                     | 1,162   |
| Data processing                                     | 461                       | 452     | 887                       | 906     |
| Professional fees                                   | 236                       | 234     | 433                       | 392     |
| Supplies and postage                                | 105                       | 100     | 218                       | 244     |
| Advertising and promotional                         | 93                        | 59      | 135                       | 112     |
| Intangible amortization                             | 112                       | 112     | 224                       | 224     |
| Loan and collection expense                         | 40                        | 66      | 66                        | 177     |
| FDIC insurance                                      | 91                        | 84      | 171                       | 179     |

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|                              |         |         |         |         |
|------------------------------|---------|---------|---------|---------|
| Other                        | 403     | 481     | 763     | 884     |
| Total noninterest expense    | 4,213   | 4,281   | 8,270   | 8,397   |
| Income before income tax     | 1,818   | 1,799   | 3,501   | 3,460   |
| Income tax expense           | 481     | 487     | 916     | 913     |
| Net income                   | \$1,337 | \$1,312 | \$2,585 | \$2,547 |
| Basic earnings per share     | \$0.40  | \$0.40  | \$0.78  | \$0.77  |
| Diluted earnings per share   | \$0.40  | \$0.40  | \$0.78  | \$0.77  |
| Dividends declared per share | \$0.15  | \$0.13  | \$0.29  | \$0.26  |

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME** (Unaudited)

| (Dollars in thousands)   | Three Months |          | Six Months |         |
|--|--------------|----------|------------|---------|
|  | Ended        |          | Ended      |         |
|  | June 30,     |          | June 30,   |         |
|  | 2014         | 2013     | 2014       | 2013    |
| Net income   | \$1,337      | \$1,312  | \$2,585    | \$2,547 |
| Other comprehensive income:  |              |          |            |         |
| Unrealized holding gains/(losses) on available for sale securities | 948          | (2,435)  | 1,190      | (2,277) |
| Less: Reclassification adjustment for gain recognized in earnings  | (27 )        | (53 )    | (92 )      | (76 )   |
| Net unrealized gain/(loss)   | 921          | (2,488)  | 1,098      | (2,353) |
| Tax (expense)/benefit  | (313 )       | 846      | (372 )     | 800     |
| Other comprehensive income/(loss), net of tax                      | 608          | (1,642)  | 726        | (1,553) |
| Comprehensive income/(loss)  | \$1,945      | \$(330 ) | \$3,311    | \$994   |

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY** (Unaudited)

| (Dollars in thousands)                     | Number of<br>Shares | Common                             |                      | Accumulated                              |          |
|--|---------------------|------------------------------------|----------------------|--|----------|
|  |                     | Stock<br>and<br>Paid in<br>Capital | Retained<br>Earnings | Other<br>Comprehensive<br>Income,<br>Net | Total    |
| Balance, January 1, 2013                   | 3,298,081           | \$46,649                           | \$11,501             | \$ 2,356                                 | \$60,506 |
| Net income                                 |                     |                                    | 2,547                |  | 2,547    |
| Other comprehensive loss                   |                     |                                    |                      | (1,553 )                                 | (1,553 ) |
| Shares repurchased                         | (7,468 )            | (125 )                             |                      |  | (125 )   |
| Shares issued                              | 5,311               | 76                                 |                      |  | 76       |
| Change in ESOP repurchase obligation       |                     | (13 )                              |                      |  | (13 )    |
| Effect of employee stock purchases         |                     | 6                                  |                      |  | 6        |
| Cash dividends declared (\$0.26 per share) |                     |                                    | (858 )               |  | (858 )   |
| Balance, June 30, 2013                     | 3,295,924           | \$46,593                           | \$13,190             | \$ 803                                   | \$60,586 |
| Balance, January 1, 2014                   | 3,295,463           | \$46,595                           | \$14,815             | \$ 148                                   | \$61,558 |
| Net income                                 |                     |                                    | 2,585                |  | 2,585    |
| Other comprehensive income                 |                     |                                    |                      | 726                                      | 726      |
| Shares issued                              | 4,775               | 75                                 |                      |  | 75       |
| Change in ESOP repurchase obligation       |                     | (8 )                               |                      |  | (8 )     |
| Effect of employee stock purchases         |                     | 6                                  |                      |  | 6        |
| Restricted stock units issued              |                     | 11                                 |                      |  | 11       |
| Cash dividends declared (\$0.29 per share) |                     |                                    | (956 )               |  | (956 )   |
| Balance, June 30, 2014                     | 3,300,238           | \$46,679                           | \$16,444             | \$ 874                                   | \$63,997 |

See accompanying notes to consolidated financial statements.



ChoiceOne Financial Services, Inc.

**CONSOLIDATED STATEMENTS OF CASH FLOWS** (Unaudited)

| (Dollars in thousands)   | Six Months Ended<br>June 30, |          |
|--|------------------------------|----------|
|  | 2014                         | 2013     |
| Cash flows from operating activities:                                      |                              |          |
| Net income   | \$2,585                      | \$2,547  |
| Adjustments to reconcile net income to net cash from operating activities: |                              |          |
| Provision for loan losses  | 100                          | 300      |
| Depreciation   | 499                          | 449      |
| Amortization   | 776                          | 842      |
| Compensation expense on stock purchases and restricted stock units         | 17                           | 6        |
| Gains on sales of securities   | (92 )                        | (76 )    |
| Gains on sales of loans  | (450 )                       | (974 )   |
| Loans originated for sale  | (12,722)                     | (25,337) |
| Proceeds from loan sales   | 12,739                       | 26,508   |
| Earnings on bank-owned life insurance                                      | (143 )                       | (150 )   |
| (Gains)/losses on sales of other real estate owned                         | (14 )                        | 24       |
| Write-downs of other real estate owned                                     | 125                          | 277      |
| Proceeds from sales of other real estate owned                             | 432                          | 554      |
| Deferred federal income tax (benefit)/expense                              | (119 )                       | 242      |
| Net changes in other assets  | 18                           | 881      |
| Net changes in other liabilities   | 689                          | (519 )   |
| Net cash from operating activities   | 4,440                        | 5,574    |
| Cash flows from investing activities:                                      |                              |          |
| Securities available for sale:   |                              |          |
| Sales  | 10,829                       | 2,344    |
| Maturities, prepayments and calls  | 6,349                        | 13,612   |
| Purchases  | (19,719)                     | (15,454) |
| Loan originations and payments, net  | (14,291)                     | (5,064 ) |
| Additions to premises and equipment  | (421 )                       | (622 )   |
| Net cash from investing activities   | (17,253)                     | (5,184 ) |
| Cash flows from financing activities:                                      |                              |          |
| Net change in deposits   | 9,642                        | (19,761) |
| Net change in repurchase agreements  | (3,672 )                     | (2,280 ) |
| Net change in federal funds purchased                                      | —                            | 1,879    |
| Proceeds from Federal Home Loan Bank advances                              | 25,000                       | 13,000   |
| Payments on Federal Home Loan Bank advances                                | (17,014)                     | (1,014 ) |
| Issuance of common stock   | 75                           | 76       |
| Repurchase of common stock   | —                            | (125 )   |
| Cash dividends   | (956 )                       | (858 )   |
| Net cash from financing activities   | 13,075                       | (9,083 ) |

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|  |          |          |
|--|----------|----------|
| Net change in cash and cash equivalents            | 262      | (8,693 ) |
| Beginning cash and cash equivalents                | 20,479   | 19,034   |
| Ending cash and cash equivalents                   | \$20,741 | \$10,341 |
| Supplemental disclosures of cash flow information: |          |          |
| Cash paid for income taxes                         | \$200    | \$975    |
| Cash paid for interest                             | \$599    | \$778    |
| Loans transferred to other real estate owned       | \$384    | \$409    |

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Principles of Consolidation

The consolidated financial statements include ChoiceOne Financial Services, Inc. (“ChoiceOne” or the “Registrant”) and its wholly-owned subsidiary, ChoiceOne Bank (the “Bank”), and the Bank’s wholly-owned subsidiary, ChoiceOne Insurance Agencies, Inc. Intercompany transactions and balances have been eliminated in consolidation.

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information, prevailing practices within the banking industry and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

The accompanying consolidated financial statements reflect all adjustments ordinary in nature which are, in the opinion of management, necessary for a fair presentation of the Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013, the Consolidated Statements of Income for the three- and six-month periods ended June 30, 2014 and June 30, 2013, the Consolidated Statements of Comprehensive Income for the three- and six-month periods ended June 30, 2014 and June 30, 2013, the Consolidated Statements of Changes in Shareholders' Equity for the six-month periods ended June 30, 2014 and June 30, 2013, and the Consolidated Statements of Cash Flows for the six-month periods ended June 30, 2014 and June 30, 2013. Operating results for the six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed adequate by management to absorb probable incurred losses inherent in the consolidated loan portfolio. Management’s evaluation of the adequacy of the allowance is an estimate based on reviews of individual loans, assessments of the impact of current economic conditions on the portfolio and historical loss experience of seasoned loan portfolios. See Note 3 to the interim consolidated financial statements for additional information.

Management believes the accounting estimate related to the allowance for loan losses is a “critical accounting estimate” because (1) the estimate is highly susceptible to change from period to period because of assumptions concerning the changes in the types and volumes of the portfolios and economic conditions and (2) the impact of recognizing an impairment or loan loss could have a material effect on ChoiceOne’s assets reported on the balance sheet as well as its net income.

#### Stock Transactions

A total of 2,270 shares of common stock were issued to the Registrant’s Board of Directors for a cash price of \$40,000 under the terms of the Directors’ Stock Purchase Plan in the first six months of 2014. A total of 2,315 shares were issued to employees for a cash price of \$35,000 under the Employee Stock Purchase Plan in the first half of 2014. A total of 190 shares were issued upon the exercise of stock options in the first two quarters of 2014.

#### Stock-Based Compensation

Effective July 1, 2013, ChoiceOne began granting Restricted Stock Units to a select group of employees under the Stock Incentive Plan of 2012. All of the Restricted Stock Units are initially unvested and vest in three annual installments on each of the next three anniversaries of the grant date. Certain additional vesting provisions apply. Each unit, once vested, is settled by delivery of one share of ChoiceOne common stock.

Reclassifications

Certain amounts presented in prior periods have been reclassified to conform to the current presentation.

**NOTE 2 - SECURITIES**

The fair value of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

| (Dollars in thousands)             | <b>June 30, 2014</b> |                              |                               |               |
|------------------------------------|----------------------|------------------------------|-------------------------------|---------------|
|                                    | Amortized<br>Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. Government and federal agency | \$41,811             | \$ 116                       | \$ (277 )                     | \$41,650      |
| U.S. Treasury                      | 13,251               | 15                           | (76 )                         | 13,190        |
| State and municipal                | 63,288               | 1,776                        | (492 )                        | 64,572        |
| Mortgage-backed                    | 9,878                | 63                           | (79 )                         | 9,862         |
| Corporate                          | 6,910                | 37                           | (22 )                         | 6,925         |
| Foreign debt                       | 1,000                | —                            | (7 )                          | 993           |
| Equity securities                  | 1,707                | 34                           | —                             | 1,741         |
| Asset-backed securities            | 427                  | —                            | (6 )                          | 421           |
| Total                              | \$138,272            | \$ 2,041                     | \$ (959 )                     | \$139,354     |

|                                    | <b>December 31, 2013</b> |                              |                               |               |
|------------------------------------|--------------------------|------------------------------|-------------------------------|---------------|
|                                    | Amortized<br>Cost        | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. Government and federal agency | \$44,059                 | \$ 166                       | \$ (503 )                     | \$43,722      |
| U.S. Treasury                      | 7,285                    | 17                           | (78 )                         | 7,224         |
| State and municipal                | 64,215                   | 1,622                        | (1,062 )                      | 64,775        |
| Mortgage-backed                    | 8,541                    | 95                           | (166 )                        | 8,470         |
| Corporate                          | 8,805                    | 61                           | (51 )                         | 8,815         |
| Foreign debt                       | 1,000                    | —                            | (10 )                         | 990           |
| Equity securities                  | 1,707                    | 7                            | (111 )                        | 1,603         |
| Asset-backed securities            | 486                      | —                            | (3 )                          | 483           |
| Total                              | \$136,098                | \$ 1,968                     | \$ (1,984 )                   | \$136,082     |

ChoiceOne reviews its securities portfolio on a quarterly basis to determine whether unrealized losses are considered to be temporary or other-than-temporary. No other-than-temporary impairment charges were recorded during the six months ended June 30, 2014. ChoiceOne believed that unrealized losses on securities were temporary in nature and

were due to changes in interest rates and reduced market liquidity and not as a result of credit quality issues.

**NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

Activity in the allowance for loan losses and balances in the loan portfolio were as follows:

| (Dollars in thousands)                   | Agricultural | Commercial<br>land<br>Industrial | Consumer | Commercial<br>Real Estate | Construction<br>Real<br>Estate | Residential<br>Real<br>Estate | Unallocated | Total    |
|--|--------------|----------------------------------|----------|---------------------------|--------------------------------|-------------------------------|-------------|----------|
| <b><u>Allowance for Loan Losses</u></b>  |              |                                  |          |                           |                                |                               |             |          |
| <b><u>Three Months Ended</u></b>         |              |                                  |          |                           |                                |                               |             |          |
| <b><u>June 30, 2014</u></b>              |              |                                  |          |                           |                                |                               |             |          |
| Beginning balance                        | \$ 187       | \$ 586                           | \$ 187   | \$ 1,664                  | \$ 7                           | \$ 1,563                      | \$ 402      | \$ 4,596 |
| Charge-offs                              | —            | —                                | (64 )    | —                         | —                              | (20 )                         | —           | (84 )    |
| Recoveries                               | 4            | 18                               | 57       | 38                        | —                              | 27                            | —           | 144      |
| Provision                                | (11 )        | 44                               | 15       | 70                        | (2 )                           | (301 )                        | 185         | —        |
| Ending balance                           | \$ 180       | \$ 648                           | \$ 195   | \$ 1,772                  | \$ 5                           | \$ 1,269                      | \$ 587      | \$ 4,656 |
| <b><u>Six Months Ended</u></b>           |              |                                  |          |                           |                                |                               |             |          |
| <b><u>June 30, 2014</u></b>              |              |                                  |          |                           |                                |                               |             |          |
| Beginning balance                        | \$ 179       | \$ 562                           | \$ 192   | \$ 1,842                  | \$ 12                          | \$ 1,625                      | \$ 323      | \$ 4,735 |
| Charge-offs                              | —            | —                                | (117 )   | (185 )                    | —                              | (110 )                        | —           | (412 )   |
| Recoveries                               | 5            | 38                               | 107      | 52                        | —                              | 31                            | —           | 233      |
| Provision                                | (4 )         | 48                               | 13       | 63                        | (7 )                           | (277 )                        | 264         | 100      |
| Ending balance                           | \$ 180       | \$ 648                           | \$ 195   | \$ 1,772                  | \$ 5                           | \$ 1,269                      | \$ 587      | \$ 4,656 |
| Individually evaluated<br>for impairment | \$ 20        | \$ 38                            | \$ 4     | \$ 836                    | \$ —                           | \$ 254                        | \$ —        | \$ 1,152 |
| Collectively evaluated<br>for impairment | \$ 160       | \$ 610                           | \$ 191   | \$ 936                    | \$ 5                           | \$ 1,015                      | \$ 587      | \$ 3,504 |
| <b><u>Three Months Ended</u></b>         |              |                                  |          |                           |                                |                               |             |          |
| <b><u>June 30, 2013</u></b>              |              |                                  |          |                           |                                |                               |             |          |
| Beginning balance                        | \$ 190       | \$ 553                           | \$ 236   | \$ 2,900                  | \$ 15                          | \$ 1,552                      | \$ 435      | \$ 5,881 |
| Charge-offs                              | —            | (28 )                            | (87 )    | (68 )                     | —                              | (119 )                        | —           | (302 )   |
| Recoveries                               | 1            | 202                              | 52       | 21                        | —                              | 9                             | —           | 285      |
| Provision                                | (51 )        | 83                               | 14       | (403 )                    | 5                              | 229                           | 123         | —        |
| Ending balance                           | \$ 140       | \$ 810                           | \$ 215   | \$ 2,450                  | \$ 20                          | \$ 1,671                      | \$ 558      | \$ 5,864 |
| <b><u>Six Months Ended</u></b>           |              |                                  |          |                           |                                |                               |             |          |
| <b><u>June 30, 2013</u></b>              |              |                                  |          |                           |                                |                               |             |          |
| Beginning balance                        | \$ 140       | \$ 381                           | \$ 250   | \$ 2,596                  | \$ 15                          | \$ 1,923                      | \$ 547      | \$ 5,852 |
| Charge-offs                              | —            | (49 )                            | (184 )   | (166 )                    | —                              | (283 )                        | —           | (682 )   |

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|                                       |          |           |          |            |          |          |        |           |
|---------------------------------------|----------|-----------|----------|------------|----------|----------|--------|-----------|
| Recoveries                            | 2        | 239       | 104      | 31         | —        | 18       | —      | 394       |
| Provision                             | (2 )     | 239       | 45       | (11 )      | 5        | 13       | 11     | 300       |
| Ending balance                        | \$ 140   | \$ 810    | \$215    | \$2,450    | \$ 20    | \$1,671  | \$ 558 | \$5,864   |
| Individually evaluated for impairment | \$ 23    | \$ 280    | \$6      | \$ 817     | \$ —     | \$ 315   | \$ —   | \$1,441   |
| Collectively evaluated for impairment | \$ 117   | \$ 530    | \$209    | \$1,633    | \$ 20    | \$1,356  | \$ 558 | \$4,423   |
| Loans                                 |          |           |          |            |          |          |        |           |
| June 30, 2014                         |          |           |          |            |          |          |        |           |
| Individually evaluated for impairment | \$ 224   | \$ 451    | \$31     | \$3,941    | \$ —     | \$2,605  |        | \$7,252   |
| Collectively evaluated for impairment | 31,871   | 82,569    | 20,552   | 97,293     | 1,380    | 88,777   |        | 322,442   |
| Ending balance                        | \$32,095 | \$ 83,020 | \$20,583 | \$ 101,234 | \$ 1,380 | \$91,382 |        | \$329,694 |
| December 31, 2013                     |          |           |          |            |          |          |        |           |
| Individually evaluated for impairment | \$452    | \$ 776    | \$37     | \$4,195    | \$ —     | \$2,827  |        | \$8,287   |
| Collectively evaluated for impairment | 36,596   | 67,754    | 19,894   | 92,792     | 890      | 89,753   |        | 307,679   |
| Ending balance                        | \$37,048 | \$ 68,530 | \$19,931 | \$96,987   | \$ 890   | \$92,580 |        | \$315,966 |



The process to monitor the credit quality of ChoiceOne's loan portfolio includes tracking (1) the risk ratings of business loans, (2) the level of classified business loans, and (3) delinquent and nonperforming consumer loans. Business loans are risk rated on a scale of 1 to 8. A description of the characteristics of the ratings follows:

Risk ratings 1 and 2: These loans are considered pass credits. They exhibit good to exceptional credit risk and demonstrate the ability to repay the loan from normal business operations.

Risk rating 3: These loans are considered pass credits. They exhibit acceptable credit risk and demonstrate the ability to repay the loan from normal business operations.

Risk rating 4: These loans are considered pass credits. However, they have potential developing weaknesses that, if not corrected, may cause deterioration in the ability of the borrower to repay the loan. While a loss is possible for a loan with this rating, it is not anticipated.

Risk rating 5: These loans are considered special mention credits. Loans in this risk rating are considered to be inadequately protected by the net worth and debt service coverage of the borrower or of any pledged collateral. These loans have well defined weaknesses that may jeopardize the borrower's ability to repay the loan. If the weaknesses are not corrected, loss of principal and interest could be probable.

Risk rating 6: These loans are considered substandard credits. These loans have well defined weaknesses, the severity of which makes collection of principal and interest in full questionable. Loans in this category may be placed on nonaccrual status.

Risk rating 7: These loans are considered doubtful credits. Some loss of principal and interest has been determined to be probable. The estimate of the amount of loss could be affected by factors such as the borrower's ability to provide additional capital or collateral. Loans in this category are on nonaccrual status.

Risk rating 8: These loans are considered loss credits. They are considered uncollectible and will be charged off against the allowance for loan losses.

Information regarding the Bank's credit exposure is as follows:

## Corporate Credit Exposure - Credit Risk Profile By Creditworthiness Category

| (Dollars in thousands) | Agricultural |              | Commercial and Industrial |              | Commercial Real Estate |              |
|------------------------|--------------|--------------|---------------------------|--------------|------------------------|--------------|
|                        | June 30,     | December 31, | June 30,                  | December 31, | June 30,               | December 31, |
|                        | 2014         | 2013         | 2014                      | 2013         | 2014                   | 2013         |
| Risk ratings 1 and 2   | \$6,035      | \$ 8,339     | \$8,939                   | \$ 7,333     | \$2,689                | \$ 3,000     |
| Risk rating 3          | 19,889       | 23,036       | 59,204                    | 46,943       | 59,324                 | 53,681       |
| Risk rating 4          | 5,324        | 4,330        | 13,069                    | 12,557       | 27,310                 | 27,610       |
| Risk rating 5          | 783          | 1,193        | 1,293                     | 1,025        | 7,040                  | 6,813        |
| Risk rating 6          | 64           | 150          | 454                       | 608          | 4,753                  | 5,818        |
| Risk rating 7          | —            | —            | 61                        | 64           | 118                    | 65           |
|                        | \$32,095     | \$ 37,048    | \$83,020                  | \$ 68,530    | \$101,234              | \$ 96,987    |

## Corporate Credit Exposure - Credit Risk Profile Based On Payment Activity

|               | Consumer      |                   | Construction Real Estate |                   | Residential Real Estate |                   |
|---------------|---------------|-------------------|--------------------------|-------------------|-------------------------|-------------------|
|               | June 30, 2014 | December 31, 2013 | June 30, 2014            | December 31, 2013 | June 30, 2014           | December 31, 2013 |
| Performing    | \$20,555      | \$19,900          | \$1,380                  | \$890             | \$88,877                | \$89,959          |
| Nonperforming | 28            | 31                | —                        | —                 | 2,505                   | 2,621             |
|               | \$20,583      | \$19,931          | \$1,380                  | \$890             | \$91,382                | \$92,580          |

There were no loans that were considered TDR's as of June 30, 2013 that were modified during the second quarter or first six months of 2013. The following schedule provides information on loans that were considered TDRs that were modified during the three- and six-months periods ended June 30, 2014:

| (Dollars in thousands)  | Three Months Ended June 30, 2014       |                               | Six Months Ended June 30, 2014         |                               |
|-------------------------|--|-------------------------------|--|-------------------------------|
|                         | Pre-Modification Number of Outstanding | Post-Modification Outstanding | Pre-Modification Number of Outstanding | Post-Modification Outstanding |
|                         | Recorded Loan Investment               | Recorded Investment           | Recorded Loan Investment               | Recorded Investment           |
| Commercial real estate  | — \$ —                                 | \$ —                          | 3 \$ 436                               | \$ 440                        |
| Residential real estate | — —                                    | —                             | 1 89                                   | 89                            |
|                         | — \$ —                                 | \$ —                          | 4 \$ 525                               | \$ 529                        |

The pre-modification and post-modification outstanding recorded investment represents amounts as of the date of loan modification. If a difference exists between the pre-modification and post-modification outstanding recorded investment, it represents impairment recognized through the provision for loan losses computed based on a loan's post-modification present value of expected future cash flows discounted at the loan's original effective interest rate. If no difference exists, a loss is not expected to be incurred based on an assessment of the borrower's expected cash flows.

The following schedule provides information on TDRs as of June 30, 2014 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three months and six months ended June 30, 2014 that had been modified during the year prior to the default:

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| (Dollars in thousands)    | Three Months Ended June 30, 2014 |                     | Six Months Ended June 30, 2014 |                     |
|---------------------------|----------------------------------|---------------------|--------------------------------|---------------------|
|                           | Number of Loans                  | Recorded Investment | Number of Loans                | Recorded Investment |
| Commercial and industrial | 1                                | \$ 217              | 1                              | \$ 217              |
| Commercial real estate    | 1                                | 429                 | 2                              | 464                 |
| Residential real estate   | 1                                | 61                  | 1                              | 61                  |
|                           | 3                                | \$ 707              | 4                              | \$ 742              |

The following schedule provides information on TDRs as of June 30, 2013 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three months and six months ended June 30, 2013 that had been modified during the year prior to the default:

| (Dollars in thousands)    | Three Months Ended June 30, 2013 |                     | Six Months Ended June 30, 2013 |                     |
|---------------------------|----------------------------------|---------------------|--------------------------------|---------------------|
|                           | Number of Loans                  | Recorded Investment | Number of Loans                | Recorded Investment |
| Agricultural              | —                                | \$ —                | 1                              | \$ 70               |
| Commercial and industrial | 1                                | 88                  | 1                              | 88                  |
| Commercial real estate    | 1                                | 138                 | 1                              | 138                 |
| Consumer                  | —                                | —                   | 1                              | 31                  |
|                           | 2                                | \$ 226              | 4                              | \$ 327              |

Loans are classified as performing when they are current as to principal and interest payments or are past due on payments less than 90 days. Loans are classified as nonperforming when they are past due 90 days or more as to principal and interest payments or are considered a troubled debt restructuring.

Impaired loans by loan category follow:

| (Dollars in thousands)             | Recorded   | Unpaid<br>Principal | Related   |
|------------------------------------|------------|---------------------|-----------|
|                                    | Investment | Balance             | Allowance |
| <u>June 30, 2014</u>               |            |                     |           |
| With no related allowance recorded |            |                     |           |
| Agricultural                       | \$ —       | \$ —                | \$ —      |
| Commercial and industrial          | 68         | 110                 | —         |
| Consumer                           | —          | —                   | —         |
| Commercial real estate             | 121        | 192                 | —         |
| Residential real estate            | 233        | 279                 | —         |
| Subtotal                           | 422        | 581                 | —         |
| With an allowance recorded         |            |                     |           |
| Agricultural                       | 224        | 224                 | 20        |
| Commercial and industrial          | 383        | 385                 | 38        |
| Consumer                           | 31         | 31                  | 4         |
| Commercial real estate             | 3,820      | 4,576               | 836       |
| Residential real estate            | 2,372      | 2,381               | 254       |
| Subtotal                           | 6,830      | 7,597               | 1,152     |
| Total                              |            |                     |           |
| Agricultural                       | 224        | 224                 | 20        |
| Commercial and industrial          | 451        | 495                 | 38        |
| Consumer                           | 31         | 31                  | 4         |
| Commercial real estate             | 3,941      | 4,768               | 836       |
| Residential real estate            | 2,605      | 2,660               | 254       |
| Total                              | \$ 7,252   | \$ 8,178            | \$ 1,152  |
| <br>                               |            |                     |           |
| December 31, 2013                  |            |                     |           |
| With no related allowance recorded |            |                     |           |
| Agricultural                       | \$ 452     | \$ 455              | \$ —      |
| Commercial and industrial          | 229        | 300                 | —         |
| Consumer                           | 2          | 3                   | —         |
| Commercial real estate             | 782        | 843                 | —         |
| Residential real estate            | 891        | 1,128               | —         |
| Subtotal                           | 2,356      | 2,729               | —         |
| With an allowance recorded         |            |                     |           |
| Agricultural                       | —          | —                   | —         |
| Commercial and industrial          | 547        | 554                 | 53        |
| Consumer                           | 35         | 35                  | 3         |
| Commercial real estate             | 3,413      | 3,997               | 699       |
| Residential real estate            | 1,936      | 1,936               | 308       |
| Subtotal                           | 5,931      | 6,522               | 1,063     |
| Total                              |            |                     |           |
| Agricultural                       | 452        | 455                 | —         |
| Commercial and industrial          | 776        | 854                 | 53        |

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|                         |          |          |          |
|-------------------------|----------|----------|----------|
| Consumer                | 37       | 38       | 3        |
| Commercial real estate  | 4,195    | 4,840    | 699      |
| Residential real estate | 2,827    | 3,064    | 308      |
| Total                   | \$ 8,287 | \$ 9,251 | \$ 1,063 |

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The following schedule provides information regarding average balances of impaired loans and interest recognized on impaired loans for the six months ended June 30, 2014 and 2013:

| (Dollars in thousands)             | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|------------------------------------|-----------------------------------|----------------------------------|
| <u>June 30, 2014</u>               |                                   |                                  |
| With no related allowance recorded |                                   |                                  |
| Agricultural                       | \$ 150                            | \$ —                             |
| Commercial and industrial          | 119                               | —                                |
| Consumer                           | 1                                 | —                                |
| Commercial real estate             | 445                               | 5                                |
| Residential real estate            | 576                               | 6                                |
| Subtotal                           | 1,291                             | 11                               |
| With an allowance recorded         |                                   |                                  |
| Agricultural                       | 196                               | —                                |
| Commercial and industrial          | 437                               | 4                                |
| Consumer                           | 33                                | 1                                |
| Commercial real estate             | 3,801                             | 53                               |
| Residential real estate            | 2,206                             | 45                               |
| Subtotal                           | 6,673                             | 103                              |
| Total                              |                                   |                                  |
| Agricultural                       | 346                               | —                                |
| Commercial and industrial          | 556                               | 4                                |
| Consumer                           | 34                                | 1                                |
| Commercial real estate             | 4,246                             | 58                               |
| Residential real estate            | 2,782                             | 51                               |
| Total                              | \$ 7,964                          | \$ 114                           |
| <br>                               |                                   |                                  |
| June 30, 2013                      |                                   |                                  |
| With no related allowance recorded |                                   |                                  |
| Agricultural                       | \$ 189                            | \$ 8                             |
| Commercial and industrial          | 62                                | —                                |
| Consumer                           | 4                                 | —                                |
| Commercial real estate             | 644                               | —                                |
| Residential real estate            | 302                               | 6                                |
| Subtotal                           | 1,201                             | 14                               |
| With an allowance recorded         |                                   |                                  |
| Agricultural                       | 85                                | 2                                |
| Commercial and industrial          | 254                               | 6                                |
| Consumer                           | 47                                | 2                                |
| Commercial real estate             | 4,052                             | 133                              |
| Residential real estate            | 2,274                             | 43                               |
| Subtotal                           | 6,712                             | 186                              |
| Total                              |                                   |                                  |
| Agricultural                       | 274                               | 10                               |
| Commercial and industrial          | 316                               | 6                                |
| Consumer                           | 51                                | 2                                |



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|                         |          |        |
|-------------------------|----------|--------|
| Commercial real estate  | 4,696    | 133    |
| Residential real estate | 2,576    | 49     |
| Total                   | \$ 7,913 | \$ 200 |

An aging analysis of loans by loan category follows:

| (Dollars in thousands)    | 30 to<br>59<br>Days | 60 to<br>89<br>Days | Greater<br>Than<br>90<br>Days<br>(1) | Total   | Loans Not<br>Past Due | Total<br>Loans | 90 Days<br>Past<br>Due and<br>Accruing |
|---------------------------|---------------------|---------------------|--------------------------------------|---------|-----------------------|----------------|--|
| <u>June 30, 2014</u>      |                     |                     |                                      |         |                       |                |  |
| Agricultural              | \$—                 | \$—                 | \$224                                | \$224   | \$31,871              | \$32,095       | \$ —                                   |
| Commercial and industrial | 256                 | —                   | 60                                   | 316     | 82,704                | 83,020         | —                                      |
| Consumer                  | 81                  | 4                   | —                                    | 85      | 20,498                | 20,583         | —                                      |
| Commercial real estate    | 847                 | 1,219               | 494                                  | 2,560   | 98,674                | 101,234        | —                                      |
| Construction real estate  | —                   | —                   | —                                    | —       | 1,380                 | 1,380          | —                                      |
| Residential real estate   | 1,605               | 93                  | 397                                  | 2,095   | 89,287                | 91,382         | 32                                     |
|                           | \$2,789             | \$1,316             | \$1,175                              | \$5,280 | \$324,414             | \$329,694      | \$ 32                                  |
| <br>                      |                     |                     |                                      |         |                       |                |  |
| December 31, 2013         |                     |                     |                                      |         |                       |                |  |
| Agricultural              | \$9                 | \$1                 | \$428                                | \$438   | \$36,610              | \$37,048       | \$ —                                   |
| Commercial and industrial | 93                  | 352                 | 73                                   | 518     | 68,012                | 68,530         | —                                      |
| Consumer                  | 60                  | 7                   | —                                    | 67      | 19,864                | 19,931         | —                                      |
| Commercial real estate    | 901                 | 884                 | 242                                  | 2,027   | 94,960                | 96,987         | —                                      |
| Construction real estate  | —                   | —                   | —                                    | —       | 890                   | 890            | —                                      |
| Residential real estate   | 673                 | 186                 | 167                                  | 1,026   | 91,554                | 92,580         | 11                                     |
|                           | \$1,736             | \$1,430             | \$910                                | \$4,076 | \$311,890             | \$315,966      | \$ 11                                  |

(1) Includes nonaccrual loans.

Nonaccrual loans by loan category follow:

| (Dollars in thousands)    | June 30,<br>2014 | December 31,<br>2013 |
|---------------------------|------------------|----------------------|
| Agricultural              | \$224            | \$452                |
| Commercial and industrial | 225              | 372                  |
| Consumer                  | —                | 2                    |
| Commercial real estate    | 2,365            | 1,606                |
| Residential real estate   | 526              | 691                  |
|                           | \$3,340          | \$3,123              |

**NOTE 4 - EARNINGS PER SHARE**

Earnings per share are based on the weighted average number of shares outstanding during the period. A computation of basic earnings per share and diluted earnings per share follows:

| (Dollars in thousands, except per share data)                              | Three Months Ended |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | June 30,<br>2014   | 2013      | June 30,<br>2014 | 2013      |
| <b><u>Basic Earnings Per Share</u></b>                                     |                    |           |                  |           |
| Net income available to common shareholders                                | \$1,337            | \$1,312   | \$2,585          | \$2,547   |
| Weighted average common shares outstanding                                 | 3,298,432          | 3,298,307 | 3,297,397        | 3,298,607 |
| Basic earnings per share   | \$0.40             | \$0.40    | \$0.78           | \$0.77    |
| <b><u>Diluted Earnings Per Share</u></b>                                   |                    |           |                  |           |
| Net income available to common shareholders                                | \$1,337            | \$1,312   | \$2,585          | \$2,547   |
| Weighted average common shares outstanding                                 | 3,298,432          | 3,298,307 | 3,297,397        | 3,298,607 |
| Plus dilutive stock options and restricted stock units                     | 6,892              | 1,660     | 6,660            | 1,450     |
| Weighted average common shares outstanding and potentially dilutive shares | 3,305,324          | 3,299,967 | 3,304,057        | 3,300,057 |
| Diluted earnings per share   | \$0.40             | \$0.40    | \$0.78           | \$0.77    |

There were 28,625 stock options as June 30, 2014 and 24,800 as of June 30, 2013, that are considered to be anti-dilutive to earnings per share for the three-month and six-month periods ended June 30, 2014 and 2013. These stock options have been excluded from the calculation above.

**NOTE 5 – FINANCIAL INSTRUMENTS**

Financial instruments as of the dates indicated were as follows:

| (Dollars in thousands)                                | Carrying | Estimated  | Quoted    | Significant | Significant  |
|---|----------|------------|-----------|-------------|--------------|
|   |          |            | Prices    | Other       | Unobservable |
|   |          |            | in Active | Observable  | Inputs       |
|   |          |            | Markets   | Inputs      |              |
|   |          |            | for       |             |              |
|   |          |            | Identical |             |              |
|   |          |            | Assets    |             |              |
|   | Amount   | Fair Value | (Level 1) | (Level 2)   | (Level 3)    |
| <u>June 30, 2014</u>                                  |          |            |           |             |              |
| Assets:   |          |            |           |             |              |
| Cash and due from banks                               | \$20,741 | \$20,741   | \$20,741  | \$—         | \$—          |
| Securities available for sale                         | 139,354  | 139,354    | 242       | 128,909     | 10,203       |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,750    | 3,750      | —         | 3,750       | —            |
| Loans held for sale                                   | 1,323    | 1,369      | —         | 1,369       | —            |
| Loans, net  | 325,038  | 327,161    | —         | —           | 327,161      |
| Liabilities:  |          |            |           |             |              |
| Noninterest-bearing deposits                          | 119,754  | 119,754    | —         | 119,754     | —            |
| Interest-bearing deposits                             | 308,015  | 308,290    | —         | 308,290     | —            |
| Repurchase agreements                                 | 22,361   | 22,361     | —         | 22,361      | —            |
| Federal Home Loan Bank advances                       | 14,378   | 14,418     | —         | 14,418      | —            |
| <br>December 31, 2013                                 |          |            |           |             |              |
| Assets:   |          |            |           |             |              |
| Cash and due from banks                               | \$20,479 | \$20,479   | \$20,479  | \$—         | \$—          |
| Securities available for sale                         | 136,082  | 136,082    | 214       | 124,540     | 11,328       |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,750    | 3,750      | —         | 3,750       | —            |
| Loans held for sale                                   | 931      | 957        | —         | 957         | —            |
| Loans, net  | 311,231  | 313,659    | —         | —           | 313,659      |
| Liabilities:  |          |            |           |             |              |
| Noninterest-bearing deposits                          | 102,243  | 102,243    | —         | 102,243     | —            |
| Interest-bearing deposits                             | 315,884  | 316,222    | —         | 316,222     | —            |

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|                                 |        |        |   |        |   |
|---------------------------------|--------|--------|---|--------|---|
| Repurchase agreements           | 26,033 | 26,033 | — | 26,033 | — |
| Federal Home Loan Bank advances | 6,392  | 6,428  | — | 6,428  | — |

The estimated fair values approximate the carrying amounts for all assets and liabilities except those described later in this paragraph. The methodology for determining the estimated fair value for securities available for sale is described in Note 6. The estimated fair value for loans is based on the rates charged at June 30, 2014 and December 31, 2013 for new loans with similar maturities, applied until the loan is assumed to reprice or be paid. The allowance for loan losses is considered to be a reasonable estimate of discount for credit quality concerns. The estimated fair values for time deposits and Federal Home Loan Bank (“FHLB”) advances are based on the rates paid at June 30, 2014 and December 31, 2013 for new deposits or FHLB advances, applied until maturity. The estimated fair values for other financial instruments and off-balance sheet loan commitments are considered nominal.

**NOTE 6 – FAIR VALUE MEASUREMENTS**

The following tables present information about the Bank's assets and liabilities measured at fair value on a recurring basis and the valuation techniques used by the Bank to determine those fair values.

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

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

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

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

There were no liabilities measured at fair value as of June 30, 2014 or December 31, 2013. Disclosures concerning assets measured at fair value are as follows:

**Assets Measured at Fair Value on a Recurring Basis**

| (Dollars in thousands)   | Quoted<br>Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance at<br>Date<br>Indicated |
|--|---|---|--|---------------------------------|
| <u>Investment Securities, Available for Sale – June 30, 2014</u> |   |   |  |                                 |
| U.S. Treasury  | \$ —  | \$ 13,190   | \$ —   | \$ 13,190                       |
| U.S. Government and federal agency                               | —   | 41,650  | —  | 41,650                          |
| State and municipal  | —   | 56,266  | 8,306  | 64,572                          |
| Mortgage-backed  | —   | 9,862   | —  | 9,862                           |
| Corporate  | —   | 6,527   | 398  | 6,925                           |
| Foreign debt   | —   | 993   | —  | 993                             |

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|                         |        |            |           |            |
|-------------------------|--------|------------|-----------|------------|
| Equity securities       | 242    | —          | 1,499     | 1,741      |
| Asset backed securities | —      | 421        | —         | 421        |
| Total                   | \$ 242 | \$ 128,909 | \$ 10,203 | \$ 139,354 |

Investment Securities, Available for  
Sale - December 31, 2013

|                                    |        |            |           |            |
|------------------------------------|--------|------------|-----------|------------|
| U.S. Treasury                      | \$ —   | \$ 7,224   | \$ —      | \$ 7,224   |
| U.S. Government and federal agency | —      | 43,722     | —         | 43,722     |
| State and municipal                | —      | 55,234     | 9,541     | 64,775     |
| Mortgage-backed                    | —      | 8,470      | —         | 8,470      |
| Corporate                          | —      | 8,417      | 398       | 8,815      |
| Foreign debt                       | —      | 990        | —         | 990        |
| Equity securities                  | 214    | —          | 1,389     | 1,603      |
| Asset backed securities            | —      | 483        | —         | 483        |
| Total                              | \$ 214 | \$ 124,540 | \$ 11,328 | \$ 136,082 |

**Changes in Level 3 Assets Measured at Fair Value on a Recurring Basis**

(Dollars in thousands)

|  | 2014     | 2013    |
|--|----------|---------|
| <u>Investment Securities, Available for Sale</u>                       |          |         |
| Balance, January 1   | \$11,328 | \$2,599 |
| Total realized and unrealized losses included in income                | (11 )    | —       |
| Total unrealized gains (losses) included in other comprehensive income | (69 )    | 252     |
| Net purchases, sales, calls, and maturities                            | (1,119 ) | 1,642   |
| Net transfers into Level 3   | 74       | —       |
| Balance, June 30   | \$10,203 | \$4,493 |

Of the Level 3 assets that were held by the Bank at June 30, 2014, the net unrealized gain for the six months ended June 30, 2014 was \$92,000, which is recognized in other comprehensive income in the consolidated balance sheet. There were no purchases of Level 3 securities during the first half of 2014. Purchases of Level 3 securities during the first half of 2013 consisted of local municipal issues. There was one sale of a Level 3 security in the first half of 2014 resulting in an \$11,000 loss. There were no sales of Level 3 securities in the first and second quarters of 2013.

Both observable and unobservable inputs may be used to determine the fair value of positions classified as Level 3 investment securities and liabilities. As a result, the unrealized gains and losses for these assets and liabilities presented in the tables above may include changes in fair value that were attributable to both observable and unobservable inputs.

Available for sale investment securities categorized as Level 3 assets primarily consist of bonds issued by local municipalities. The Bank estimates the fair value of these bonds based on the present value of expected future cash flows using management's best estimate of key assumptions, including forecasted interest yield and payment rates, credit quality and a discount rate commensurate with the current market and other risks involved.

The Bank also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets are not normally measured at fair value, but can be subject to fair value adjustments in certain circumstances, such as impairment. Disclosures concerning assets measured at fair value on a non-recurring basis are as follows:

**Assets Measured at Fair Value on a Non-recurring Basis**

| (Dollars in thousands) | Balance<br>at | Quoted<br>Prices | Significant<br>Other | Significant<br>Unobservable |
|------------------------|---------------|------------------|----------------------|-----------------------------|
|------------------------|---------------|------------------|----------------------|-----------------------------|



|                          |                    | in Active Observable Inputs<br>Markets |           |           |
|--------------------------|--------------------|--|-----------|-----------|
|                          |                    | Inputs                                 |           |           |
|                          |                    | for<br>Identical<br>Assets             |           |           |
|                          | Dates<br>Indicated | (Level 1)                              | (Level 2) | (Level 3) |
| <u>Impaired Loans</u>    |                    |  |           |           |
|                          | June 30, 2014      | \$ 7,252                               | \$ —      | \$ 7,252  |
|                          | December 31, 2013  | \$ 8,287                               | \$ —      | \$ 8,287  |
| <u>Other Real Estate</u> |                    |  |           |           |
|                          | June 30, 2014      | \$ 349                                 | \$ —      | \$ 349    |
|                          | December 31, 2013  | \$ 508                                 | \$ —      | \$ 508    |

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

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

The following discussion is designed to provide a review of the consolidated financial condition and results of operations of ChoiceOne Financial Services, Inc. ("ChoiceOne" or the "Registrant") and its wholly-owned subsidiary, ChoiceOne Bank (the "Bank"), and the Bank's wholly-owned subsidiary, ChoiceOne Insurance Agencies, Inc. This discussion should be read in conjunction with the consolidated financial statements and related notes.

## **FORWARD-LOOKING STATEMENTS**

This discussion and other sections of this quarterly report contain forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and ChoiceOne itself. Words such as "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "is likely," "plans," "predicts," "projects," "may," "could," variations of such words and similar expressions are intended to identify such forward-looking statements. Management's determination of the provision and allowance for loan losses, the carrying value of goodwill and loan servicing rights, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary) and management's assumptions concerning pension and other postretirement benefit plans involve judgments that are inherently forward-looking. All of the information concerning interest rate sensitivity is forward-looking. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood, and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed, implied or forecasted in such forward-looking statements. Furthermore, ChoiceOne undertakes no obligation to update, amend, or clarify forward-looking statements, whether as a result of new information, future events, or otherwise.

Risk factors include, but are not limited to, the risk factors discussed in Item 1A of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013; changes in banking laws and regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of pending and future litigation and contingencies; trends in customer behavior as well as their abilities to repay loans; changes in the local and national economies; changes in market conditions; the level and timing of asset growth; various other local and global uncertainties such as acts of terrorism and military actions; and current uncertainties and fluctuations in the financial markets and stocks of financial services providers due to concerns about capital and credit availability and concerns about the Michigan economy in particular. These are representative of the risk factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

## **RESULTS OF OPERATIONS**

### Summary

Net income for the second quarter of 2014 was \$1,337,000, which represented an increase of \$25,000 or 2% compared to the same period in 2013. Net income for the first six months of 2014 was \$2,585,000, which represented an increase of \$38,000 or 1% over the same period in 2013. A decrease in noninterest expense was offset by a decrease in noninterest income in the second quarter of 2014 compared to the same quarter in 2013. In the first half of 2014, a decrease in the provision for loan losses and in noninterest expense was offset by lower net interest income and noninterest income compared to the same period in the prior year. Basic and diluted earnings per common share were \$0.40 for the second quarter of 2014 and \$0.78 for the first six months of 2014, compared to \$0.40 and \$0.77, respectively, for the same periods in 2013. The return on average assets and return on average shareholders' equity percentages were 1.00% and 8.22%, respectively, for the first half of 2014, compared to 1.02% and 8.31%, respectively, for the same period in 2013.

#### Dividends

Cash dividends of \$495,000 or \$0.15 per share were declared in the second quarter of 2014, compared to \$429,000 or \$0.13 per share in the second quarter of 2013. The cash dividends declared in the first six months of 2014 were \$956,000 or \$0.29 per share, compared to \$858,000 or \$0.26 per share declared in the same period in 2013. The cash dividend payout percentage was 37% for the first six months of 2014, compared to 34% in the same period a year ago.

Interest Income and Expense

Tables 1 and 2 on the following pages provide information regarding interest income and expense for the six-month periods ended June 30, 2014 and 2013, respectively. Table 1 documents ChoiceOne's average balances and interest income and expense, as well as the average rates earned or paid on assets and liabilities. Table 2 documents the effect on interest income and expense of changes in volume (average balance) and interest rates. These tables are referred to in the discussion of interest income, interest expense and net interest income.

**Table 1 – Average Balances and Tax-Equivalent Interest Rates**

| (Dollars in thousands)  | Six Months Ended June 30, |          |       |                    |          |       |
|---|---------------------------|----------|-------|--------------------|----------|-------|
|   | 2014                      |          |       | 2013               |          |       |
|   | Average<br>Balance        | Interest | Rate  | Average<br>Balance | Interest | Rate  |
| <b>Assets:</b>  |                           |          |       |                    |          |       |
| Loans (1)   | \$322,397                 | \$7,771  | 4.82% | \$311,551          | \$8,015  | 5.15% |
| Taxable securities (2) (3)  | 98,296                    | 936      | 1.90  | 91,146             | 917      | 2.01  |
| Nontaxable securities (1) (2)   | 43,732                    | 1,042    | 4.77  | 42,015             | 1,048    | 4.99  |
| Other   | 3,445                     | 4        | 0.23  | 3,419              | 5        | 0.29  |
| Interest-earning assets   | 467,870                   | 9,753    | 4.17  | 448,131            | 9,985    | 4.46  |
| Noninterest-earning assets  | 48,742                    |          |       | 53,393             |          |       |
| Total assets  | \$516,612                 |          |       | \$501,524          |          |       |
| <b>Liabilities and Shareholders' Equity:</b>                                    |                           |          |       |                    |          |       |
| Interest-bearing demand deposits  | \$137,121                 | 122      | 0.18% | \$132,409          | 133      | 0.20% |
| Savings deposits  | 67,726                    | 19       | 0.06  | 66,135             | 21       | 0.06  |
| Certificates of deposit   | 107,913                   | 400      | 0.74  | 122,883            | 560      | 0.91  |
| Advances from Federal Home Loan Bank  | 10,729                    | 26       | 0.48  | 3,574              | 15       | 0.84  |
| Other   | 21,754                    | 24       | 0.22  | 17,985             | 19       | 0.22  |
| Interest-bearing liabilities  | 345,243                   | 591      | 0.34  | 342,986            | 748      | 0.44  |
| Noninterest-bearing demand deposits   | 106,631                   |          |       | 93,499             |          |       |
| Other noninterest-bearing liabilities   | 1,851                     |          |       | 3,745              |          |       |
| Total liabilities   | 453,725                   |          |       | 440,230            |          |       |
| Shareholders' equity  | 62,887                    |          |       | 61,294             |          |       |
| Total liabilities and shareholders' equity                                      | \$516,612                 |          |       | \$501,524          |          |       |
| Net interest income (tax-equivalent basis) - interest spread                    |                           | 9,162    | 3.83% |                    | 9,237    | 4.02% |
| Tax-equivalent adjustment (1)   |                           | (359 )   |       |                    | (362 )   |       |
| Net interest income   |                           | \$8,803  |       |                    | \$8,875  |       |
| Net interest income as a percentage of earning assets<br>(tax-equivalent basis) |                           |          | 3.92% |                    |          | 4.12% |

- (1) Adjusted to a fully tax-equivalent basis to facilitate comparison to the taxable interest-earning assets. The adjustment uses an incremental tax rate of 34% for the periods presented.
- (2) Includes the effect of unrealized gains or losses on securities.
- (3) Taxable securities include dividend income from Federal Home Loan Bank and Federal Reserve Bank stock.

**Table 2 – Changes in Tax-Equivalent Net Interest Income**

| (Dollars in thousands)                           | Six Months Ended June |        |          |
|--|-----------------------|--------|----------|
|  | 30,<br>2014 Over 2013 |        |          |
|  | Total                 | Volume | Rate     |
| Increase (decrease) in interest income (1)       |                       |        |          |
| Loans (2)  | \$(244)               | \$ 632 | \$(876 ) |
| Taxable securities                               | 19                    | 128    | (109 )   |
| Nontaxable securities (2)                        | (5 )                  | 87     | (92 )    |
| Other  | (1 )                  | —      | (1 )     |
| Net change in tax-equivalent interest income     | (231)                 | 847    | (1,078)  |
| Increase (decrease) in interest expense (1)      |                       |        |          |
| Interest-bearing demand deposits                 | (11 )                 | 12     | (23 )    |
| Savings deposits                                 | (2 )                  | 1      | (3 )     |
| Certificates of deposit                          | (159)                 | (63 )  | (96 )    |
| Advances from Federal Home Loan Bank             | 11                    | 30     | (19 )    |
| Other  | 4                     | 4      | —        |
| Net change in interest expense                   | (157)                 | (16 )  | (141 )   |
| Net change in tax-equivalent net interest income | \$(74 )               | \$ 863 | \$(937 ) |

- The volume variance is computed as the change in volume (average balance) multiplied by the previous year's interest rate. The rate variance is computed as the change in interest rate multiplied by the previous year's volume (average balance). The change in interest due to both volume and rate has been allocated to the volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.
- (1) Interest on nontaxable investment securities and loans has been adjusted to a fully tax-equivalent basis using an incremental tax rate of 34% for the periods presented.

### Net Interest Income

The presentation of net interest income on a tax-equivalent basis is not in accordance with generally accepted accounting principles (“GAAP”), but is customary in the banking industry. This non-GAAP measure ensures comparability of net interest income arising from both taxable and tax-exempt loans and investment securities. The adjustments to determine net interest income on a tax-equivalent basis were \$359,000 and \$362,000 for the six months ended June 30, 2014 and 2013, respectively. These adjustments were computed using a 34% federal income tax rate.

As shown in Tables 1 and 2, tax-equivalent net interest income decreased \$75,000 in the first six months of 2014 compared to the same period in 2013. The relationship between growth in average interest-earning assets and a small amount of growth in the average balance of interest-bearing liabilities caused net interest income to increase \$862,000

in the first half of 2014 compared to the same period in the prior year. A reduction of 19 basis points in the net interest spread from 4.02% in the first six months of 2013 to 3.83% in the first half of 2014 resulted in a \$937,000 decrease in net interest income.

The average balance of loans increased \$10.8 million in the first six months of 2014 compared to the same period in 2013. Average commercial loans were \$15.6 million higher and average consumer loans were \$0.8 million higher in the first half of 2014 than the same period in 2013. This was partially offset by a \$5.6 million decline in the average balance of residential mortgage loans in the same time periods. The average interest rate earned on loans declined 33 basis points from the first six months of 2013 to the same period in 2014 as a result of renewals of existing loans and new loan production at a lower rate than in the existing portfolio. The increase in the average loans balance, offset by the decrease in the average rate earned caused tax-equivalent interest income from loans to decline \$244,000 in the first half of 2014 compared to the same period in the prior year. The average balance of total securities grew \$8.9 million in the first six months of 2014 compared to the same period in 2013. Additional securities were purchased during 2013 and 2014 to provide earning asset growth. Growth in average securities, offset by the effect of lower interest rates earned, caused interest income to increase \$13,000 in the first six months of 2014 compared to the same period in 2013.

The average balance of interest-bearing demand deposits increased \$4.7 million in the first six months of 2014 compared to the same period in 2013. The effect of the higher average balance and a 2 basis point decline in the average rate paid, caused interest expense to decrease \$11,000 in the first half of 2014 compared to the same period in 2013. The average balance of savings deposits increased \$1.6 million in the first six months of 2014 compared to the same period in the prior year. The impact of the savings deposit growth was offset by a less than 1 basis point drop in the average rate paid, which caused interest expense to decline \$2,000 in the first half of 2014 compared to the same period in 2013. The average balance of certificates of deposit was down \$15.0 million in the first six months of 2014 compared to the same period in 2013. The decline in certificates of deposit plus a 17 basis point reduction in the average rate paid on certificates caused interest expense to fall \$159,000 in the first half of 2014 compared to the same period in 2013. A \$7.2 million increase in the average balance of Federal Home Loan Bank advances offset by a 36 basis point reduction in the average rate paid caused interest expense to grow \$11,000 in the first six months of 2014 compared to the same period in the prior year. A \$3.8 million increase in the average balance of other interest-bearing liabilities in the first six months of 2014 compared to the first half of 2013 caused a \$4,000 increase in interest expense.

ChoiceOne's net interest income spread was 3.83% in the first six months of 2014, compared to 4.02% for the first half of 2013. The decline in the interest spread was due to a 29 basis point decrease in the average rate earned on interest-earning assets, which was partially offset by a 10 basis point decrease in the average rate paid on interest-bearing liabilities. The reduction in the average rate earned on interest-earning assets was caused by relatively low general market rates which affected new loan originations and securities purchases in 2013 and the first half of 2014. Interest rates on loans are also being impacted by rate pressure from some of ChoiceOne's competing financial institutions. The lower rate paid on interest-bearing liabilities resulted from repricing of local deposits as general market interest rates remained low during 2013 and the first six months of 2014.

#### Provision and Allowance for Loan Losses

Total loans have grown \$13.7 million since the end of 2013, while the allowance for loan losses declined \$79,000 during the same time period. The provision for loan losses was \$0 in the second quarter and \$100,000 in the first half of 2014, compared to \$0 and \$300,000, respectively, in the same periods in 2013. The reduction in the provision for loan losses was due to a lower level of net charge-offs in the second quarter and first six months of 2014 than in the same periods in 2013. Nonperforming loans were \$7.1 million as of June 30, 2014, compared to \$8.1 million as of March 31, 2014 and \$7.7 million as of December 31, 2013. The allowance for loan losses was 1.41% of total loans at June 30, 2014, compared to 1.43% at March 31, 2014 and 1.52% at December 31, 2013.

Charge-offs and recoveries for respective loan categories for the six months ended June 30 were as follows:

| (Dollars in thousands) | 2014        |            | 2013        |            |
|------------------------|-------------|------------|-------------|------------|
|                        | Charge-offs | Recoveries | Charge-offs | Recoveries |
| Agricultural           | \$—         | \$ 5       | \$—         | \$ 2       |



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|                           |       |        |       |        |
|---------------------------|-------|--------|-------|--------|
| Commercial and industrial | —     | 38     | 49    | 239    |
| Consumer                  | 117   | 107    | 184   | 104    |
| Real estate, commercial   | 185   | 52     | 166   | 31     |
| Real estate, residential  | 110   | 31     | 283   | 18     |
|                           | \$412 | \$ 233 | \$682 | \$ 394 |

Net recoveries of \$61,000 in the second quarter of 2014 and charge-offs of \$179,000 in the first six months of 2014 compare to net charge-offs of \$17,000 and \$288,000 in the same periods in 2013. A \$190,000 recovery of a commercial and industrial loan charge-off was recorded in the second quarter of 2013. Net charge-offs on an annualized basis as a percentage of average loans were 0.11% in the first six months of 2014 compared to 0.18% for the same period in the prior year. Management is aware that the economic climate in Michigan will continue to affect business and personal borrowers. Management has worked and intends to continue to work with delinquent borrowers in an attempt to lessen the negative impact to ChoiceOne. As charge-offs, changes in the level of nonperforming loans, and changes within the composition of the loan portfolio occur throughout 2014, the provision and allowance for loan losses will be reviewed by the Bank's management and adjusted as necessary.

### Noninterest Income

Total noninterest income decreased \$50,000 in the second quarter of 2014 and \$214,000 in the first six months of 2014 compared to the same periods in 2013 primarily due to declines in gains on loan sales of \$177,000 in the second quarter and \$524,000 in the first six months of 2014 compared to the same periods in 2013. These declines resulted from decreased residential mortgage refinancing activity which supported \$12.7 million of loan sales in the first half of 2014, compared to \$26.5 million in the first six months of 2013. An increase in customer service charges of \$29,000 in the second quarter and \$50,000 in the first half of 2014 compared to the same periods in the prior year was due to a higher volume in debit card activity. Insurance and investment commission income grew \$12,000 in the first quarter and \$94,000 in the first six months of 2014 compared to the same periods in 2013 as a result of increased sales of investment products and growth in investment advisory fees. Decreases of \$121,000 in the first quarter and \$189,000 in the first six months of 2014 in losses on sales and write-downs of other real estate and other assets when compared to the same periods in 2013 resulted from less write-downs of foreclosed properties in other real estate (“ORE”).

### Noninterest Expense

Total noninterest expense decreased \$68,000 in the second quarter of 2014 and \$127,000 in the first six months of 2014 compared to the same periods in 2013. Salaries and benefits expense decreased \$25,000 in the second quarter and increased \$43,000 in the first six months of 2014 compared to the same periods in the prior year. Higher costs related to salaries and health insurance was partially offset by lower bonus and commission expenses. Occupancy and equipment expense grew \$4,000 in the second quarter of 2014 and \$51,000 in the first half of 2014 compared to the same periods in 2013 as a result of costs related to the extended winter weather conditions in 2014 and to higher equipment depreciation expense. The increase of \$41,000 in professional fees in the first six months of 2014 compared to the same period in the prior year was due to higher legal fees. Advertising and promotional expense increases of \$34,000 in the second quarter and \$23,000 in the first half of 2014 compared to the same periods in 2013 were caused by higher levels of direct mail advertising and expenses related to website design. Loan and collection expense was \$26,000 lower in the first quarter and \$111,000 lower in the first half of 2014 compared to the same period in the prior year as a result of lower costs related to collection of nonperforming loans and maintenance of foreclosed properties. Other noninterest expense decreased \$77,000 in the first quarter of 2014 and \$121,000 in the first six months of 2014 compared to the same periods in 2013 because of lower recruiting expenses and lower costs related to sales of residential mortgage loans in the secondary market.

### Income Tax Expense

Income tax expense was \$916,000 in the first six months of 2014 compared to \$913,000 for the same period in 2013. The effective tax rate was 26.2% for 2014 and 26.4% for 2013.

## **FINANCIAL CONDITION**

Securities

The securities available for sale portfolio decreased \$3.9 million in the second quarter of 2014 and increased \$3.3 million in the first six months of 2014. The decline in the securities portfolio in the current quarter resulted as funds from maturities and sales were redeployed into loans. Various securities totaling \$19.7 million were purchased in the first half of 2014 to provide earning assets and to replace maturities, principal repayments, and calls within the securities portfolio. Approximately \$5.1 million in various securities were called or matured since the end of 2013. Principal repayments on securities totaled \$1.2 million in the first six months of 2014. Approximately \$10.8 million of securities were sold in the first two quarters of 2014 for a net gain of \$92,000.

Loans

The loan portfolio (excluding loans held for sale) increased \$9.2 million in the second quarter of 2014 and \$13.7 million in the first six months of 2014. Commercial and industrial loans increased \$8.1 million and \$13.5 million, respectively, in the second quarter and first half of 2014. Smaller levels of growth were experienced by commercial real estate loans, agricultural loans, and consumer loans, while residential mortgage loans declined in both time periods.

Asset Quality

Information regarding impaired loans can be found in Note 3 to the consolidated financial statements included in this report. The total balance of loans classified as impaired was \$7.3 million as of June 30, 2014, compared to \$8.4 million as of March 31, 2014 and \$8.3 million as of December 31, 2013. The balance of impaired loans has decreased in all loan categories since the end of 2013.

As part of its review of the loan portfolio, management also monitors the various nonperforming loans. Nonperforming loans are comprised of: (1) loans accounted for on a nonaccrual basis; (2) loans, not included in nonaccrual loans, which are contractually past due 90 days or more as to interest or principal payments; and (3) loans, not included in nonaccrual or loans past due 90 days or more, which are considered troubled debt restructurings.

The balances of these nonperforming loans were as follows:

| (Dollars in thousands)   | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| Loans accounted for on a nonaccrual basis  | \$3,340          | \$3,123              |
| Accruing loans contractually past due 90 days or more as to principal or interest payments | 32               | 11                   |
| Loans considered troubled debt restructurings  | 3,799            | 4,523                |
| Total  | \$7,171          | \$7,657              |

At June 30, 2014, nonaccrual loans included \$2,365,000 in commercial real estate loans, \$526,000 in residential real estate loans, \$225,000 in commercial and industrial loans, and \$224,000 in agricultural loans. At December 31, 2013, nonaccrual loans included \$1,606,000 in commercial real estate loans, \$691,000 in residential real estate loans, \$452,000 in agricultural loans, and \$373,000 in commercial and industrial loans. Management believes the allowance allocated to its nonperforming loans is sufficient at June 30, 2014; however, management believes future credit deterioration is possible given the status of the Michigan economy.

### Deposits and Borrowings

Total deposits decreased \$667,000 in the second quarter of 2014 and increased \$9.6 million since the end of 2013. Checking and savings deposits grew \$384,000 in the second quarter of 2014 and \$14.6 million in the first six months of 2014. Local certificates of deposit decreased \$1.1 million in the second quarter and \$4.9 million in the first half of 2014.

A decrease of \$3.7 million in repurchase agreements in the first six months of 2014 was due to normal fluctuations in funds provided by bank customers. Certain securities are sold under agreements to repurchase them the following day. Management plans to continue this practice as a low-cost source of funding. Federal Home Loan Bank advances increased \$8.0 million in the first half of 2014 due to short-term advances taken in the second quarter of 2014.

### Shareholders' Equity

Total shareholders' equity increased \$2.4 million from December 31, 2013 to June 30, 2014. Growth in equity resulted from current year's net income, proceeds from the issuance of ChoiceOne stock, and an increase in accumulated other comprehensive income, offset by cash dividends paid. The \$726,000 improvement in accumulated other comprehensive income since the end of 2013 was caused by net unrealized gains on available for sale securities. The change in unrealized gains resulted from decreases in mid- and short-term rates in the second quarter of 2014, which increased the market value of the Bank's securities.

Following is information regarding the Bank's compliance with regulatory capital requirements:

| (Dollars in thousands)  | Leverage | Tier 1   | Total    |         |
|---|----------|----------|----------|---------|
|   |          |          | Risk-    | Based   |
|   | Capital  | Capital  | Capital  | Capital |
| Capital balances at June 30, 2014   | \$45,910 | \$45,910 | \$50,041 |         |
| Required regulatory capital to be considered "well capitalized"                     | 24,864   | 21,006   | 35,011   |         |
| Capital in excess of "well capitalized" minimum                                     | 21,046   | 24,904   | 15,030   |         |
| Capital ratios at June 30, 2014   | 9.23 %   | 13.11 %  | 14.29 %  |         |
| Regulatory capital ratios - minimum requirement to be considered "well capitalized" | 5.00 %   | 6.00 %   | 10.00 %  |         |

Management reviews the capital levels of ChoiceOne and the Bank on a regular basis. The Board of Directors (the "Board") and management believe that the capital levels as of June 30, 2014 are adequate for the foreseeable future. The Board's determination of appropriate cash dividends for future periods will be based on market conditions and ChoiceOne's requirements for cash and capital.

### Liquidity

Net cash provided from operating activities was \$4.4 million for the six months ended June 30, 2014 compared to \$5.6 million provided in the same period a year ago. Lower net proceeds from loan sales were the primary cause of the decrease. Net cash used in investing activities was \$17.3 million for the first half of 2014 compared to \$5.2 million in the same period in 2013. The change was due to a higher level of net loan originations and net securities purchases. Net cash provided by financing activities was \$13.1 million in the six months ended June 30, 2014, compared to net cash used by financing activities of \$9.1 million during the same period in the prior year. An increase in deposits in the first half of 2014 compared to a decrease in the same period in 2013 was partially offset by lower net proceeds from Federal Home Loan Bank advances.

Management believes that the current level of liquidity is sufficient to meet the Bank's normal operating needs. This belief is based upon the availability of deposits from both the local and national markets, maturities of securities, normal loan repayments, income retention, federal funds purchased from correspondent banks, and advances available from the Federal Home Loan Bank. The Bank also has a secured line of credit available from the Federal Reserve Bank.

### Item 4. Controls and Procedures.

An evaluation was performed under the supervision and with the participation of the Registrant's management, including the Chief Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Registrant's disclosure controls and procedures. Based on and as of the time of that evaluation, the Registrant's management, including the Chief Executive Officer and Principal Financial Officer, concluded that the Registrant's disclosure controls and procedures were effective as of the end of the period covered by this report to ensure that material information required to be disclosed in the reports that ChoiceOne files or submits under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that ChoiceOne files or submits under the Exchange Act is accumulated and communicated to management, including ChoiceOne's principal executive and principal financial officers, as appropriate to allow for timely decisions regarding required disclosure. There was no change in the Registrant's internal control over financial reporting that occurred during the three months ended June 30, 2014 that has materially affected, or that is reasonably likely to materially affect, the Registrant's internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

There are no material pending legal proceedings to which the Registrant or the Bank is a party or to which any of their properties are subject, except for proceedings that arose in the ordinary course of business. In the opinion of management, pending or current legal proceedings will not have a material effect on the consolidated financial condition of the Registrant.

### **Item 1A. Risk Factors.**

Information concerning risk factors is contained in the discussion in Item 1A, "Risk Factors," in the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013. As of the date of this report, ChoiceOne does not believe that there has been a material change in the nature or categories of ChoiceOne's risk factors, as compared to the information disclosed in the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On April 25, 2014, the Registrant issued 564 shares of common stock, without par value, to the directors of the Registrant pursuant to the Directors' Stock Purchase Plan for an aggregate cash price of \$10,000. On May 28, 2014, the Registrant issued 821 shares of common stock, without par value, to the directors of the Registrant pursuant to the Directors' Stock Purchase Plan for an aggregate cash price of \$15,000. The Registrant relied on the exemption contained in Section 4(a)(5) of the Securities Act of 1933 in connection with these sales.

## **ISSUER PURCHASES OF EQUITY SECURITIES**

There were no purchases of equity securities by the Registrant in the second quarter of 2014. As of June 30, 2014, there are 84,920 shares remaining that may yet be purchased under approved plans or programs. The repurchase plan was adopted and announced on July 26, 2007. There is no stated expiration date. The plan authorized the repurchase of up to 100,000 shares.



Item 6. Exhibits

The following exhibits are filed or incorporated by reference as part of this report:

Exhibit

Number Document

- |       |  |
|-------|--|
| 3.1   | Amended and Restated Articles of Incorporation of the Registrant. Previously filed as an exhibit to the Registrant's Form 10-K Annual Report for the year ended December 31, 2013. Here incorporated by reference.           |
| 3.2   | Bylaws of the Registrant as currently in effect and any amendments thereto. Previously filed as an exhibit to the Registrant's Form 10-K Annual Report for the year ended December 31, 2013. Here incorporated by reference. |
| 24.1  | Power of Attorney  |
| 31.1  | <u>Certification of President and Chief Executive Officer</u>  |
| 31.2  | <u>Certification of Treasurer</u>  |
| 32.1  | <u>Certification pursuant to 18 U.S.C. § 1350.</u>   |
| 101.1 | Interactive Data File.   |

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CHOICEONE FINANCIAL SERVICES, INC.

Date: August 13, 2014 /s/ Thomas L. Lampen by Power of Attorney  
James A. Bosserd  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 13, 2014 /s/ Thomas L. Lampen  
Thomas L. Lampen  
Treasurer  
(Principal Financial and Accounting Officer)