

CHOICEONE FINANCIAL SERVICES INC
Form 10-Q
August 14, 2018

**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, 2018

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

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

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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, 2018, the Registrant had outstanding 3,613,916 shares of common stock.

PART I. FINANCIAL INFORMATIONItem 1. Financial Statements.ChoiceOne Financial Services, Inc.
CONSOLIDATED BALANCE SHEETS

| (Dollars in thousands) | June 30, 2018 (Unaudited) | December 31, 2017 (Audited) |
|---|---------------------------------|--------------------------------------|
| Assets | | |
| Cash and due from banks | \$ 11,877 | \$ 36,837 |
| Equity securities at fair value (Note 2) | 3,338 | — |
| Securities available for sale (Note 2) | 161,687 | 155,591 |
| Federal Home Loan Bank stock | 1,994 | 1,994 |
| Federal Reserve Bank stock | 1,573 | 1,573 |
| Loans held for sale | 617 | 1,721 |
| Loans to other financial institutions | 9,006 | 6,802 |
| Loans (Note 3) | 395,898 | 398,785 |
| Allowance for loan losses (Note 3) | (4,659) | (4,577) |
| Loans, net | 391,239 | 394,208 |
| Premises and equipment, net | 13,571 | 12,855 |
| Cash surrender value of life insurance policies | 14,706 | 14,514 |
| Goodwill | 13,728 | 13,728 |
| Other assets | 7,501 | 6,721 |
| Total assets | \$ 630,837 | \$ 646,544 |
| Liabilities | | |
| Deposits – noninterest-bearing | \$ 147,040 | \$ 151,462 |
| Deposits – interest-bearing | 380,881 | 388,391 |
| Total deposits | 527,921 | 539,853 |
| Repurchase agreements | — | 7,148 |
| Federal funds purchased | 4,000 | — |
| Advances from Federal Home Loan Bank | 20,251 | 20,268 |
| Other liabilities | 2,397 | 2,725 |
| Total liabilities | 554,569 | 569,994 |

Shareholders' Equity

Common stock and paid in capital, no par value; shares authorized: 7,000,000; shares outstanding:

| | | |
|---|------------|------------|
| 3,613,080 at June 30, 2018 and 3,448,569 at December 31, 2017 | 54,289 | 50,290 |
| Retained earnings | 24,146 | 26,023 |
| Accumulated other comprehensive income (loss), net | (2,167) | 237 |
| Total shareholders' equity | 76,268 | 76,550 |
| Total liabilities and shareholders' equity | \$ 630,837 | \$ 646,544 |

See accompanying notes to interim consolidated financial statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

| (Dollars in thousands, except per share data) | Three Months Ended | | Six Months Ended | |
|---|--------------------|---------|------------------|---------|
| | June 30, 2018 | 2017 | June 30, 2018 | 2017 |
| Interest income | | | | |
| Loans, including fees | \$5,028 | \$4,401 | \$9,624 | \$8,565 |
| Securities: | | | | |
| Taxable | 713 | 663 | 1,398 | 1,284 |
| Tax exempt | 362 | 352 | 723 | 713 |
| Other | 12 | 9 | 69 | 24 |
| Total interest income | 6,115 | 5,425 | 11,814 | 10,586 |
| Interest expense | | | | |
| Deposits | 463 | 292 | 809 | 540 |
| Advances from Federal Home Loan Bank | 57 | 52 | 102 | 107 |
| Other | 25 | 4 | 26 | 7 |
| Total interest expense | 545 | 348 | 937 | 654 |
| Net interest income | 5,570 | 5,077 | 10,877 | 9,932 |
| Provision for loan losses (Note 3) | — | 25 | 35 | 25 |
| Net interest income after provision for loan losses | 5,570 | 5,052 | 10,842 | 9,907 |
| Noninterest income | | | | |
| Customer service charges | 1,120 | 1,049 | 2,175 | 2,023 |
| Insurance and investment commissions | 72 | 262 | 134 | 500 |
| Gains on sales of loans | 288 | 341 | 549 | 565 |
| Gains on sales of securities | 16 | 60 | 25 | 126 |
| Net gain on sales of other assets | — | 4 | 8 | 4 |
| Earnings on life insurance policies | 98 | 99 | 192 | 198 |
| Other | 127 | 127 | 286 | 258 |
| Total noninterest income | 1,721 | 1,942 | 3,369 | 3,674 |
| Noninterest expense | | | | |
| Salaries and benefits | 2,779 | 2,591 | 5,528 | 5,106 |
| Occupancy and equipment | 664 | 689 | 1,344 | 1,397 |
| Data processing | 555 | 554 | 1,089 | 1,130 |
| Professional fees | 311 | 262 | 528 | 491 |
| Supplies and postage | 97 | 90 | 213 | 191 |
| Advertising and promotional | 85 | 73 | 177 | 127 |
| Other | 623 | 520 | 1,199 | 1,006 |
| Total noninterest expense | 5,114 | 4,779 | 10,078 | 9,448 |

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| | | | | |
|-------------------------------------|---------|---------|---------|---------|
| Income before income tax | 2,177 | 2,215 | 4,132 | 4,133 |
| Income tax expense | 344 | 580 | 642 | 1,052 |
| Net income | \$1,833 | \$1,635 | \$3,491 | \$3,081 |
| Basic earnings per share (Note 4) | \$0.51 | \$0.45 | \$0.97 | \$0.85 |
| Diluted earnings per share (Note 4) | \$0.50 | \$0.45 | \$0.96 | \$0.85 |
| Dividends declared per share | \$0.18 | \$0.16 | \$0.35 | \$0.31 |

All per share amounts have been adjusted where applicable for the 5% stock dividends paid on May 31, 2017 and May 31, 2018.

See accompanying notes to interim consolidated financial statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

| (Dollars in thousands) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------------|---------|---------------------------------|---------|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$1,833 | \$1,635 | \$3,491 | \$3,081 |
| Other comprehensive income: | | | | |
| Changes in net unrealized gains and losses on investment securities available for sale, net of tax benefit (expense) of \$86 and \$(557) for the three months ended June 30, 2018 and June 30, 2017 respectively. Changes in net unrealized gains on investment securities available for sale, net of tax benefit (expense) of \$569 and \$(910) for the six months ended June 30, 2018 and June 30, 2017 respectively. | (324) | 1,081 | (2,140) | 1,766 |
| Less: | | | | |
| Less: Reclassification adjustment for realized gain on sale of investment securities available for sale included in net income, net of tax expense of \$3 and \$21 for the three months ended June 30, 2018 and June 30, 2017 respectively. Reclassification adjustment for realized gain on sale of investment securities available for sale included in net income, net of tax expense of \$5 and \$43 for the six months ended June 30, 2018 and June 30, 2017 respectively. | (12) | (39) | (20) | (83) |
| Other comprehensive income (loss), net of tax | (336) | 1,042 | (2,160) | 1,683 |
| Comprehensive income | \$1,497 | \$2,677 | \$1,331 | \$4,764 |

See accompanying notes to interim consolidated financial statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

| (Dollars in thousands) | Number of Shares | Common Stock and Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), Net | Total |
|--|---------------------|--|----------------------|--|----------|
| Balance, January 1, 2017 | 3,277,944 | \$46,299 | \$25,997 | \$ (598) | \$71,698 |
| Net income | | | 3,081 | | 3,081 |
| Other comprehensive income | | | | 1,683 | 1,683 |
| Shares issued | 5,318 | 82 | | | 82 |
| Effect of employee stock purchases | | 6 | | | 6 |
| Stock options exercised | 1,000 | 13 | | | 13 |
| Stock-based compensation expense | | 116 | | | 116 |
| Restricted stock units vested | 4,104 | | | | — |
| Stock dividend declared (5%) | 163,989 | 3,779 | (3,786) | | (7) |
| Cash dividends declared (\$0.31 per share) (1) (2) | | | (1,144) | | (1,144) |
| Balance, June 30, 2017 | 3,452,355 | \$50,295 | \$24,148 | \$ 1,085 | \$75,528 |
| Balance, January 1, 2018 | 3,448,569 | \$50,290 | \$26,023 | \$ 237 | \$76,550 |
| Net income | | | 3,491 | | 3,491 |
| Other comprehensive loss | | | | (2,160) | (2,160) |
| Shares issued | 4,532 | 50 | | | 50 |
| Shares repurchased | (20,228) | (523) | | | (523) |
| Effect of employee stock purchases | | 6 | | | 6 |
| Stock options exercised | 809 | | | | — |
| Stock-based compensation expense | | 131 | | | 131 |
| Restricted stock units vested | 7,304 | | | | — |
| Adoption effect of ASU 2016-01 (3) | | | 244 | (244) | — |
| Stock dividend declared (5%) | 172,094 | 4,335 | (4,342) | | (7) |
| Cash dividends declared (\$0.35 per share) (2) | | | (1,270) | | (1,270) |
| Balance, June 30, 2018 | 3,613,080 | \$54,289 | \$24,146 | \$ (2,167) | \$76,268 |

(1) Adjusted for 5% stock dividend issued on May 31, 2017.

(2) Adjusted for 5% stock dividend issued on May 31, 2018.

(3) ASU 2016-01 is further addressed in Note 1 to the financial statements.

See accompanying notes to interim consolidated financial statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

| (Dollars in thousands) | Six Months Ended | |
|--|------------------|-----------|
| | June 30, 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$3,491 | \$3,081 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Provision for loan losses | 35 | 25 |
| Depreciation | 579 | 643 |
| Amortization | 460 | 549 |
| Compensation expense on stock purchases and restricted stock units | 148 | 163 |
| Gains on sales of securities | (25) | (126) |
| Gains on sales of loans | (549) | (565) |
| Loans originated for sale | (17,835) | (14,456) |
| Proceeds from loan sales | 19,120 | 14,180 |
| Earnings on bank-owned life insurance | (192) | (198) |
| Gains on sales of other real estate owned | (8) | — |
| Proceeds from sales of other real estate owned | 114 | 172 |
| Deferred federal income tax benefit | 40 | 138 |
| Net changes in other assets | (853) | 309 |
| Net changes in other liabilities | 219 | (468) |
| Net cash from operating activities | 4,744 | 3,447 |
| Cash flows from investing activities: | | |
| Securities available for sale: | | |
| Sales | 2,716 | 12,520 |
| Maturities, prepayments and calls | 6,072 | 8,011 |
| Purchases | (21,177) | (24,301) |
| Loan originations and payments, net | 686 | (14,378) |
| Additions to premises and equipment | (1,143) | (291) |
| Net cash used in investing activities | (12,846) | (18,439) |
| Cash flows from financing activities: | | |
| Net change in deposits | (11,932) | 11,958 |
| Net change in repurchase agreements | (7,148) | (5,612) |
| Net change in federal funds purchased | 4,000 | — |
| Proceeds from Federal Home Loan Bank advances | 30,000 | 117,500 |
| Payments on Federal Home Loan Bank advances | (30,017) | (105,517) |
| Issuance of common stock | 40 | 55 |
| Repurchase of common stock | (523) | — |
| Cash dividends and fractional shares from stock dividend | (1,278) | (1,151) |
| Net cash provided by (used in) financing activities | (16,858) | 17,233 |
| Net change in cash and cash equivalents | (24,960) | 2,241 |

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| | | |
|--|-----------|-----------|
| Beginning cash and cash equivalents | 36,837 | 14,809 |
| Ending cash and cash equivalents | \$ 11,877 | \$ 17,050 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | \$ 889 | \$ 596 |
| Cash paid for taxes | \$ 700 | 800 |
| Cash paid for income taxes | \$ — | \$ — |
| Loans transferred to other real estate owned | \$ 179 | \$ 207 |

See accompanying notes to interim 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”) 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, 2018 and December 31, 2017, the Consolidated Statements of Income for the three- and six-month periods ended June 30, 2018 and June 30, 2017, the Consolidated Statements of Comprehensive Income for the three- and six-month periods ended June 30, 2018 and June 30, 2017, the Consolidated Statements of Changes in Shareholders' Equity for the six-month periods ended June 30, 2018 and June 30, 2017, and the Consolidated Statements of Cash Flows for the six-month periods ended June 30, 2018 and June 30, 2017. Operating results for the six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in ChoiceOne’s Annual Report on Form 10-K for the year ended December 31, 2017.

Loans to Other Financial Institutions - The Bank entered into an agreement with another financial institution to fund mortgage loans. Loans to other financial institutions are purchased participating interests in individual advances made to mortgage bankers nation-wide from an unaffiliated originating bank. The originating bank services these loans and cash flows on the individual advances (principal, interest, and fees) which are allocated pro-rata based on ownership in the participating interest, less fees paid for the servicing activity. The underlying collateral is generally

made up of 1-4 family first residential mortgages owned by the mortgage banker and held for sale in the secondary market and have been underwritten using secondary market underwriting standards prior to purchasing the participating interest. Once the mortgage banker delivers the loan to the secondary market, the advance is required to be paid off, including the Bank's participating interest. If the advance (in which the Bank has a participating interest) is outstanding over 90 days, the originating bank has the right to request the participating interest be paid off by the mortgage banker. The participating interests are subject to concentration risk to 8 different mortgage bankers, with the largest creditor outstanding representing 44% of the total at June 30, 2018.

Credit risk associated with the participating interest is measured as an allowance for loan losses when necessary. Losses are charged off against the allowance when incurred and recoveries of loan charge-offs are recorded when received. At least quarterly, the Bank reviews the portfolio of participating interests for potential losses including any participating interest that is outstanding over 90 days (even if the advance and participating interest is current). At June 30, 2018, there was one participating interest in loans to other financial institutions totaling \$254,000 that was over 30 days. Since the inception of the program, there were no losses or charge-offs of participating interests.

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 sheets as well as its net income.

Stock Transactions

A total of 2,709 shares of common stock were issued to ChoiceOne's Board of Directors for a cash price of \$68,000 under the terms of the Directors' Stock Purchase Plan in the first six months of 2018. A total of 1,824 shares for a cash price of \$40,000 were issued under the Employee Stock Purchase Plan in the first half of 2018. A total of 809 shares were issued upon the exercise of stock options in the first six months of 2018. A total of 7,304 shares were issued to employees for Restricted Stock Units that vested during the first half of 2018.

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.

Recent Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The ASU adopts a standardized approach for revenue recognition and was a joint effort with the International Accounting Standards Board (IASB). The new revenue recognition standard is based on a core principle of recognizing revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU does not apply to financial instruments. Management implemented ASU 2014-09 effective January 1, 2018 by identifying revenue streams in scope of the guidance, including interchange revenue, deposit service charges, and investment advisory income, but the timing and amount of these revenue streams were not significantly changed upon adoption.

The FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. The ASU covers various changes to the accounting, measurement, and disclosure related to certain financial instruments. The most significant change included in the update is the requirement for certain equity investments (excluding investments that are consolidated or accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. An entity may choose to measure equity investments that do not have readily determinable fair values at cost, minus impairment. When a qualitative assessment of equity investments without readily determinable fair values indicates that impairment exists, an entity is required to measure the

investment at fair value. The update also eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The company implemented ASU 2016-01 effective January 1, 2018. A cumulative-effect adjustment was recorded as of January 1, 2018 to reclassify \$244,000 of unrealized gains on equity securities from accumulated other comprehensive income to retained earnings. Equity securities have also been presented separately from available for sale debt securities on the June 30, 2018 balance sheet and the fair value of loans has been estimated using an exit price notion in Note 5.

The FASB issued ASU 2016-02, *Leases*. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. As ChoiceOne owns most of its branch locations, the impact of this ASU is not expected to be material.

The FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This ASU provides financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing the incurred loss impairment methodology in current generally accepted accounting principles (GAAP) with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The new guidance attempts to reflect an entity's current estimate of all expected credit losses and broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually to include forecasted information, as well as past events and current conditions. There is no specified method for measuring expected credit losses, and an entity may apply methods that reasonably reflect its expectations of the credit loss estimate. Although an entity may still use its current systems and methods for recording the allowance for credit losses, under the new rules, the inputs used to record the allowance for credit losses generally will need to change to appropriately reflect an estimate of all expected credit losses and the use of reasonable and supportable forecasts. Additionally, credit losses on available-for-sale debt securities will have to be presented as an allowance rather than as a write-down. This ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within those years. Management is currently evaluating the impact of this new ASU on its consolidated financial statements.

NOTE 2 - SECURITIES

The fair value of equity securities at fair value and the related gross unrealized gains recognized in other noninterest income were as follows:

| (Dollars in thousands) | June 30, 2018 | | | |
|------------------------|-------------------|------------------------------|-----------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Loss | Fair Value |
| Equity securities | \$3,002 | \$ 336 | \$ | —\$3,338 |

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) | June 30, 2018 | | | |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Government and federal agency | \$34,099 | \$ — | \$ (971) | \$33,128 |
| U.S. Treasury | 1,991 | — | (72) | 1,919 |
| State and municipal | 104,958 | 378 | (1,731) | 103,605 |
| Mortgage-backed | 18,310 | 11 | (409) | 17,912 |
| Corporate | 5,146 | — | (79) | 5,067 |
| Asset-backed securities | 56 | — | — | 56 |
| Total | \$164,560 | \$ 389 | \$ (3,262) | \$161,687 |

| (Dollars in thousands) | December 31, 2017 | | | |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. Government and federal agency | \$35,518 | \$— | \$(392) | \$35,126 |
| U.S. Treasury | 1,991 | — | (31) | 1,960 |
| State and municipal | 99,609 | 910 | (471) | 100,048 |
| Mortgage-backed | 9,943 | 8 | (131) | 9,820 |
| Corporate | 5,184 | 2 | (35) | 5,151 |
| Equity securities | 3,083 | 309 | — | 3,392 |
| Asset-backed securities | 95 | — | (1) | 94 |
| Total | \$155,423 | \$1,229 | \$(1,061) | \$155,591 |

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 in the three and six months ended June 30, 2018. 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.

Presented below is a schedule of maturities of securities as of June 30, 2018, the fair value of securities as of June 30, 2018 and December 31, 2017, and the weighted average yields of securities as of June 30, 2018:

| (Dollars in thousands) | Securities maturing within: | | | | Fair | Fair |
|------------------------------------|-----------------------------|------------------|--------------------|--------------------|------------------------|------------------------|
| | Less than 1 Year | 1 Year - 5 Years | 5 Years - 10 Years | More than 10 Years | Value at June 30, 2018 | Value at Dec. 31, 2017 |
| U.S. Government and federal agency | \$16,460 | \$9,888 | \$6,780 | \$— | \$33,128 | \$35,126 |
| U.S. Treasury notes and bonds | — | 1,919 | — | — | 1,919 | 1,960 |
| State and municipal | 10,694 | 50,580 | 40,314 | 2,017 | 103,605 | 100,048 |
| Corporate | 1,992 | 2,587 | 488 | — | 5,067 | 5,151 |
| Asset-backed securities | 56 | — | — | — | 56 | 94 |
| Total debt securities | 29,202 | 64,974 | 47,582 | 2,017 | 143,775 | 142,379 |
| Mortgage-backed securities | — | 11,656 | 6,256 | — | 17,912 | 9,820 |
| Equity securities (1) | — | — | 1,000 | 2,338 | 3,338 | 3,392 |
| Total | \$29,202 | \$76,630 | \$54,838 | \$4,355 | \$165,025 | \$155,591 |

| | Weighted average yields: | | | | | Total |
|------------------------------------|--------------------------|------------------|--------------------|--------------------|--|-------|
| | Less than 1 Year | 1 Year - 5 Years | 5 Years - 10 Years | More than 10 Years | | |
| U.S. Government and federal agency | 2.19% | 1.78% | 2.67% | —% | | 2.17% |
| U.S. Treasury notes and bonds | — | 1.85 | — | — | | 1.85 |
| State and municipal (2) | 3.10 | 3.05 | 3.58 | 1.22 | | 3.23 |
| Corporate | — | 2.48 | 3.21 | — | | 1.58 |
| Asset-backed securities | 2.59 | — | — | — | | 2.59 |
| Mortgage-backed securities | — | 2.92 | 3.01 | — | | 2.95 |
| Equity securities (1) | — | — | 4.78 | 1.07 | | 2.18 |

(1) Equity securities are preferred and common stock that may or may not have a stated maturity.

(2) The yield is computed for tax-exempt securities on a fully tax-equivalent basis at an incremental rate of 21%.

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Following is information regarding unrealized gains and losses on equity securities for the three- and six-month periods ending June 30, 2018:

| | Three Months | Six Months |
|---|------------------|------------------|
| | Ended | Ended |
| | June 30, 2018 | June 30, 2018 |
| Net gains and losses recognized during the period | \$26 | \$58 |
| Less: Net gains and losses recognized during the period on securities sold | — | 9 |
| Unrealized gains and losses recognized during the reporting period on securities still held at the reporting date | \$26 | \$49 |

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 and Industrial | Consumer | Commercial Real Estate | Commercial Construction Real Estate | Residential Real Estate | Unallocated | Total |
|---------------------------------------|--------------|---------------------------------|----------|------------------------------|--|-------------------------------|-------------|----------|
| <u>Allowance for Loan Losses</u> | | | | | | | | |
| <u>Three Months Ended</u> | | | | | | | | |
| <u>June 30, 2018</u> | | | | | | | | |
| Beginning balance | \$ 350 | \$ 1,005 | \$ 245 | \$ 1,786 | \$ 18 | \$ 625 | \$ 680 | \$ 4,709 |
| Charge-offs | — | (57) | (50) | — | — | (9) | — | (116) |
| Recoveries | — | — | 15 | 3 | — | 48 | — | 66 |
| Provision | 9 | 22 | (5) | 122 | (2) | (44) | (102) | 35 |
| Ending balance | \$ 359 | \$ 970 | \$ 205 | \$ 1,911 | \$ 16 | \$ 620 | \$ 578 | \$ 4,659 |
| <u>Six Months Ended</u> | | | | | | | | |
| <u>June 30, 2018</u> | | | | | | | | |
| Beginning balance | \$ 506 | \$ 1,001 | \$ 262 | \$ 1,761 | \$ 35 | \$ 726 | \$ 286 | \$ 4,577 |
| Charge-offs | — | (58) | (118) | — | — | (13) | — | (188) |
| Recoveries | — | 53 | 51 | 59 | — | 73 | — | 236 |
| Provision | (147) | (26) | 10 | 91 | (19) | (166) | 292 | 35 |
| Ending balance | \$ 359 | \$ 970 | \$ 205 | \$ 1,911 | \$ 16 | \$ 620 | \$ 578 | \$ 4,659 |
| Individually evaluated for impairment | | | | | | | | |
| | \$ — | \$ 76 | \$ 1 | \$ 28 | \$ — | \$ 221 | \$ — | \$ 326 |
| Collectively evaluated for impairment | | | | | | | | |
| | \$ 359 | \$ 894 | \$ 204 | \$ 1,883 | \$ 16 | \$ 399 | \$ 577 | \$ 4,333 |
| <u>Three Months Ended</u> | | | | | | | | |
| <u>June 30, 2017</u> | | | | | | | | |
| Beginning balance | \$ 406 | \$ 745 | \$ 286 | \$ 1,414 | \$ 23 | \$ 727 | \$ 724 | \$ 4,325 |
| Charge-offs | — | (352) | (57) | — | — | — | — | (409) |
| Recoveries | — | — | 39 | 49 | 40 | 29 | — | 157 |
| Provision | (11) | 511 | 26 | 88 | (39) | (7) | (543) | 25 |
| Ending balance | \$ 395 | \$ 904 | \$ 294 | \$ 1,551 | \$ 24 | \$ 749 | \$ 181 | \$ 4,098 |
| <u>Six Months Ended</u> | | | | | | | | |
| <u>June 30, 2017</u> | | | | | | | | |
| Beginning balance | \$ 433 | \$ 688 | \$ 305 | \$ 1,438 | \$ 62 | \$ 1,014 | \$ 337 | \$ 4,277 |

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| | | | | | | | | |
|----------------|--------|--------|--------|----------|-------|--------|--------|----------|
| Charge-offs | — | (362) | (137) | — | — | (34) | — | (533) |
| Recoveries | — | — | 91 | 161 | 40 | 37 | — | 329 |
| Provision | (38) | 578 | 35 | (48) | (78) | (268) | (156) | 25 |
| Ending balance | \$ 395 | \$ 904 | \$ 294 | \$ 1,551 | \$ 24 | \$ 749 | \$ 181 | \$ 4,098 |

Individually evaluated
for

| | | | | | | | | |
|------------|------|-------|------|-------|------|--------|------|--------|
| impairment | \$ — | \$ 27 | \$ 4 | \$ 65 | \$ — | \$ 271 | \$ — | \$ 367 |
|------------|------|-------|------|-------|------|--------|------|--------|

Collectively evaluated
for

| | | | | | | | | |
|------------|--------|--------|--------|----------|-------|--------|--------|----------|
| impairment | \$ 395 | \$ 877 | \$ 290 | \$ 1,486 | \$ 24 | \$ 478 | \$ 181 | \$ 3,731 |
|------------|--------|--------|--------|----------|-------|--------|--------|----------|

Loans

June 30, 2018

Individually evaluated
for

| | | | | | | | | |
|------------|--------|--------|-------|--------|------|----------|--|----------|
| impairment | \$ 421 | \$ 292 | \$ 58 | \$ 815 | \$ — | \$ 2,692 | | \$ 4,278 |
|------------|--------|--------|-------|--------|------|----------|--|----------|

Collectively evaluated
for

| | | | | | | | | |
|------------|--------|--------|--------|---------|-------|--------|--|---------|
| impairment | 38,951 | 96,746 | 24,122 | 135,394 | 3,682 | 92,725 | | 391,620 |
|------------|--------|--------|--------|---------|-------|--------|--|---------|

| | | | | | | | | |
|----------------|-----------|-----------|-----------|------------|----------|-----------|--|------------|
| Ending balance | \$ 39,372 | \$ 97,038 | \$ 24,180 | \$ 136,209 | \$ 3,682 | \$ 95,417 | | \$ 395,898 |
|----------------|-----------|-----------|-----------|------------|----------|-----------|--|------------|

December 31, 2017

Individually evaluated
for

| | | | | | | | | |
|------------|--------|--------|-------|--------|------|----------|--|----------|
| impairment | \$ 423 | \$ 124 | \$ 36 | \$ 778 | \$ — | \$ 2,779 | | \$ 4,140 |
|------------|--------|--------|-------|--------|------|----------|--|----------|

Collectively evaluated
for

| | | | | | | | | |
|------------|--------|---------|--------|---------|-------|--------|--|---------|
| impairment | 48,041 | 104,262 | 24,477 | 122,709 | 6,613 | 88,543 | | 394,645 |
|------------|--------|---------|--------|---------|-------|--------|--|---------|

| | | | | | | | | |
|----------------|-----------|------------|-----------|------------|----------|-----------|--|------------|
| Ending balance | \$ 48,464 | \$ 104,386 | \$ 24,513 | \$ 123,487 | \$ 6,613 | \$ 91,322 | | \$ 398,785 |
|----------------|-----------|------------|-----------|------------|----------|-----------|--|------------|

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, |
| | 2018 | 2017 | 2018 | 2017 | 2018 | 2017 |
| Risk ratings 1 and 2 | \$11,449 | \$14,813 | \$12,253 | \$13,491 | \$8,392 | \$8,227 |
| Risk rating 3 | 17,983 | 22,721 | 60,172 | 63,366 | 91,126 | 78,868 |
| Risk rating 4 | 9,108 | 10,199 | 23,292 | 26,943 | 33,074 | 33,429 |
| Risk rating 5 | 411 | 308 | 1,188 | 491 | 2,269 | 1,533 |
| Risk rating 6 | 421 | 423 | 133 | 95 | 1,348 | 1,430 |
| | \$39,372 | \$48,464 | \$97,038 | \$104,386 | \$136,209 | \$123,487 |

Corporate Credit Exposure - Credit Risk Profile Based On Payment Activity

| (Dollars in thousands) | Consumer | | Construction Real Estate | | Residential Real Estate | |
|------------------------|----------|--------------|--------------------------|--------------|-------------------------|--------------|
| | June 30, | December 31, | June 30, | December 31, | June 30, | December 31, |
| | 2018 | 2017 | 2018 | 2017 | 2018 | 2017 |
| Performing | \$24,180 | \$24,497 | \$3,682 | \$6,613 | \$94,875 | \$90,629 |
| Nonperforming | — | 1 | — | — | — | 257 |
| Nonaccrual | — | 15 | — | — | 542 | 436 |
| | \$24,180 | \$24,513 | \$3,682 | \$6,613 | \$95,417 | \$91,322 |

The following schedule provides information on loans that were considered troubled debt restructurings ("TDRs") that were modified during the three and six months periods ended June 30, 2018. There were no loans that were considered TDRs that were modified during the three and six months periods ended June 30, 2017:

| (Dollars in thousands) | Three Months Ended June 30, 2018 | | Six Months Ended June 30, 2018 | |
|------------------------|----------------------------------|-------------------------------|--------------------------------|-------------------------------|
| | Pre-Modification Outstanding | Post-Modification Outstanding | Pre-Modification Outstanding | Post-Modification Outstanding |
| | Number of Recorded | Recorded | Number of Recorded | Recorded |

| | Loans | Investment | Loans | Investment |
|---------------------------|-------|------------|-------|------------|
| Commercial and industrial | — | \$ — | 1 | \$ 39 |

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, 2018 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three month and six months ended June 30, 2018 that had been modified during the year prior to the default:

| (Dollars in thousands) | Three Months Ended June 30, 2018 | | Six Months Ended June 30, 2018 | |
|---------------------------|-------------------------------------|------------------------|-----------------------------------|------------------------|
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment |
| Commercial and industrial | 1 | \$39 | 1 | \$39 |

The following schedule provides information on TDRs as of June 30, 2017 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three month and six months ended June 30, 2017 that had been modified during the year prior to the default:

| (Dollars in thousands) | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2017 | |
|------------------------|--|------------------------|--------------------------------------|------------------------|
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment |
| Commercial real estate | — | \$ — | 1 | \$ 128 |

Impaired loans by loan category follow:

| (Dollars in thousands) | Recorded | Unpaid Principal | Related |
|------------------------------------|------------|---------------------|-----------|
| | Investment | Balance | Allowance |
| <u>June 30, 2018</u> | | | |
| With no related allowance recorded | | | |
| Agricultural | \$ 421 | \$ 455 | \$ — |
| Commercial and industrial | 61 | 61 | — |
| Consumer | — | — | — |
| Commercial real estate | 53 | 55 | — |
| Residential real estate | 110 | 122 | — |
| Subtotal | 645 | 693 | — |
| With an allowance recorded | | | |
| Agricultural | — | — | — |
| Commercial and industrial | 231 | 266 | 76 |
| Consumer | 58 | 59 | 1 |
| Commercial real estate | 762 | 849 | 28 |
| Residential real estate | 2,582 | 2,616 | 221 |
| Subtotal | 3,633 | 3,790 | 326 |
| Total | | | |
| Agricultural | 421 | 455 | — |
| Commercial and industrial | 292 | 327 | 76 |
| Consumer | 58 | 59 | 1 |
| Commercial real estate | 815 | 904 | 28 |
| Residential real estate | 2,692 | 2,738 | 221 |
| Total | \$ 4,278 | \$ 4,483 | \$ 326 |
| | | | |
| December 31, 2017 | | | |
| With no related allowance recorded | | | |
| Agricultural | \$ 423 | \$ 455 | \$ — |
| Commercial and industrial | — | — | — |
| Consumer | — | — | — |
| Commercial real estate | 127 | 258 | — |
| Residential real estate | 115 | 126 | — |
| Subtotal | 665 | 839 | — |
| With an allowance recorded | | | |
| Agricultural | — | — | — |
| Commercial and industrial | 124 | 124 | 26 |
| Consumer | 36 | 36 | 3 |
| Commercial real estate | 651 | 734 | 49 |
| Residential real estate | 2,664 | 2,690 | 224 |
| Subtotal | 3,475 | 3,584 | 302 |
| Total | | | |
| Agricultural | 423 | 455 | — |
| Commercial and industrial | 124 | 124 | 26 |
| Consumer | 36 | 36 | 3 |

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| | | | |
|-------------------------|----------|----------|--------|
| Commercial real estate | 778 | 992 | 49 |
| Residential real estate | 2,779 | 2,816 | 224 |
| Total | \$ 4,140 | \$ 4,423 | \$ 302 |

The following schedule provides information regarding average balances of impaired loans and interest recognized on impaired loans for the six months ended June 30, 2018 and 2017:

| (Dollars in thousands) | Average Recorded Investment | Interest Income Recognized |
|------------------------------------|-----------------------------------|----------------------------------|
| <u>June 30, 2018</u> | | |
| With no related allowance recorded | | |
| Agricultural | \$ 423 | \$ — |
| Commercial and industrial | 20 | 2 |
| Consumer | 3 | — |
| Commercial real estate | 79 | — |
| Residential real estate | 137 | 1 |
| Subtotal | 662 | 3 |
| With an allowance recorded | | |
| Agricultural | — | — |
| Commercial and industrial | 215 | 8 |
| Consumer | 43 | 1 |
| Commercial real estate | 733 | 22 |
| Residential real estate | 2,633 | 63 |
| Subtotal | 3,624 | 94 |
| Agricultural | 423 | — |
| Commercial and industrial | 235 | 10 |
| Consumer | 46 | 1 |
| Commercial real estate | 812 | 22 |
| Residential real estate | 2,770 | 64 |
| Total | \$ 4,286 | \$ 97 |
| <u>June 30, 2017</u> | | |
| With no related allowance recorded | | |
| Agricultural | \$ 308 | \$ — |
| Commercial and industrial | 186 | — |
| Consumer | — | — |
| Commercial real estate | 181 | — |
| Residential real estate | 158 | 2 |
| Subtotal | 833 | 2 |
| With an allowance recorded | | |
| Agricultural | 175 | — |
| Commercial and industrial | 182 | 1 |
| Consumer | 31 | 1 |
| Commercial real estate | 853 | 17 |
| Residential real estate | 2,590 | 56 |
| Subtotal | 3,831 | 75 |
| Agricultural | 483 | — |
| Commercial and industrial | 368 | 1 |

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| | | |
|-------------------------|----------|-------|
| Consumer | 31 | 1 |
| Commercial real estate | 1,034 | 17 |
| Residential real estate | 2,748 | 58 |
| Total | \$ 4,664 | \$ 77 |

16

An aging analysis of loans by loan category follows:

| (Dollars in thousands) | 30 to 59 Days | 60 to 89 Days | Greater | Loans Not Past Due | Total Loans | 90 Days Past Due and Accruing | |
|---------------------------|---------------------|---------------------|------------------------------------|-----------------------|----------------|--|--------|
| | | | Than 90 Days (1) Total | | | | |
| <u>June 30, 2018</u> | | | | | | | |
| Agricultural | \$— | \$— | \$ 421 | \$421 | \$38,951 | \$39,372 | \$ — |
| Commercial and industrial | — | — | 39 | 39 | 96,999 | 97,038 | — |
| Consumer | 93 | — | — | 93 | 24,087 | 24,180 | — |
| Commercial real estate | 84 | 79 | — | 163 | 136,046 | 136,209 | — |
| Construction real estate | 268 | — | — | 268 | 3,414 | 3,682 | — |
| Residential real estate | 694 | 475 | 66 | 1,235 | 94,182 | 95,417 | — |
| | \$1,139 | \$554 | \$ 526 | \$2,219 | \$393,679 | \$395,898 | \$ — |
| <u>December 31, 2017</u> | | | | | | | |
| Agricultural | \$— | \$— | \$ 83 | \$83 | \$48,381 | \$48,464 | \$ — |
| Commercial and industrial | 20 | — | — | 20 | 104,366 | 104,386 | — |
| Consumer | 142 | 38 | 1 | 181 | 24,332 | 24,513 | — |
| Commercial real estate | 95 | 58 | 69 | 222 | 123,265 | 123,487 | — |
| Construction real estate | — | — | — | — | 6,613 | 6,613 | — |
| Residential real estate | 585 | 272 | 296 | 1,153 | 90,169 | 91,322 | 258 |
| | \$842 | \$368 | \$ 449 | \$1,659 | \$397,126 | \$398,785 | \$ 258 |

(1) Includes nonaccrual loans.

Nonaccrual loans by loan category follow:

| (Dollars in thousands) | June 30, 2018 | December 31, 2017 |
|---------------------------|---------------------|-------------------------|
| Agricultural | \$421 | \$ 423 |
| Commercial and industrial | 39 | — |
| Consumer | — | 15 |
| Commercial real estate | 138 | 222 |
| Construction real estate | — | — |
| Residential real estate | 542 | 436 |
| | \$1,140 | \$ 1,096 |

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, 2018 | 2017 | June 30, 2018 | 2017 |
| <u>Basic Earnings Per Share</u> | | | | |
| Net income available to common shareholders | \$1,833 | \$1,635 | \$3,491 | \$3,081 |
| Weighted average common shares outstanding | 3,613,398 | 3,622,290 | 3,614,197 | 3,618,729 |
| Basic earnings per share | \$0.51 | \$0.45 | \$0.97 | \$0.85 |
| <u>Diluted Earnings Per Share</u> | | | | |
| Net income available to common shareholders | \$1,833 | \$1,635 | \$3,491 | \$3,081 |
| Weighted average common shares outstanding | 3,613,398 | 3,622,290 | 3,614,197 | 3,618,729 |
| Plus dilutive stock options and restricted stock units | 12,550 | 4,049 | 10,463 | 3,482 |
| Weighted average common shares outstanding and potentially dilutive shares | 3,625,948 | 3,626,339 | 3,624,660 | 3,622,211 |
| Diluted earnings per share | \$0.50 | \$0.45 | \$0.96 | \$0.85 |

There were no stock options that were considered to be anti-dilutive to earnings per share for the three months ended June 30, 2018. There were 15,000 options that were considered to be anti-dilutive to earnings per share for the six months ended June 30, 2018 and were excluded from the calculation above.

There were 31,500 stock options that were considered to be anti-dilutive for the three months ended June 30, 2017 and there were 47,250 stock options that were considered to be anti-dilutive for the six months ended June 30, 2017. These stock options have been excluded from the calculation of diluted earnings above.

All per share amounts have been adjusted for the 5% stock dividend issued on May 31, 2018 and the 5% stock dividend issued on May 31, 2017, where applicable.

NOTE 5 – FINANCIAL INSTRUMENTS

Financial instruments as of the dates indicated were as follows:

| (Dollars in thousands) | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|--------------------|-------------------------|---|---|--|
| June 30, 2018 | | | | | |
| Assets: | | | | | |
| Cash and due from banks | \$11,877 | \$11,877 | \$11,877 | \$— | \$— |
| Equity securities at fair value | 3,338 | 3,338 | 1,838 | — | 1,500 |
| Securities available for sale | 161,687 | 161,687 | — | 150,348 | 11,339 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,567 | 3,567 | — | 3,567 | — |
| Loans held for sale | 617 | 647 | — | 647 | — |
| Loans to other financial institutions | 9,006 | 9,006 | — | 9,006 | — |
| Loans, net | 391,239 | 390,988 | — | — | 390,988 |
| Accrued interest receivable | 2,220 | 2,220 | — | 2,220 | — |
| Liabilities: | | | | | |
| Noninterest-bearing deposits | 147,040 | 147,040 | — | 147,040 | — |
| Interest-bearing deposits | 380,881 | 379,501 | — | 379,501 | — |
| Federal funds purchased | 4,000 | 4,000 | — | 4,000 | — |
| Federal Home Loan Bank advances | 20,251 | 20,259 | — | 20,259 | — |
| Accrued interest payable | 98 | 98 | — | 98 | — |
| December 31, 2017 | | | | | |
| Assets: | | | | | |
| Cash and due from banks | \$36,837 | \$36,837 | \$36,837 | \$— | \$— |
| Securities available for sale | 155,591 | 155,591 | 1,892 | 140,301 | 13,398 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,567 | 3,567 | — | 3,567 | — |
| Loans held for sale | 1,721 | 1,773 | — | 1,773 | — |
| Loans to other financial institutions | 6,802 | 6,802 | — | 6,802 | — |
| Loans, net | 394,208 | 394,819 | — | — | 394,819 |
| Accrued interest receivable | 2,146 | 2,146 | — | 2,146 | — |
| Liabilities: | | | | | |
| Noninterest-bearing deposits | 151,462 | 151,462 | — | 151,462 | — |

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| | | | | | |
|---------------------------------|---------|---------|---|---------|---|
| Interest-bearing deposits | 388,391 | 387,343 | — | 387,343 | — |
| Repurchase agreements | 7,148 | 7,148 | — | 7,148 | — |
| Federal Home Loan Bank advances | 20,268 | 20,271 | — | 20,271 | — |
| Accrued interest payable | 49 | 49 | — | 49 | — |

NOTE 6 – FAIR VALUE MEASUREMENTS

The following tables present information about assets and liabilities measured at fair value on a recurring basis and the valuation techniques used 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, 2018 or December 31, 2017. Disclosures concerning assets measured at fair value are as follows:

Assets Measured at Fair Value on a Recurring Basis

| (Dollars in thousands) | Quoted | Significant | | Balance at |
|---|-----------|-------------|--------------|------------|
| | Prices | Other | Significant | |
| | in Active | Observable | Unobservable | Date |
| | Markets | | | Indicated |
| | for | Inputs | Inputs | |
| | Identical | (Level 2) | (Level 3) | |
| | Assets | | | |
| | (Level 1) | | | |
| <u>Equity Securities Held at Fair Value - June 30, 2018</u> | | | | |
| Equity securities | \$ 1,838 | \$— | \$ 1,500 | \$3,338 |
| Investment Securities, Available for | | | | |
| Sale – June 30, 2018 | | | | |
| U.S. Treasury notes and bonds | \$— | \$ 1,919 | \$ — | \$1,919 |
| U.S. Government and federal agency | — | 33,128 | — | 33,128 |
| State and municipal | — | 92,266 | 11,339 | 103,605 |
| Mortgage-backed | — | 17,912 | — | 17,912 |
| Corporate | — | 5,067 | — | 5,067 |

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| | | | | |
|-------------------------|-----|------------|-----------|------------|
| Asset backed securities | — | 56 | — | 56 |
| Total | \$— | \$ 150,348 | \$ 11,339 | \$ 161,687 |

Investment Securities, Available for
Sale - December 31, 2017

| | | | | |
|------------------------------------|----------|------------|-----------|------------|
| U.S. Treasury notes and bonds | \$— | \$ 1,960 | \$ — | \$ 1,960 |
| U.S. Government and federal agency | — | 35,126 | — | 35,126 |
| State and municipal | — | 88,150 | 11,898 | 100,048 |
| Mortgage-backed | — | 9,820 | — | 9,820 |
| Corporate | — | 5,151 | — | 5,151 |
| Equity securities | 1,892 | — | 1,500 | 3,392 |
| Asset backed securities | — | 94 | — | 94 |
| Total | \$ 1,892 | \$ 140,301 | \$ 13,398 | \$ 155,591 |

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

(Dollars in thousands)

| | 2018 | 2017 |
|--|----------|----------|
| <u>Investment Securities</u> | | |
| Balance, January 1 | \$13,398 | \$15,103 |
| Total realized and unrealized gains included in income | — | — |
| Total unrealized gains (losses) included in other comprehensive income | (246) | 162 |
| Net purchases, sales, calls, and maturities | (313) | (407) |
| Net transfers into Level 3 | — | — |
| Balance, June 30 | \$12,839 | \$14,858 |

Of the Level 3 assets that were held by the company as available for sale at June 30, 2018, the net unrealized gain as of June 30, 2018 was \$84,000, which is recognized in accumulated other comprehensive income in the consolidated balance sheet. A total of \$231,000 of Level 3 securities were purchased in the six months ended June 30, 2018.

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.

Securities categorized as Level 3 assets primarily consist of bonds issued by local municipalities and equity securities of community banks. The company 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 company 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 at | Quoted | Significant | |
|------------------------|------------|-----------|-------------|--------------|
| | | Prices | Other | Significant |
| | | in Active | | |
| | | Markets | | |
| | | for | Observable | Unobservable |
| | | Identical | | |
| | | Assets | Inputs | Inputs |

| | Dates Indicated | (Level 1) | (Level 2) | (Level 3) |
|--------------------------|--------------------|-----------|-----------|-----------|
| <u>Impaired Loans</u> | | | | |
| June 30, 2018 | \$ 4,278 | \$ — | \$ — | \$ 4,278 |
| December 31, 2017 | \$ 4,140 | \$ — | \$ — | \$ 4,140 |
| <u>Other Real Estate</u> | | | | |
| June 30, 2018 | \$ 179 | \$ — | \$ — | \$ 179 |
| December 31, 2017 | \$ 106 | \$ — | \$ — | \$ 106 |

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The company estimates the fair value of the loans based on the present value of expected future cash flows using management's 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). The changes in fair value consisted of charge-downs of impaired loans that were posted to the allowance for loan losses and write-downs of other real estate that were posted to a valuation account.

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") 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 interim 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," and 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, 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 ChoiceOne's Annual Report on Form 10-K for the year ended December 31, 2017. 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 2018 was \$1,833,000, which represented an increase of \$198,000 or 12% compared to the same period in 2017. Net income for the first six months of 2018 was \$3,491,000, which represented an increase of \$410,000 or 13% compared to the first half of the prior year. Growth in net interest income was offset by a decline in noninterest income and growth in noninterest expense in both the second quarter and first six months of 2018 compared to the same periods in 2017. The reduction in ChoiceOne's corporate tax rate also contributed to the higher net income in 2018. Basic earnings per common share were \$0.51 for the second quarter and \$0.97 for the first

six months of 2018, compared to \$0.45 for the second quarter and \$0.85 for the first half of the prior year. Earnings per share for 2018 were adjusted for the 5% stock dividend paid in May 2018 and per share amounts for 2017 were adjusted for the 5% stock dividends paid in May 2018 and May 2017. The return on average assets and return on average shareholders' equity percentages were 1.12% and 9.20%, respectively, for the first six months of 2018, compared to 0.99% and 8.35%, respectively, for the same period in 2017.

Dividends

Cash dividends of \$651,000 or \$0.18 per share were declared in the second quarter of 2018, compared to \$587,000 or an adjusted \$0.16 per share in the second quarter of 2017. The cash dividends declared in the first six months of 2018 were \$1,270,000 or an adjusted \$0.35 per share, compared to \$1,144,000 or an adjusted \$0.31 per share in the same period in the prior year. The per share amounts for 2018 were adjusted for the 5% stock dividend paid in May 2018 and the per share amounts for the prior year were adjusted for the 5% stock dividends paid in May 2018 and May 2017. The cash dividend payout percentage was 36% in the first six months of 2018 and 37% in the same period in the prior year.

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, 2018 and 2017. 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, | | | | | |
|--|---------------------------|----------|--------|--------------------|----------|--------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest | Rate | Average Balance | Interest | Rate |
| Assets: | | | | | | |
| Loans (1) | \$395,951 | \$9,626 | 4.86 % | \$378,420 | \$8,568 | 4.53 % |
| Taxable securities (2) (3) | 111,969 | 1,329 | 2.37 | 126,906 | 1,284 | 2.02 |
| Nontaxable securities (1) (2) | 55,752 | 917 | 3.29 | 55,252 | 1,076 | 3.90 |
| Other | 7,529 | 69 | 1.84 | 5,331 | 24 | 0.90 |
| Interest-earning assets | 571,201 | 11,941 | 4.18 | 565,909 | 10,952 | 3.87 |
| Noninterest-earning assets | 54,467 | | | 55,704 | | |
| Total assets | \$625,668 | | | \$621,613 | | |
| Liabilities and Shareholders' Equity: | | | | | | |
| Interest-bearing demand deposits | \$207,443 | 253 | 0.24 % | \$205,396 | 181 | 0.18 % |
| Savings deposits | 76,964 | 7 | 0.02 | 77,210 | 7 | 0.02 |
| Certificates of deposit | 100,879 | 549 | 1.09 | 105,133 | 352 | 0.68 |
| Advances from Federal Home Loan Bank | 12,415 | 102 | 1.64 | 20,918 | 107 | 1.02 |
| Other | 5,123 | 26 | 1.02 | 5,813 | 7 | 0.24 |
| Interest-bearing liabilities | 402,824 | 937 | 0.47 | 414,470 | 654 | 0.32 |
| Noninterest-bearing demand deposits | 145,803 | | | 130,775 | | |
| Other noninterest-bearing liabilities | 1,151 | | | 2,607 | | |
| Total liabilities | 549,778 | | | 547,852 | | |
| Shareholders' equity | 75,890 | | | 73,761 | | |
| Total liabilities and shareholders' equity | \$625,668 | | | \$621,613 | | |
| Net interest income (tax-equivalent basis)- interest spread (Non-GAAP) | | | | | | |
| | | 11,004 | 3.71 % | | 10,298 | 3.55 % |
| Tax-equivalent adjustment (1) | | | | | | |
| | | (127) | | | (366) | |
| Net interest income (GAAP) | | | | | | |
| | | \$10,877 | | | \$9,932 | |
| Net interest income as a percentage of earning assets (tax-equivalent basis) (Non-GAAP) | | | | | | |
| | | | 3.85 % | | | 3.64 % |

(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 21% in 2018 and 34% in 2017. See "Net Interest Income" below for additional information.

(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.

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Table 2 – Changes in Tax-Equivalent Net Interest Income

| (Dollars in thousands) | Six Months Ended June 30, | | |
|--|---------------------------|--------|-------|
| | 2018 Over 2017 | | |
| | Total | Volume | Rate |
| Increase (decrease) in interest income (1) | | | |
| Loans (2) | \$1,058 | \$408 | \$650 |
| Taxable securities | 45 | (341) | 386 |
| Nontaxable securities (2) | (159) | 28 | (187) |
| Other | 45 | 13 | 32 |
| Net change in tax-equivalent interest income | 989 | 108 | 881 |
| Increase (decrease) in interest expense (1) | | | |
| Interest-bearing demand deposits | 72 | 2 | 70 |
| Savings deposits | — | — | — |
| Certificates of deposit | 197 | (42) | 239 |
| Advances from Federal Home Loan Bank | (5) | (106) | 101 |
| Other | 19 | (2) | 21 |
| Net change in interest expense | 283 | (148) | 431 |
| Net change in tax-equivalent net interest income | \$706 | \$256 | \$450 |

- 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.
- (2) Interest on nontaxable investment securities and loans has been adjusted to a fully tax-equivalent basis using an incremental tax rate of 21% for 2018 and 34% for 2017.

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 \$127,000 and \$366,000 for the six months ended June 30, 2018 and 2017, respectively. These adjustments were computed using a 21% federal income tax rate in 2018 and a 34% federal income tax rate in 2017.

Tax-equivalent net interest income increased \$706,000 in the first six months of 2018 compared to the same period in 2017. The effect of growth in average loans partially offset by lower average securities was supplemented by a decrease in average interest-bearing liabilities in the first half of 2018 compared to the same period in the prior year. The net interest spread increased by 16 basis points from 3.55% in the first six months of 2017 to 3.71% in the first half of 2018 and caused tax-equivalent net interest income to increase by \$450,000 in the first half of 2018 compared to the same period in the prior year.

The average balance of loans increased \$17.5 million in the first six months of 2018 compared to the same period in 2017. Average commercial and industrial loans and commercial real estate loans drove this growth with an increase of \$13.4 million during the first half of 2018 compared to the first half of 2017. Average consumer loans grew \$1.7 million while average residential mortgage loans increased \$2.4 million. The increase in the average loans balance was complemented by a 33 basis point increase in the average rate earned. This caused tax-equivalent interest income from loans to increase \$650,000 in the first six months of 2018 compared to the same period in the prior year. The average balance of total securities declined \$14.4 million in the first half of 2018 compared to the same period in 2017. The decline was primarily due to the sale of approximately \$35 million of securities in the fourth quarter of 2017. The effect of the average balance decline, offset by a 9 basis point increase in the average rate earned on securities, caused tax-equivalent securities income to decrease \$114,000 in the first six months of 2018 compared to the same period in 2017.

The average balance of interest-bearing demand deposits increased \$2.0 million in the first six months of 2018 compared to the same period in 2017. In addition to the higher average balance, an increase of 6 basis points in the average rate paid caused interest expense to increase \$72,000 in the first half of 2018 compared to the same period in 2017. The average balance of certificates of deposit declined \$4.3 million in the first six months of 2018 compared to the same period in 2017. The decrease in the average balance of certificates of deposit resulted from a reduction in the average balance of brokered certificates of deposit by \$10.0 million, while the average balance of local certificates of deposit grew \$5.7 million in the first six months of 2018 compared to the same period in 2017. The decline in the average balance of certificates of deposit was more than offset by a 41 basis point increase in the average rate paid on certificates, which caused interest expense to increase \$197,000 in the first half of 2018 compared to the same period in 2017. The effect of an \$8.5 million reduction in the average balance on advances of Federal Home Loan Bank was partially offset by the impact of a 62 basis point increase in the average rate paid and caused interest expense to decrease \$5,000 in the first six months of 2018 compared to the same period in 2017. An increase of 78 basis points in the average rate paid on other interest-bearing liabilities caused interest expense to grow by \$19,000.

ChoiceOne's net interest income spread was 3.71% in the first six months of 2018, compared to 3.55% in the first half of 2017. The increase in the interest spread was due to growth of 31 basis points in the average rate earned on interest earning assets, partially offset by a 15 basis point increase in the average rate paid on interest-bearing liabilities. Increases in short-term interest rates were the primary factor for the higher average rates for both interest earning assets and interest-bearing liabilities.

Provision and Allowance for Loan Losses

Total loans decreased \$2.9 million in the first six months of 2018, while the allowance for loan losses increased \$82,000 during the same period. The provision for loan losses was \$0 in the second quarter and \$35,000 in the first six months of 2018, compared to \$25,000 in the second quarter and \$25,000 in the first six months of 2017. Nonperforming loans were \$3.7 million as of June 30, 2018, compared to \$4.1 million as of March 31, 2018, and \$4.3 million as of December 31, 2017. The small decline in nonperforming loans in the second quarter of 2018 was primarily due to reductions in nonaccrual loans and loans considered troubled debt restructurings. The allowance for loan losses was 1.18% of total loans at June 30, 2018, compared to 1.22% at March 31, 2018, and 1.15% at December 31, 2017.

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

| (Dollars in thousands) | 2018 | | 2017 | |
|---------------------------|-------------|------------|-------------|------------|
| | Charge-offs | Recoveries | Charge-offs | Recoveries |
| Agricultural | \$— | \$— | \$— | \$— |
| Commercial and industrial | 58 | 53 | 362 | — |
| Consumer | 118 | 51 | 137 | 91 |
| Commercial real estate | — | 59 | — | 161 |
| Construction real estate | — | — | — | 40 |
| Residential real estate | 13 | 73 | 34 | 37 |

\$189 \$ 236 \$533 \$ 329

Net charge-offs of \$50,000 and net recoveries of \$48,000 were recorded in the second quarter and first six months of 2018 respectively, compared to net charge-offs of \$252,000 and \$204,000 in the second quarter and first six months of 2017. Net recoveries on an annualized basis as a percentage of average loans were 0.02% in the first half of 2018, compared to net charge-offs of 0.11% of average loans in the same period in the prior year. Management is aware that the economic climate in Michigan will continue to affect business and individual 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 2018, the provision and allowance for loan losses will be reviewed by the Bank's management and adjusted as determined to be necessary.

Noninterest Income

Total noninterest income decreased \$221,000 in the second quarter and \$305,000 in the first six months of 2018 compared to the same periods in 2017. Insurance and investment commissions income was \$366,000 lower in the first half of 2018 than in the same period in the prior year as a result of the sale of a majority of the Bank's investment book of business in the fourth quarter of 2017. Gains on sales of securities were \$101,000 lower in the first six months of 2018 than in the same period in 2017 as higher interest rates have caused an unrealized loss in the Bank's securities portfolio. Partially offsetting these declines was growth in customer service charges income in the first six months of the current year compared to the same period in the prior year.

Noninterest Expense

Total noninterest expense increased \$335,000 in the second quarter and \$630,000 in the first six months of 2018 compared to the same periods in 2017. Salaries and benefits expense was \$422,000 higher in the first half of 2018 than in the first half of the prior year. The salaries and benefits growth was primarily due to annual wage increases as well as staffing additions in preparation for two additional branch locations which are scheduled to open later in 2018. The \$193,000 increase in other noninterest expense resulted in part from higher expenses related to training and loan originations and collections.

Income Tax Expense

Income tax expense was \$642,000 in the first six months of 2018 compared to \$1,052,000 for the same period in 2017. The effective tax rate was 15.5% for 2018 and 25.5% for 2017. The decline in income tax expense was due to the impact of the Tax Cut and Jobs Act passed in December 2017, which adjusted the ChoiceOne's statutory rate from 34% to 21% effective January 1, 2018.

FINANCIAL CONDITION

Securities

Total securities declined \$2.5 million in the second quarter and grew \$9.4 million in the first six months of 2018. The increase in the securities portfolio in the first half of 2018 resulted from ChoiceOne's desire to supplement growth in earning assets and to replace some of the \$35 million in securities sold in the fourth quarter of 2017. Securities purchases slowed in the second quarter of 2018 as the Bank's investment opportunities were limited by changes occurring in market interest rates. Various securities totaling \$21.2 million were purchased in the first six months of 2018, partially offset by approximately \$4.6 million called or matured during that same time period. Principal repayments on securities totaled \$1.4 million in the first half of 2018. Approximately \$2.7 million of securities were sold in the first six months of 2018 for a net gain of \$25,000. Due to rising interest rates in the first half of 2018, the Bank's unrealized gain of \$0.2 million as of December 31, 2017 declined to an unrealized loss of \$2.5 million as of June 30, 2018.

Loans

After declining in the first quarter of 2018, the loan portfolio (excluding loans held for sale and loans to other financial institutions) grew \$9.5 million in the second quarter of 2018 for a net decline in loans of \$2.9 million in the first six months of 2018. In the first half of 2018, decreases of \$9.1 million, \$7.4 million, \$2.9 million, and \$0.3 million in agricultural loans, commercial and industrial loans, construction real estate loans, and consumer loans, respectively, were partially offset by growth of \$12.7 million in commercial real estate loans and \$4.1 million in residential real estate loans. The decrease in agricultural loans was primarily due to seasonal pay downs by borrowers. The other changes resulted from normal fluctuations in borrower activity.

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 \$4.3 million as of June 30, 2018, compared to \$4.4 million as of March 31, 2018, and \$4.1 million as of December 31, 2017. The small decline in the second quarter of 2018 was caused by a \$147,000 decrease in residential real estate loans classified as impaired.

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, 2018 | December 31, 2017 |
|---|---------------------|-------------------------|
| Loans accounted for on a nonaccrual basis | \$1,140 | \$ 1,096 |
| Accruing loans contractually past due 90 days or more as to principal or interest payments | — | 258 |
| Loans considered troubled debt restructurings | 2,572 | 2,896 |
| Total | \$3,712 | \$ 4,250 |

At June 30, 2018, nonaccrual loans included \$421,000 in agricultural loans, \$39,000 in commercial and industrial loans, \$138,000 in commercial real estate loans, and \$542,000 in residential real estate loans. At December 31, 2017, nonaccrual loans included \$423,000 in agricultural loans, \$222,000 in commercial and industrial loans, \$15,000 in consumer loans, and \$436,000 in residential real estate loans. Approximately 91% of the balance of loans considered troubled debt restructurings was performing according to their restructured terms as of June 30, 2018. Management believes the allowance allocated to its nonperforming loans is sufficient at June 30, 2018.

Deposits and Borrowings

Total deposits decreased \$4.4 million in the second quarter of 2018 and \$11.9 million since the end of 2017. Checking and savings deposits decreased \$28.2 million, while certificates of deposit grew \$16.3 million in the first six months of 2018. The decline in checking and savings accounts was primarily due to seasonal fluctuations for ChoiceOne's depositors which is a normal occurrence in the first half of the year. \$14.9 million of the growth in certificates of deposit in the first half of 2018 was caused by increased brokered certificates of deposit. Brokered deposits were obtained in the first six months of 2018 to supplement the decrease in local deposits.

The balance of repurchase agreements declined from \$7.1 million to \$0 in the first six months of 2018. The reduction resulted from normal fluctuations in funds provided by bank customers and from transfers to deposit accounts offered by the Bank. The balance of Federal Home Loan Bank advances was virtually the same at June 30, 2018 as it was at the end of 2017. The Bank continued to use this resource as an offset to the decline in local deposits.

Shareholders' Equity

Total shareholders' equity declined \$282,000 from December 31, 2017 to June 30, 2018. An other comprehensive loss of \$2.4 million in the first six months of 2018 was caused by an increase in general market interest rates, which

negatively impacted the market value of the Bank's available for sale securities. Share repurchases totaling \$523,000 also occurred in the first half of 2018. Partially offsetting these was the first half of 2018's net income, net of cash dividends declared.

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

| (Dollars in thousands) | Actual | | Minimum Required for Capital Adequacy Purposes | | Minimum Required to be Well Capitalized Under Prompt Corrective Regulations | |
|--|----------|-------|--|-------|---|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <u>June 30, 2018</u> | | | | | | |
| ChoiceOne Financial Services Inc. | | | | | | |
| Total capital (to risk weighted assets) | \$69,359 | 14.0% | \$39,564 | 8.0% | N/A | N/A |
| Common Equity Tier 1 Capital (to risk weighted assets) | 64,706 | 13.1 | 22,255 | 4.5 | N/A | N/A |
| Tier 1 capital (to risk weighted assets) | 64,706 | 13.1 | 19,782 | 6.0 | N/A | N/A |
| Tier 1 capital (to average assets) | 64,706 | 10.5 | 24,561 | 4.0 | N/A | N/A |
| ChoiceOne Bank | | | | | | |
| Total capital (to risk weighted assets) | \$64,499 | 13.1% | \$39,362 | 8.0% | \$49,203 | 10.0% |
| Common Equity Tier 1 Capital (to risk weighted assets) | 59,846 | 12.2 | 22,141 | 4.5 | 31,982 | 6.5 |
| Tier 1 capital (to risk weighted assets) | 59,846 | 12.2 | 19,681 | 6.0 | 29,522 | 8.0 |
| Tier 1 capital (to average assets) | 59,846 | 9.8 | 24,420 | 4.0 | 30,524 | 5.0 |
| December 31, 2017 | | | | | | |
| ChoiceOne Financial Services Inc. | | | | | | |
| Total capital (to risk weighted assets) | \$67,155 | 13.9% | \$38,761 | 8.0% | N/A | N/A |
| Common Equity Tier 1 Capital (to risk weighted assets) | 62,584 | 12.9 | 21,803 | 4.5 | N/A | N/A |
| Tier 1 capital (to risk weighted assets) | 62,584 | 12.9 | 29,071 | 6.0 | N/A | N/A |
| Tier 1 capital (to average assets) | 62,584 | 9.9 | 25,301 | 4.0 | N/A | N/A |
| ChoiceOne Bank | | | | | | |
| Total capital (to risk weighted assets) | \$62,393 | 12.9% | \$38,555 | 8.0% | \$48,194 | 10.0% |
| Common Equity Tier 1 Capital (to risk weighted assets) | 57,822 | 12.0 | 21,687 | 4.5 | 31,326 | 6.5 |
| Tier 1 capital (to risk weighted assets) | 57,822 | 12.0 | 28,917 | 6.0 | 38,555 | 8.0 |
| Tier 1 capital (to average assets) | 57,822 | 9.2 | 25,156 | 4.0 | 31,445 | 5.0 |

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, 2018 are adequate for the foreseeable future. The Board's determination of appropriate cash dividends for future periods will be based on, among other things, market conditions and ChoiceOne's requirements for cash and capital.

Liquidity

Net cash provided from operating activities was \$4.7 million for the six months ended June 30, 2018 compared to \$3.4 million provided in the same period a year ago. The increase was due to higher proceeds from loan sales in the first half of 2018 compared to the same period in the prior year. Net cash used for investing activities was \$12.8 million for the first half of 2018 compared to \$18.4 million in the same period in 2017. The change was due to less loan growth in the first six months of 2018 compared to the same period in 2017. Net cash used in financing activities was \$16.9 million in the six months ended June 30, 2018, compared to net cash provided by financing activities of \$17.2 million in the same period in the prior year. The change was primarily caused by a decline in deposits in the first half of the current year in contrast to growth in the same period in the prior year.

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 ChoiceOne's management, including the Chief Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of ChoiceOne's disclosure controls and procedures. Based on and as of the time of that evaluation, ChoiceOne's management, including the Chief Executive Officer and Principal Financial Officer, concluded that ChoiceOne'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 ChoiceOne's internal control over financial reporting that occurred during the three months ended June 30, 2018 that has materially affected, or that is reasonably likely to materially affect, ChoiceOne's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

There are no material pending legal proceedings to which ChoiceOne 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 belief of management, pending or current legal proceedings should not have a material effect on the consolidated financial condition of ChoiceOne.

Item 1A. Risk Factors.

Information concerning risk factors is contained in the discussion in Item 1A, "Risk Factors," in ChoiceOne's Annual Report on Form 10-K for the year ended December 31, 2017. 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 ChoiceOne's Annual Report on Form 10-K for the year ended December 31, 2017.

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

On April 25, 2018, ChoiceOne issued 703 shares of common stock, without par value, to the directors of ChoiceOne pursuant to the Directors' Stock Purchase Plan for an aggregate cash price of \$18,000. On May 22, 2018, ChoiceOne issued 1,368 shares of common stock, without par value, to the directors of ChoiceOne pursuant to the Directors' Stock Purchase Plan for an aggregate cash price of \$35,000. ChoiceOne 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

The following table provides information regarding ChoiceOne's purchases of its common stock during the quarter ended June 30, 2018.

| (Dollars in thousands, except per share data) | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan | Maximum Number of Shares that May Yet be Purchased Under the Plan |
|---|---|--|---|--|
| | | | | |
| April 1 - April 30, 2018 | | | | |
| Employee Transactions (1) | 2,231 | \$ 26.00 | 2,231 | |
| Repurchase Plan | — | \$— | — | 87,541 |
| May 1 - May 31, 2018 | | | | |
| Employee Transactions | — | \$— | — | |
| Repurchase Plan (2) | 10,000 | \$ 26.75 | 10,000 | 77,541 |
| June 1 - June 30, 2018 | | | | |
| Employee Transactions (1) | 274 | \$ 26.49 | 274 | |
| Repurchase Plan | — | \$— | — | 77,267 |
| Total | 12,505 | \$ 26.61 | 12,505 | 77,267 |

(1) Shares submitted for cancellation to satisfy tax withholding obligations that occur upon the vesting of restricted units. The value of the shares delivered or withheld is determined by

the applicable stock compensation plan.

(2) The Company purchased 10,000 shares of its own common stock during the quarter ended June 30, 2018. As of June 30, 2018, there are 77,267 shares remaining that may yet be purchased under approved plans. The repurchase plan was adopted and announced on July 26, 2007. There was no stated expiration date. The plan authorized the repurchase of up to 100,000 shares upon initiation and another 100,000 shares were authorized in January 24, 2018.

Item 5. Other Information

None.

Item 6. Exhibits

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

Exhibit

Number Document

- | | |
|-------------|---|
| <u>3.1</u> | Amended and Restated Articles of Incorporation of ChoiceOne. Previously filed as an exhibit to ChoiceOne's Form 10-K Annual Report for the year ended December 31, 2013. Here incorporated by reference. |
| <u>3.2</u> | Bylaws of ChoiceOne as currently in effect and any amendments thereto. Previously filed as an exhibit to ChoiceOne's Form 10-K Annual Report for the year ended December 31, 2017. Here incorporated by reference. |
| <u>10.1</u> | Stock Incentive Plan of 2012 as amended. Previously filed as Appendix A to ChoiceOne's definitive proxy statement for ChoiceOne's 2018 Annual Meeting of Shareholders, filed on April 19, 2018. Here incorporated by reference. |
| <u>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. |
| 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 14, 2018 /s/ Kelly J. Potes
Kelly J. Potes
Chief Executive Officer
(Principal Executive Officer)

Date: August 14, 2018 /s/ Thomas L. Lampen
Thomas L. Lampen
Treasurer
(Principal Financial and Accounting Officer)