CHOICEONE FINANCIAL SERVICES INC
Form 10-Q
November 14, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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

For the transition period from ______________ to ______________

Commission File Number: 000-19202

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

Michigan (State or Other Jurisdiction of Incorporation or Organization)	38-2659066 (I.R.S. Employer Identification No.)
109 East Division Sparta, Michigan (Address of Principal Executive Offices)	49345 (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 x No o

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 x No o

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 o	Accelerated filer o
Non-accelerated filer o	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

As of October 31, 2012, the Registrant had outstanding 3,301,716 shares of common stock.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.
ChoiceOne Financial Services, Inc.
CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)	September 30, 2012 (Unaudited)	December 31 2011 (Audited)
Assets		
Cash and due from banks	$ 26,966	$ 17,125
Federal funds sold	0	0
Cash and cash equivalents	26,966	17,125
Securities available for sale	138,208	114,276
Federal Home Loan Bank stock	2,478	2,478
Federal Reserve Bank stock	1,272	1,271
Loans held for sale	887	1,262
Loans	302,483	320,127
Allowance for loan losses	(5,773)	(5,213)
Loans, net	296,710	314,914
Premises and equipment, net	11,736	12,080
Other real estate owned, net	1,761	1,934
Cash value of life insurance policies	9,891	9,834
Intangible assets, net	1,836	2,172
Goodwill	13,728	13,728
Other assets	4,838	4,840
Total assets	$ 510,311	$ 495,914
Liabilities		
Deposits – noninterest-bearing	$ 82,092	$ 78,263
Deposits – interest-bearing	337,948	325,102
Total deposits	420,040	403,365
Repurchase agreements	20,263	21,869
Advances from Federal Home Loan Bank	5,427	8,447
Other liabilities	4,245	4,329
Total liabilities	449,975	438,010
Shareholders' Equity		
Preferred stock; shares authorized: 100,000; shares outstanding: none	—	—
Common stock and paid in capital, no par value; shares authorized: 7,000,000; shares outstanding: 3,300,970 at September 30, 2012 and 3,293,269 at December 31, 2011	46,707	46,602
Retained earnings	10,825	8,887
Accumulated other comprehensive income, net	2,804	2,415

Total shareholders’ equity		60,336		57,904
Total liabilities and shareholders’ equity	$	510,311	$	495,914

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Dollars in thousands, except per share data)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Interest income				
Loans, including fees	$ 4,272	$ 4,635	$ 12,783	$ 13,777
Securities:				
Taxable	474	449	1,009	1,313
Tax exempt	349	312	1,471	961
Other	8	3	19	16
Total interest income	5,103	5,399	15,282	16,067
Interest expense				
Deposits	499	728	1,643	2,280
Advances from Federal Home Loan Bank	59	78	247	230
Other	33	70	171	217
Total interest expense	591	876	2,061	2,727
Net interest income	4,512	4,523	13,221	13,340
Provision for loan losses	500	950	1,975	2,800
Net interest income after provision for loan losses	4,012	3,573	11,246	10,540
Noninterest income				
Customer service charges	875	898	2,461	2,613
Insurance and investment commissions	164	163	546	533
Gains on sales of loans	446	125	1,206	396
Gains on sales of securities	21	5	307	67
Gains/(losses) on sales of other real estate and other assets	(81)	27	(320)	69
Earnings on life insurance policies	78	90	368	267
Other	145	198	486	585
Total noninterest income	1,648	1,506	5,054	4,530
Noninterest expense				
Salaries and benefits	1,981	1,842	5,799	5,518
Occupancy and equipment	574	592	1,711	1,724
Data processing	503	436	1,379	1,302
Professional fees	251	199	650	582
Supplies and postage	118	115	369	394
Advertising and promotional	47	26	128	112
Intangible amortization	112	112	336	336

Loan and collection expense		163		146		405		397
FDIC insurance		80		108		290		405
Other		338		342		1,126		1,082
Total noninterest expense		4,167		3,918		12,193		11,852
Income before income tax		1,493		1,161		4,107		3,218
Income tax expense		371		275		949		724
Net income	$	1,122	$	886	$	3,158	$	2,494
Basic earnings per share	$	0.34	$	0.27	$	0.96	$	0.76
Diluted earnings per share	$	0.34	$	0.27	$	0.96	$	0.76
Dividends declared per share	$	0.13	$	0.12	$	0.37	$	0.36

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(Dollars in thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income	$ 1,122	$ 886	$ 3,158	$ 2,494
Other comprehensive income, net of tax:				
Unrealized holding gains on available for sale securities	243	756	591	1,781
Less: Reclassification adjustment for gain recognized in earnings, net of tax	13	3	202	44
Other comprehensive income, net of tax	230	753	389	1,737
Comprehensive income	$ 1,352	$ 1,639	$ 3,547	$ 4,231

See accompanying notes to 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, Net	Total
Balance, January 1, 2011	3,280,515	$ 46,461	$ 6,952	$ 900	$ 54,313
Net income			2,494		2,494
Other comprehensive income				1,737	1,737
Shares issued	9,923	104			104
Exercise of stock options	477				
Change in ESOP repurchase obligation		(2)			(2)
Effect of stock options granted		4			4
Effect of employee stock purchases		11			11
Cash dividends declared ($0.36 per share)			(1,182)		(1,182)
Balance, September 30, 2011	3,290,915	$ 46,578	$ 8,264	$ 2,637	$ 57,479
Balance, January 1, 2012	3,293,269	$ 46,602	$ 8,887	$ 2,415	$ 57,904
Net income			3,158		3,158
Other comprehensive income				389	389
Shares issued	7,701	97			97
Effect of employee stock purchases		8			8
Cash dividends declared ($0.37 per share)			(1,220)		(1,220)
Balance, September 30, 2012	3,300,970	$ 46,707	$ 10,825	$ 2,804	$ 60,336

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income	$ 3,158	$ 2,494
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	1,975	2,800
Depreciation	679	711
Amortization	1,150	949
Compensation expense on stock options and employee stock purchases	8	15
Gains on sales of securities	(307)	(67)
Gains on sales of loans	(1,206)	(396)
Loans originated for sale	(33,649)	(17,357)
Proceeds from loan sales	35,004	17,872
Earnings on bank-owned life insurance	(368)	(267)
Proceeds from life insurance	311	—
Gains on sales of other real estate owned	(18)	(230)
Write-downs of other real estate owned	346	164
Proceeds from sales of other real estate owned	763	2,866
Deferred federal income tax benefit	(105)	(138)
Net changes in other assets	395	2,300
Net changes in other liabilities	(178)	(2,171)
Net cash from operating activities	7,958	9,545
Cash flows from investing activities:		
Securities available for sale:		
Sales	6,799	3,031
Maturities, prepayments and calls	27,592	15,047
Purchases	(58,409)	(35,522)
Sale of Federal Home Loan Bank stock	—	411
Purchase of Federal Reserve Bank stock	(1)	(1)
Loan originations and payments, net	15,291	(9,785)
Additions to premises and equipment	(315)	(413)
Net cash from investing activities	(9,043)	(27,232)
Cash flows from financing activities:		
Net change in deposits	16,675	7,509
Net change in repurchase agreements	(1,606)	(5,131)
Net change in federal funds purchased	—	2,400
Proceeds from Federal Home Loan Bank advances	—	250
Payments on Federal Home Loan Bank advances	(3,020)	(269)
Issuance of common stock	97	104
Cash dividends	(1,220)	(1,182)
Net cash from financing activities	10,926	3,681

Net change in cash and cash equivalents		9,841		(14,006)
Beginning cash and cash equivalents		17,125		24,074
Ending cash and cash equivalents	$	26,966	$	10,068
Supplemental disclosures of cash flow information:				
Cash paid for interest	$	2,136	$	2,776
Cash paid for income taxes	$	1,225	$	415
Loans transferred to other real estate owned	$	938	$	2,274
Securities transferred to other assets	$	330	$	—
Other real estate owned transferred to premises and equipment	$	20	$	—

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

The accompanying consolidated financial statements reflect all adjustments ordinary in nature which are, in the opinion of management, necessary for a fair presentation of the Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, the Consolidated Statements of Income for the three- and nine-month periods ended September 30, 2012 and September 30, 2011, the Consolidated Statements of Comprehensive Income for the three- and nine-month periods ended September 30, 2012 and September 30, 2011, the Consolidated Statements of Changes in Shareholders' Equity for the nine-month periods ended September 30, 2012 and September 30, 2011, and the Consolidated Statements of Cash Flows for the nine-month periods ended September 30, 2012 and September 30, 2011. Operating results for the nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.

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

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

Stock Transactions
A total of 3,603 shares of common stock were issued to the Registrant's Board of Directors for a cash price of $50,000 under the terms of the Directors' Stock Purchase Plan in the first nine months of 2012. A total of 4,036 shares were issued to employees for a cash price of $47,000 under the Employee Stock Purchase Plan in the first three quarters of 2012. A total of 62 shares were issued upon the exercise of stock options in the first three quarters of 2012.

Reclassifications

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

New Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board issued ASU No. 2012-02, Intangibles – Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-02") to reduce the cost and complexity of testing indefinite-lived intangible assets for impairment. ASU 2012-02 gives an entity the option of first assessing qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with Subtopic 350-30. An entity also has the option to bypass the qualitative assessment for any indefinite-lived asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. ASU 2012-02 is effective for fiscal years beginning after September 15, 2012 and early adoption is permitted. The adoption of ASU 2012-02 is not expected to have a material impact on ChoiceOne's consolidated financial condition or results of operations.

NOTE 2 - SECURITIES

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

	September 30, 2012			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ 5,177	$ 53	$ —	$ 5,230
U.S. Government and federal agency	41,946	513	—	42,459
State and municipal	62,947	3,091	(152)	65,886
Mortgage-backed	13,592	358	—	13,950
Corporate	6,903	131	—	7,034
FDIC-guaranteed financial institution debt	2,002	8	—	2,010
Equity securities	1,650	—	(11)	1,639
Total	$ 134,217	$ 4,154	$ (163)	$ 138,208

	December 31, 2011			
(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agency	$ 39,829	$ 584	$ —	$ 40,413
State and municipal	51,859	2,729	(89)	54,499
Mortgage-backed	9,511	276	(7)	9,780
Corporate	5,914	100	(3)	6,011
FDIC-guaranteed financial institution debt	2,010	28	—	2,038
Equity securities	1,751	16	(232)	1,535
Total	$ 110,874	$ 3,733	$ (331)	$ 114,276

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 first nine months of 2012. 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. One municipal security with a fair value of $311,000 was considered to be other than temporarily impaired as of December 31, 2011. The issuer of the security defaulted upon its maturity of September 1, 2009. Impairment losses totaling $141,000 had been recorded through the end of 2011 due to uncertainty as to how much and when principal repayment would be received. Settlement was reached with the security's issuer in December 2011 and the bond's carrying value was reclassified from securities to other assets in January 2012 upon termination of the bond's contractual agreement. ChoiceOne received the carrying value of the security in the second quarter of 2012.

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	Construction Real Estate	Residential Real Estate	Unallocated	Total
Allowance for Loan Losses Three Months Ended September 30, 2012								
Beginning balance	$ 121	$ 690	$ 236	$ 2,611	$ 15	$ 1,674	$ 262	$ 5,609
Charge-offs	—	(347)	(128)	(84)	—	(44)	—	(603)
Recoveries	1	15	52	192	—	7	—	267
Provision	18	313	70	(378)	(3)	215	265	500
Ending balance	$ 140	$ 671	$ 230	$ 2,341	$ 12	$ 1,852	$ 527	$ 5,773
Nine Months Ended September 30, 2012								
Beginning balance	$ 55	$ 609	$ 197	$ 2,300	$ 34	$ 1,846	$ 172	$ 5,213
Charge-offs	—	(377)	(261)	(518)	—	(784)	—	(1,940)
Recoveries	4	45	177	213	—	86	—	525
Provision	81	394	117	346	(22)	704	355	1,975
Ending balance	$ 140	$ 671	$ 230	$ 2,341	$ 12	$ 1,852	$ 527	$ 5,773
Individually evaluated for impairment	$ —	$ 159	$ —	$ 101	$ —	$ —	$ —	$ 260
Collectively evaluated for impairment	$ 140	$ 512	$ 230	$ 2,240	$ 12	$ 1,852	$ 527	$ 5,513
Three Months Ended September 30, 2011								
Beginning balance	$ 171	$ 606	$ 209	$ 1,691	$ 2	$ 1,456	$ 667	$ 4,802
Charge-offs	—	(159)	(93)	(287)	—	(453)	—	(992)
Recoveries	3	3	46	7	—	15	—	74
Provision	50	324	55	242	1	930	(652)	950
Ending balance	$ 224	$ 774	$ 217	$ 1,653	$ 3	$ 1,948	$ 15	$ 4,834
Nine Months Ended September 30, 2011								

Beginning balance	$ 181	$ 641	$ 243	$ 1,729	$ 2	$ 1,554	$ 379	$ 4,729
Charge-offs	—	(159)	(262)	(1,092)	—	(1,502)	—	(3,015)
Recoveries	6	9	177	51	—	77	—	320
Provision	37	283	59	965	1	1,819	(364)	2,800
Ending balance	$ 224	$ 774	$ 217	$ 1,653	$ 3	$ 1,948	$ 15	$ 4,834
Individually evaluated for impairment	$ —	$ 84	$ —	$ 369	$ —	$ —	$ —	$ 453
Collectively evaluated for impairment	$ 224	$ 690	$ 217	$ 1,284	$ 3	$ 1,948	$ 15	$ 4,381
Loans								
September 30, 2012								
Individually evaluated for impairment	$ —	$ 332	$ —	$ 2,780	$ —	$ 1,829		$ 4,941
Collectively evaluated for impairment	27,542	58,891	19,132	97,015	649	94,313		297,542
Ending balance	$ 27,542	$ 59,223	$ 19,132	$ 99,795	$ 649	$ 96,142		$ 302,483
December 31, 2011								
Individually evaluated for impairment	$ —	$ 163	$ —	$ 2,758	$ —	$ 1,580		$ 4,501
Collectively evaluated for impairment	38,929	58,522	18,657	103,492	1,169	94,857		315,626
Ending balance	$ 38,929	$ 58,685	$ 18,657	$ 106,250	$ 1,169	$ 96,437		$ 320,127

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:

(Dollars in thousands)
Corporate Credit Exposure - Credit Risk Profile By Creditworthiness Category

	Agricultural		Commercial and Industrial		Commercial Real Estate	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
Risk ratings 1 and 2	$ 4,530	$ 6,486	$ 4,371	$ 4,149	$ 6,972	$ 6,403
Risk rating 3	14,249	20,211	39,040	30,109	46,586	45,034
Risk rating 4	6,187	9,499	14,428	21,993	28,724	33,462
Risk rating 5	1,337	2,672	518	1,669	11,059	14,313
Risk rating 6	1,236	57	658	680	4,387	5,009
Risk rating 7	3	4	208	85	2,067	2,029
	$ 27,542	$ 38,929	$ 59,223	$ 58,685	$ 99,795	$ 106,250

Consumer Credit Exposure - Credit Risk Profile Based On Payment Activity

	Consumer		Construction Real Estate		Residential Real Estate	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
Performing	$ 19,116	$ 18,634	$ 649	$ 1,169	$ 95,142	$ 95,732
Nonperforming	16	23	—	—	1,000	705
	$ 19,132	$ 18,657	$ 649	$ 1,169	$ 96,142	$ 96,437

The following schedule provides information on loans that were considered troubled debt restructurings ("TDRs") as of September 30, 2012 that were modified during the nine months ended September 30, 2012:

	Nine Months Ended September 30, 2012		
(Dollars in thousands)	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Agricultural	1	$ 73	$ 73
Commercial and industrial	2	158	149
Consumer	1	33	33
Commercial real estate	2	145	145
Residential real estate	3	355	355
	9	$ 764	$ 755

There were no loans that were considered TDRs as of September 30, 2012 that were modified during the third quarter of 2012.

The following schedule provides information on loans that were considered troubled debt restructurings ("TDRs") as of September 30, 2011 that were modified during the nine month period ended September 30, 2011:

	Nine Months Ended September 30, 2011		
(Dollars in thousands)	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential real estate	5	$ 554	$ 554

There were no loans that were considered TDRs as of September 30, 2011 that were modified during the third quarter of 2011.

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 September 30, 2012 where the borrower was past due with respect to principal and/or interest for 30 days or more during the three months and nine months ended September 30, 2012 that had been modified during the year prior to the default:

	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
(Dollars in thousands)	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Commercial and industrial	3	$ 198	3	$ 198

Commercial real estate	5		1,341	5		1,341
Consumer	1		32	1		32
Residential real estate	7		1,029	8		1,176
	16	$	2,600	17	$	2,747

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

Loans are classified as impaired when it is probable that the borrower will be unable to pay all amounts due, including principal and interest, according to the contractual terms and schedule established in the loan agreement. Impaired loans by loan category follow:

(Dollars in thousands)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2012					
With no related allowance recorded					
Agricultural	$ —	$ —	$ —	$ —	$ —
Commercial and industrial	172	183	—	267	6
Commercial real estate	2,027	2,529	—	1,839	—
Residential real estate	1,830	1,762	—	1,707	48
Subtotal	4,029	4,474	—	3,813	54
With an allowance recorded					
Agricultural	—	—	—	—	—
Commercial and industrial	160	507	160	102	(3)
Commercial real estate	753	753	100	1,184	(2)
Residential real estate	—	—	—	—	—
Subtotal	913	1,260	260	1,286	(5)
Total					
Agricultural	—	—	—	—	—
Commercial and industrial	332	690	160	369	3
Commercial real estate	2,780	3,282	100	3,023	(2)
Residential real estate	1,830	1,762	—	1,707	48
Total	$ 4,942	$ 5,734	$ 260	$ 5,099	$ 49
December 31, 2011					
With no related allowance recorded					
Agricultural	$ —	$ —	$ —	$ 45	$ —
Commercial and industrial	102	105	—	167	—
Commercial real estate	1,122	1,538	—	2,369	15
Residential real estate	1,580	1,580	—	1,620	50
Subtotal	2,804	3,223	—	4,201	65
With an allowance recorded					
Agricultural	—	—	—	—	—
Commercial and industrial	61	63	7	85	—
Commercial real estate	1,636	2,120	424	1,490	6
Residential real estate	—	—	—	—	—
Subtotal	1,697	2,183	431	1,575	6
Total					
Agricultural	—	—	—	45	—
Commercial and industrial	163	168	7	252	—
Commercial real estate	2,758	3,658	424	3,859	21
Residential real estate	1,580	1,580	—	1,620	50
Total	$ 4,501	$ 5,406	$ 431	$ 5,776	$ 71

An aging analysis of loans by loan category follows:

(Dollars in thousands)

	Past Due 30 to 59 Days	Past Due 60 to 89 Days	Past Due Greater Than 90 Days (1)	Past Due Total	Loans Not Past Due	Total Loans	90 Days Past Due and Accruing
September 30, 2012							
Agricultural	$ 850	$ —	$ —	$ 850	$ 26,692	$ 27,542	$ —
Commercial and industrial	11	45	114	170	59,053	59,223	—
Consumer	92	7	16	115	19,017	19,132	12
Commercial real estate	471	276	1,909	2,656	97,139	99,795	—
Construction real estate	—	—	—	—	649	649	—
Residential real estate	827	303	1,000	2,130	94,012	96,142	345
	$ 2,251	$ 631	$ 3,039	$ 5,921	$ 296,562	$ 302,483	$ 357
December 31, 2011							
Agricultural	$ 151	$ —	$ 22	$ 173	$ 38,756	$ 38,929	$ —
Commercial and industrial	541	143	97	781	57,904	58,685	—
Consumer	104	52	23	179	18,478	18,657	2
Commercial real estate	1,752	713	1,816	4,281	101,969	106,250	—
Construction real estate	—	—	—	—	1,169	1,169	—
Residential real estate	1,320	1,015	705	3,040	93,397	96,437	68
	$ 3,868	$ 1,923	$ 2,663	$ 8,454	$ 311,673	$ 320,127	$ 70

(1) Includes nonaccrual loans.

Nonaccrual loans by loan category follow:

(Dollars in thousands)

	September 30, 2012	December 31, 2011
Agricultural	$ —	$ 26
Commercial and industrial	319	143
Consumer	4	22
Commercial real estate	3,018	2,790
Construction real estate	—	—
Residential real estate	805	1,174
	$ 4,146	$ 4,155

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 September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Basic Earnings Per Share				
Net income available to common Shareholders	$ 1,122	$ 886	$ 3,158	$ 2,494
Weighted average common shares outstanding	3,299,424	3,289,203	3,296,462	3,285,377
Basic earnings per share	$ 0.34	$ 0.27	$ 0.96	$ 0.76
Diluted Earnings Per Share				
Net income available to common Shareholders	$ 1,122	$ 886	$ 3,158	$ 2,494
Weighted average common shares outstanding	3,299,424	3,289,203	3,296,462	3,285,377
Plus dilutive stock options	1,100	—	436	—
Weighted average common shares outstanding and potentially dilutive shares	3,300,524	3,289,203	3,296,898	3,285,377
Diluted earnings per share	$ 0.34	$ 0.27	$ 0.96	$ 0.76

There were 28,625 stock options as of September 30, 2012 and 46,656 as of September 30, 2011, that are considered to be anti-dilutive to earnings per share for the three-month and nine-month periods ended September 30, 2012 and 2011. These stock options have been excluded from the calculation above.

NOTE 5 – FINANCIAL INSTRUMENTS

Financial instruments as of the dates indicated were as follows (dollars in thousands):

	Carrying 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)
September 30, 2012					
Assets:					
Cash and due from banks	$ 26,966	$ 26,966	$ 26,966	$ —	$ —
Securities available for sale	138,208	138,208	—	135,132	3,076
Federal Home Loan Bank and Federal Reserve Bank stock	3,750	3,750	—	3,750	—
Loans held for sale	887	919	—	919	—
Loans, net	296,710	302,398	—	—	302,398
Liabilities:					
Noninterest-bearing deposits	82,092	82,092	82,092	—	—
Interest-bearing deposits	337,948	339,230	—	339,230	—
Repurchase agreements	20,263	19,487	—	19,487	—
Federal Home Loan Bank advances	5,427	5,524	—	5,524	—

	Carrying Amount	Estimated Fair Value
December 31, 2011		
Assets:		
Cash and due from banks	$ 17,125	$ 17,125
Securities available for sale	114,276	114,276
Federal Home Loan Bank and Federal Reserve Bank stock	3,749	3,749
Loans held for sale	1,262	1,262
Loans, net	314,914	319,017
Liabilities:		
Noninterest-bearing deposits	78,263	78,263
Interest-bearing deposits	325,102	326,123
Repurchase agreements	21,869	21,083
Federal Home Loan Bank advances	8,447	8,664

The estimated fair values approximate the carrying amounts for all assets and liabilities except those described later in this paragraph. The methodology for determining the estimated fair value for securities available for sale is described in Note 6. The estimated fair value for loans is based on the rates charged at September 30, 2012 for new loans with similar maturities, applied until the loan is assumed to reprice or be paid. The allowance for loan losses is considered to be a reasonable estimate of discount for credit quality concerns. The estimated fair values for time deposits and Federal Home Loan Bank ("FHLB") advances are based on the rates paid at September 30, 2012 for new deposits or FHLB advances, applied until maturity. The estimated fair values for other financial instruments and off-balance sheet loan commitments are considered nominal.

NOTE 6 – FAIR VALUE MEASUREMENTS

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

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

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

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

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

There were no liabilities measured at fair value as of September 30, 2012 or December 31, 2011. Disclosures concerning assets measured at fair value are as follows:

Assets Measured at Fair Value on a Recurring Basis
(Dollars in Thousands)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at Date Indicated
Investment Securities, Available for Sale – September 30, 2012				
U.S. Treasury	$ —	$ 5,230	$ —	$ 5,230
U.S. Government and federal agency	—	42,459	—	42,459
State and municipal	—	63,310	2,576	65,886
Mortgage-backed	—	13,950	—	13,950
Corporate	—	7,034	—	7,034
FDIC-guaranteed financial institution debt	—	2,010	—	2,010
Equity securities	—	1,139	500	1,639
Total	$ —	$ 135,132	$ 3,076	$ 138,208
Investment Securities, Available for Sale - December 31, 2011				
U.S. Government and federal agency	$ —	$ 40,413	$ —	$ 40,413

State and municipal	—	52,228	2,271	54,499
Mortgage-backed	—	9,780	—	9,780
Corporate	—	6,011	—	6,011
FDIC-guaranteed financial institution debt	—	2,038	—	2,038
Equity securities	—	1,035	500	1,535
Total	$ —	$ 111,505	$ 2,771	$ 114,276

Changes in Level 3 Assets Measured at Fair Value on a Recurring Basis
(Dollars in Thousands)

	2012	2011
Investment Securities, Available for Sale		
Balance, January 1	$ 2,771	$ 2,839
Total realized and unrealized gains included in income	—	—
Total unrealized gains included in other comprehensive income	6	185
Purchases of securities	563	—
Calls, maturities, and payments	(244)	(280)
Transfers into Level 3	291	67
Transfers out of Level 3	(311)	—
Balance, September 30	$ 3,076	$ 2,811

Of the Level 3 assets that were held by the Bank at September 30, 2012, the net unrealized gain for the nine months ended September 30, 2012 was $6,000, which is recognized in other comprehensive income in the consolidated balance sheet. There were no sales or purchases of Level 3 securities in the first and second quarters of 2012; three Level 3 securities were purchased in the third quarter of 2012. One municipal security was reclassified to other assets in the first quarter of 2012. The issuer of the security defaulted upon its maturity of September 1, 2009. Settlement was reached with the security's issuer in December 2011 and the bond's carrying value was reclassified upon termination of the bond's contractual agreement. One municipal security was reclassified from a Level 2 measurement of fair value to a Level 3 measurement in the first quarter of 2012 and one municipal security was reclassified from a Level 2 measurement value to a Level 3 measurement in the first quarter of 2011 as a result of a change in the marketability of the securities.

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

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

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

Assets Measured at Fair Value on a Non-recurring Basis
(Dollars in Thousands)

	Balance at Dates Indicated	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

Impaired Loans								
September 30, 2012	$	4,942	$	—	$	—	$	4,942
December 31, 2011	$	4,501	$	—	$	—	$	4,501
Other Real Estate								
September 30, 2012	$	1,761	$	—	$	—	$	1,761
December 31, 2011	$	1,934	$	—	$	—	$	1,934

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Bank estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals). 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" or the "Registrant") and its wholly-owned subsidiary, ChoiceOne Bank (the "Bank"), and the Bank's wholly-owned subsidiary, ChoiceOne Insurance Agencies, Inc. This discussion should be read in conjunction with the consolidated financial statements and related notes.

FORWARD-LOOKING STATEMENTS

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

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Goodwill

Generally accepted accounting principles require that the fair value of the assets and liabilities of an acquired entity be recorded at their fair value on the date of acquisition. The fair values are determined using both internal computations and information obtained from outside parties when deemed necessary. The net difference between the price paid for the acquired company and the net value of its balance sheet is recorded as goodwill. Accounting principles also require that goodwill be evaluated for impairment on an annual basis or more frequently whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Management performed its annual review of goodwill as of June 30, 2012. ChoiceOne engaged an outside consulting firm to assist in the goodwill impairment analysis. The following steps were used in the valuation: determination of the reporting unit, determination of the appropriate standard of value, determination of the appropriate level of value, calculation of fair value, and comparison of the fair value computed to the equity carrying value. It was determined that the relevant reporting unit to be valued was ChoiceOne Bank. The standard of value used in the valuation was fair value as determined by generally accepted accounting principles. The appropriate level of value was determined to be the controlling interest level. The appraisal methodology used to calculate the fair value included the following valuation approaches:

Income Approach: A discounted cash flow value was calculated based on earnings capacity. The discount rate used for the calculation was 12.50%. The growth assumption for assets was 1.8% for the first year and 2.0% in subsequent years. In addition, it was assumed that cost savings of 20% of noninterest expense would occur as a result of synergies and cost reductions from a change in control.

Market Approach: The analysis was based on price-to-earnings multiples, price-to-tangible-book value ratios, and core deposit premiums for selected bank sale transactions.

The Asset Approach was also an approach reviewed, but it was not used in determining the fair value since it did not render a control level indication of value. The results from the valuation approaches were used to calculate an estimate of the fair value of ChoiceOne's equity. The fair value was compared to the carrying value of equity to determine whether the Step 1 test under generally accepted accounting principles that govern the valuation of goodwill was passed. The goodwill analysis determined that the fair value of ChoiceOne's equity exceeded the carrying value by 10.8%. Based on this assessment, management believed that there was no indication of goodwill impairment.

RESULTS OF OPERATIONS

Summary

Net income for the third quarter of 2012 was $1,122,000, which represented an increase of $236,000 or 27% compared to the same period in 2011. Net income for the first nine months of 2012 was $3,158,000, which represented an increase of $664,000 or 27% over the same period in 2011. A reduction in the provision for loan losses and growth in noninterest income was offset by a decrease in net interest income and an increase in noninterest expense in both the third quarter and first nine months of 2012 compared to the same periods in the prior year. Basic and diluted earnings per common share were $0.34 for the third quarter of 2012 and $0.96 for the first nine months of 2012, compared to $0.27 and $0.76, respectively, for the same periods in 2011. The return on average assets and return on average shareholders' equity percentages were 0.84% and 7.13%, respectively, for the first three quarters of 2012, compared to 0.69% and 5.97%, respectively, for the same period in 2011.

Dividends

Cash dividends of $429,000 or $0.13 per share were declared in the third quarter of 2012, compared to $394,000 or $0.12 per share in the third quarter of 2011. The cash dividends declared in the first nine months of 2012 were $1,220,000 or $0.37 per share, compared to $1,182,000 or $0.36 per share declared in the same period in 2011. The cash dividend payout percentage was 39% for the first nine months of 2012, compared to 47% in the same period a year ago.

Interest Income and Expense

Tables 1 and 2 on the following pages provide information regarding interest income and expense for the nine-month periods ended September 30, 2012 and 2011, respectively. Table 1 documents ChoiceOne's average balances and interest income and expense, as well as the average rates earned or paid on assets and liabilities. Table 2 documents the effect on interest income and expense of changes in volume (average balance) and interest rates. These tables are referred to in the discussion of interest income, interest expense and net interest income.

Table 1 – Average Balances and Tax-Equivalent Interest Rates

(Dollars in thousands)	Nine Months Ended September 30,					
	2012			2011		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
Assets:						
Loans (1)	$ 308,141	$ 12,795	5.54 %	$ 315,767	$ 13,792	5.82 %
Taxable securities (2) (3)	89,213	1,471	2.20	69,586	1,312	2.51
Nontaxable securities (1) (2)	37,569	1,523	5.41	33,556	1,452	5.77
Other	12,076	19	0.21	8,870	16	0.24
Interest-earning assets	446,999	15,808	4.72	427,779	16,572	5.17
Noninterest-earning assets	54,117			56,895		
Total assets	$ 501,116			$ 484,674		
Liabilities and Shareholders' Equity:						
Interest-bearing demand deposits	$ 138,216	300	0.29 %	$ 125,356	416	0.44 %
Savings deposits	49,166	27	0.07	45,413	42	0.12
Certificates of deposit	139,843	1,316	1.25	154,525	1,822	1.57

Advances from Federal Home Loan Bank		7,408	247	4.45			8,464	230	3.62	
Other		22,287	171	1.02			20,650	217	1.40	
Interest-bearing liabilities		356,920	2,061	0.77			354,408	2,727	1.03	
Noninterest-bearing demand deposits		81,350					71,147			
Other noninterest-bearing liabilities		3,749					3,456			
Total liabilities		442,019					429,011			
Shareholders' equity		59,097					55,663			
Total liabilities and shareholders' equity	$	501,116				$	484,674			
Net interest income (tax-equivalent basis) – interest spread			13,747	3.95	%			13,845	4.14	%
Tax-equivalent adjustment (1)			(526)					(504)		