CHOICEONE FINANCIAL SERVICES INC
Form 10-Q
May 15, 2007

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 March 31, 2007

[ ] **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 __

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ___ Accelerated filer ___ Non-accelerated filer _X_

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

As of April 30, 2007, the Registrant had outstanding 3,243,473 shares of common stock.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)	March 31, 2007	December 31, 2006
	(Unaudited)	
Assets		
Cash and due from banks	$ 7,833	$ 9,936
Securities available for sale	78,970	77,436
Federal Home Loan Bank stock	3,304	3,304
Federal Reserve Bank stock	677	677
Loans held for sale	217	236
Loans	327,303	331,631
Allowance for loan losses	(3,549)	(3,569)
Loans, net	323,754	328,062
Premises and equipment, net	12,178	11,622
Other real estate owned, net	1,793	1,774
Loan servicing rights, net	935	992
Cash value of life insurance policies	8,289	8,070
Intangible assets, net	4,405	4,182
Goodwill	13,668	14,280
Other assets	6,512	6,079
Total assets	$ 462,535	$ 466,650
Liabilities		
Deposits - noninterest-bearing	$ 50,172	$ 57,986
Deposits - interest-bearing	311,415	308,394
Total deposits	361,587	366,380
Securities sold under agreement to repurchase	13,048	15,013
Federal funds purchased	398	460
Advances from Federal Home Loan Bank	26,914	23,908
Other liabilities	8,578	9,370
Total liabilities	410,525	415,131
Shareholders' Equity		

Preferred stock; shares authorized: 100,000; shares outstanding: none		-		-
Common stock and paid in capital, no par value; shares authorized: 4,000,000; shares outstanding: 3,242,725 at March 31, 2007 and 3,250,629 at December 31, 2006		46,122		46,253
Retained earnings		5,735		5,285
Accumulated other comprehensive income (loss), net		153		(19)
Total shareholders' equity		52,010		51,519
Total liabilities and shareholders' equity	$	462,535	$	466,650

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (Unaudited)

(Dollars in thousands)	Three Months Ended March 31,	
	2007	2006
Interest income		
Loans, including fees	$ 6,086	$ 3,167
Securities:		
Taxable	600	299
Tax exempt	333	190
Other	13	2
Total interest income	7,032	3,658
Interest expense		
Deposits	2,827	1,327
Advances from Federal Home Loan Bank	281	289
Other	151	60
Total interest expense	3,259	1,676
Net interest income	3,773	1,982
Provision for loan losses	100	10
Net interest income after provision for loan losses	3,673	1,972
Noninterest income		
Customer service charges	726	260
Insurance and investment commissions	298	204
Loan servicing fees, net	34	21
Gains on sales of loans	77	48
Losses on sales of securities	(2)	(1)
Profit sharing income	54	63
Earnings on life insurance policies	84	23
Other	157	46
Total noninterest income	1,428	664
Noninterest expense		
Salaries and benefits	1,937	1,012
Occupancy and equipment	592	278
Data processing	363	156

Professional fees	157	128
Supplies and postage	138	52
Advertising and promotional	69	33
Intangible asset amortization	125	-
Director fees	75	54
Other	339	208
Total noninterest expense	3,795	1,921
Income before income tax	1,306	715
Income tax expense	305	180
Net income	$ 1,001	$ 535
Comprehensive income	$ 1,173	$ 472
Basic earnings per share	$ 0.31	$ 0.32
Diluted earnings per share	$ 0.31	$ 0.32
Dividends declared per share	$ 0.17	$ 0.17

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 (Loss), Net	Total
Balance, January 1, 2006	1,649,940	$ 17,422	$ 4,594	$ (299)	$ 21,717
Comprehensive income					
Net income			535		535
Net change in unrealized gain (loss) on securities available for sale				(63)	(63)
Total comprehensive income					472
Shares issued	4,716	80			80
Change in ESOP repurchase obligation		1			1
Effect of stock options granted		6			6
Cash dividends declared ($0.17 per share)			(281)		(281)
Balance, March 31, 2006	1,654,656	$ 17,509	$ 4,848	$ (362)	$ 21,995
Balance, January 1, 2007	3,250,629	$ 46,253	$ 5,285	$ (19)	$ 51,519
Comprehensive income					
Net income			1,001		1,001
Net change in unrealized gain (loss) on securities available for sale				119	119
Unrealized gain (loss) on postretirement benefit plan obligation				53	53
Total comprehensive income					1,173
Shares issued	2,296	37			37
Shares repurchased	(10,200)	(181)			(181)
Change in ESOP repurchase obligation		2			2
Effect of stock options granted		7			7
Effect of employee stock purchases		4			4
Cash dividends declared ($0.17 per share)			(551)		(551)

Balance, March 31, 2007	3,242,725	$	46,122	$	5,735	$	153	$	52,010

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Cash flows from operating activities:		
Net income	$ 1,001	$ 535
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	100	10
Depreciation	233	127
Amortization	255	117
Expense related to employee stock options granted	7	6
Expense related to employee stock purchases	4	-
Losses on sales of securities	2	1
Gains on sales of loans	(77)	(48)
Loans originated for sale	(4,453)	(3,015)
Proceeds from loan sales	4,525	2,240
Earnings on bank-owned life insurance	(84)	(20)
Net changes in:		
Other assets	(410)	(186)
Other liabilities	(799)	321
Net cash from operating activities	304	88
Cash flows from investing activities:		
Securities available for sale:		
Sales	448	1,154
Maturities, prepayments and calls	3,502	472
Purchases	(5,323)	(4,860)
Loan originations and payments, net	4,124	2,240
Additions to premises and equipment, net of disposals	(73)	(92)
Purchase of bank-owned life insurance	(150)	-
Purchase of agency book of business	(348)	-
Additional cash payments for direct costs associated with the merger with Valley Ridge Financial Corp.	(72)	-
Net cash from/(used in) investing activities	2,108	(1,086)
Cash flows from financing activities:		
Net change in deposits	(4,793)	9,016
Net change in securities sold under agreements to repurchase	(1,965)	(1,468)
Net change in federal funds purchased	(62)	(2,312)
Proceeds from Federal Home Loan Bank advances	8,000	11,000
Payments on Federal Home Loan Bank advances	(5,000)	(16,750)
Issuance of common stock	37	80
Repurchase of common stock	(181)	-

Cash dividends		(551)		(281)
Net cash used in financing activities		(4,515)		(715)
Net change in cash and cash equivalents		(2,103)		(1,713)
Beginning cash and cash equivalents		9,936		4,990
Ending cash and cash equivalents	$	7,833	$	3,277
Supplemental disclosures of cash flow information:				
Cash paid for interest	$	3,437	$	1,122
Cash paid for income taxes	$	-	$	100
Loans transferred to other real estate	$	84	$	65
Goodwill allocated to premises and equipment	$	716	$	-

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. (the "Registrant") and its wholly-owned subsidiary, ChoiceOne Bank (the "Bank"), and the Bank's wholly-owned subsidiaries ChoiceOne Insurance Agencies, Inc. (the "Insurance Agency"), and ChoiceOne Mortgage Company of Michigan (the "Mortgage Company"). 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 March 31, 2007 and December 31, 2006, and the Consolidated Statements of Income and Comprehensive Income, Consolidated Statements of Changes in Shareholders' Equity, and Consolidated Statements of Cash Flows for the three-month periods ended March 31, 2007 and March 31, 2006. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

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, 2006.

Stock Transactions
A total of 1,024 shares of common stock were issued to the Registrant's Board of Directors for a cash price of $18,000 under the terms of the Directors' Stock Purchase Plan in the first quarter of 2007. A total of 171 shares of common stock were issued to shareholders for a cash price of $3,000 under the Dividend Reinvestment Plan in the quarter ended March 31, 2007. A total of $1,000 was added to surplus in January 2007 for common stock issued under the Dividend Reinvestment Plan in December 2006. A total of 1,101 shares were issued to employees for a cash price of $15,000 under the Employee Stock Purchase Plan for the quarter ended March 31, 2007. The Registrant repurchased 10,200 shares totaling $181,000 from shareholders in the first quarter of 2007.

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

Recent Accounting Pronouncements
In February 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards Number 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159). SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted subject to specific requirements outlined in SFAS No. 159. Therefore, calendar-year companies may be able to adopt SFAS No. 159 for their first quarter 2007 financial statements. ChoiceOne has not adopted the standard early, therefore SFAS No. 159 will become applicable for years beginning January 1, 2008. SFAS No. 159 allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be

measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. Management is currently evaluating the effect of this pronouncement on the Registrant's consolidated financial statements.

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

NOTE 2 - ALLOWANCE FOR LOAN LOSSES

An analysis of changes in the allowance for loan losses follows:

(Dollars in thousands)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Balance, beginning of period	$ 3,569	$ 1,963
Provision charged to expense	100	10
Recoveries credited to the allowance	72	51
Loans charged off	(192)	(93)
Balance, end of period	$ 3,549	$ 1,931

Information regarding impaired loans follows:

(Dollars in thousands)	March 31, 2007	December 31, 2006
Loans with no allowance allocated	$ 1,515	$ 5,030
Loans with allowance allocated	5,200	1,807
Amount of allowance for loan losses allocated	1,474	942

(Dollars in thousands)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Average balance during the period	$ 6,776	$ 1,399
Interest income recognized thereon	48	29
Cash basis interest income recognized	25	38

NOTE 3 - 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 March 31, 2007	Three Months Ended March 31, 2006
Basic Earnings Per Share:		
Net income available to common shareholders	$ 1,001	$ 535
Weighted average common shares outstanding for basic earnings per share	3,247,844	1,650,959
Basic earnings per share	$ 0.31	$ 0.32
Net income available to common shareholders	$ 1,001	$ 535
Weighted average common shares outstanding for basic earnings per share	3,247,844	1,650,959
Plus: dilutive effect of assumed exercise of stock options	2,425	3,159
Weighted average common and potentially dilutive common shares outstanding	3,250,269	1,654,118
Diluted earnings per share	$ 0.31	$ 0.32

There were 23,865 stock options as of March 31, 2007 and 14,365 stock options as of March 31, 2006 considered to be anti-dilutive to earnings per share and thus have been excluded from the calculation above.

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. (the "Registrant" or "ChoiceOne") and its wholly-owned subsidiary, ChoiceOne Bank (the "Bank"), and its wholly-owned subsidiaries, ChoiceOne Insurance Agencies, Inc. (the "Insurance Agency"), and ChoiceOne Mortgage Company of Michigan (the "Mortgage Company"). 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 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 the Registrant itself. Words such as "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "is likely," "plans," "predicts," "projects," variations of such words and similar expressions are intended to identify such forward-looking statements. 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, the Registrant 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 disclosed in Item 1A of the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2006; changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; 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 ability to repay loans; changes in the local and national economies; changes in market conditions; the possibility that anticipated cost savings and revenue enhancements from the merger with Valley Ridge Financial Corp. may not be fully realized at all or within the expected time frames; the level and timing of asset growth; and local and global uncertainties such as acts of terrorism and military actions. These are representative of the risk factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

MERGER WITH VALLEY RIDGE FINANCIAL CORP.

On November 1, 2006, ChoiceOne merged with Valley Ridge Financial Corp. ("Valley Ridge"). At the time of the merger, Valley Ridge was roughly equal in size in terms of assets with ChoiceOne. The income statement for the first quarter of 2007 includes the results of operations for the combined company, while the first three months of 2006 do not include results from Valley Ridge. The balance sheet as of March 31, 2007 and December 31, 2006 includes all of the assets acquired and all of the liabilities assumed from Valley Ridge in the merger. Therefore, a comparison of results of operations for the first quarter of 2007 to the results of operations for the first quarter of 2006 is materially affected as a result of the merger. For more detailed information concerning the merger, see Note 2 to the Registrant's consolidated financial statements which is incorporated by reference in the Registrant's 2006 Annual Report on Form 10-K.

RESULTS OF OPERATIONS

Summary

Net income increased $466,000 or 87% in the first quarter of 2007 compared to the same period in 2006. The increase in net income in the first quarter of 2007 resulted primarily from the merger with Valley Ridge and the restructuring of the Bank's balance sheet in the fourth quarter of 2006. Net interest income was up $1.8 million or 90% for the first quarter of 2007 compared to the first quarter of 2006. The merger added $202 million of earning assets in November 2006. ChoiceOne's interest rate spread was 18 basis points higher in the first quarter of 2007 than in the first quarter of 2006. The merger with Valley Ridge helped reduce the cost of ChoiceOne's deposits as lower cost local deposits replaced higher rate brokered deposits. Loans also repriced upward to a greater extent than certificates of deposit and borrowings. The yield on investment securities increased in the first quarter of 2007 as a result of repositioning the securities portfolio during the fourth quarter of 2006.

The provision for loan losses increased $90,000 in the first quarter of 2007 compared to the same period in the prior year due to a higher level of net charge-offs and nonperforming loans in part due to the merger with Valley Ridge. Noninterest income increased $764,000 or 115% in the first quarter of 2007 compared to the first quarter of 2006 primarily as a result of the merger. Deposit service charges increased significantly due to the additional checking and savings accounts while insurance and investment commissions and income from bank-owned life insurance also experienced increases. Various categories of other noninterest income were also up $111,000, primarily from the merger with Valley Ridge which more than doubled the volume of accounts serviced. Noninterest expense increased $1,874,000 or 98% in the first quarter of 2007 compared to the first quarter of 2006. Higher employee salaries, occupancy costs, and data processing fees were directly attributable to the merger. Eighty full-time equivalent employees and nine branch offices were added to the organization. Supplies and postage expense increased and advertising costs were higher due to ChoiceOne's branding campaign that began in early 2007. Noninterest expense included $116,000 of intangible amortization in the first quarter of 2007 that resulted from the merger.

The return on average assets was 0.87% for the first three months of 2007, which was the same as the period a year ago. The return on average shareholders' equity was 7.71% for the first quarter of 2007, compared to 9.77% for the first quarter of 2006. The decrease in return on average shareholders' equity is due to the issuance of $28.5 million of common stock in connection with the merger with Valley Ridge.

Dividends

Cash dividends of $551,000 or $0.17 per common share were declared in the first quarter of 2007, compared to $281,000 or $0.17 per common share in the first quarter of 2006. The cash dividend payout percentage was 55% for the first three months of 2007, compared to 53% for 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 three-month periods ended March 31, 2007 and 2006, 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)	Three Months Ended March 31,					
	2007			2006		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
Assets:						
Loans (1)	$ 328,215	$ 6,098	7.43%	$ 184,204	$ 3,174	6.89%
Taxable securities (2) (3)	48,141	600	4.99	29,061	299	4.12
Nontaxable securities (1) (2)	32,973	505	6.13	19,474	288	5.91
Other	874	13	5.95	132	2	6.06
Interest-earning assets	410,203	7,216	7.04	232,871	3,763	6.46
Noninterest-earning assets	51,325			13,040		
Total assets	$ 461,528			$ 245,911		
Liabilities and Shareholders' Equity:						
Interest-bearing demand deposits	$ 88,800	521	2.35%	$ 53,020	331	2.50%
Savings deposits	28,037	35	0.50	8,495	11	0.50
Certificates of deposit	193,223	2,271	4.70	102,312	985	3.85
Advances from Federal Home Loan Bank	22,657	281	4.96	29,155	289	3.97
Other	17,171	151	3.52	8,378	60	2.86
Interest-bearing liabilities	349,888	3,259	3.73	201,360	1,676	3.33
Noninterest-bearing demand deposits	53,331			21,128		