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 (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 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 INFORMATION

Item 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.

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

(Dollars in thousands, except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	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

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, 2018	2017	Six Months Ended June 30, 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

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.

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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:

	June 30, 2018			
(Dollars in thousands)	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

	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.

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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:

	Securities maturing within:					
(Dollars in thousands)	Less than 1 Year	1 Year - 5 Years	5 Years - 10 Years	More than 10 Years	Fair Value at June 30, 2018	Fair 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:				
	Less than 1 Year	1 Year - 5 Years	5 Years - 10 Years	More than 10 Years	Total
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%.

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

	Three Months Ended June 30, 2018	Six Months Ended 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

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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 June 30, 2018								
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
Six Months Ended June 30, 2018								
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
Three Months Ended June 30, 2017								
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
Six Months Ended June 30, 2017								
Beginning balance	$ 433	$ 688	$ 305	$ 1,438	$ 62	$ 1,014	$ 337	$ 4,277

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
<u>Loans</u>								
<u>June 30, 2018</u>								
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
<u>December 31, 2017</u>								
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, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 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, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 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		
	Number of	Pre-Modification Outstanding Recorded	Post-Modification Outstanding Recorded	Number of	Pre-Modification Outstanding Recorded	Post-Modification Outstanding Recorded

	Loans	Investment	Investment	Loans	Investment	Investment
Commercial and industrial	—	$ —	$ —	1	$ 39	$ 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.

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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:

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
(Dollars in thousands)	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:

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

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Impaired loans by loan category follow:

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
June 30, 2018			
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

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
June 30, 2018		
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
June 30, 2017		
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

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

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An aging analysis of loans by loan category follows:

(Dollars in thousands)	30 to 59 Days	60 to 89 Days	Greater Than 90 Days (1)	Total	Loans Not Past Due	Total Loans	90 Days Past Due and Accruing
June 30, 2018							
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	$ —
December 31, 2017							
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

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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 June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Basic Earnings Per Share				
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
Diluted Earnings Per Share				
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	—

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 Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at Date Indicated
Equity Securities Held at Fair Value - June 30, 2018				
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

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
Investment Securities		
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 Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs

	Dates Indicated	(Level 1)	(Level 2)	(Level 3)
Impaired Loans				
June 30, 2018	$ 4,278	$ —	$ —	$ 4,278
December 31, 2017	$ 4,140	$ —	$ —	$ 4,140
Other Real Estate				
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

	Six Months Ended June 30,					
	2018			2017		
(Dollars in thousands)	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

(1) 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	