



**CHOICEONE FINANCIAL SERVICES, INC.**

**2009**

**ANNUAL REPORT TO SHAREHOLDERS**

**CHOICEONE FINANCIAL SERVICES, INC.**

2009 Annual Report to Shareholders

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## TO OUR SHAREHOLDERS

This 2009 Annual Report to Shareholders contains our audited financial statements, detailed financial review and all of the information that regulations of the Securities and Exchange Commission (the "SEC") require to be presented in annual reports to shareholders. For legal purposes, this is the ChoiceOne Financial Services, Inc. 2009 Annual Report to Shareholders. Although attached to our proxy statement, this report is not part of our proxy statement, is not considered to be soliciting material and is not considered to be filed with the SEC except to the extent that it is expressly incorporated by reference in a document filed with the SEC. Shareholders who would like to receive even more detailed information than that contained in this 2009 Annual Report to Shareholders are invited to request our Annual Report on Form 10-K.

**Our Annual Report on Form 10-K for the year ended December 31, 2009, including the financial statements and financial statement schedules, will be provided to any shareholder, without charge, upon written request to Mr. Thomas Lampen, Treasurer, ChoiceOne Financial Services, Inc., 109 East Division Street, Sparta, Michigan 49345.**

### ABOUT CHOICEONE FINANCIAL SERVICES, INC.

ChoiceOne Financial Services, Inc. is a single-bank holding company. Its principal banking subsidiary, ChoiceOne Bank (Sparta, Michigan), primarily serves communities in portions of Kent, Muskegon, Newaygo, and Ottawa counties in Michigan where the Bank's offices are located and the areas immediately surrounding those communities. Currently the Bank serves those markets through thirteen full-service offices. ChoiceOne Insurance Agencies, Inc. is a wholly-owned subsidiary of ChoiceOne Bank and sells insurance and investment products. ChoiceOne Mortgage Company of Michigan, formerly a wholly-owned subsidiary of ChoiceOne Bank, was formed on January 1, 2002 and was engaged in mortgage lending. As of December 31, 2008, ChoiceOne consolidated the operations of ChoiceOne Mortgage Company of Michigan into ChoiceOne Bank and eliminated the separate mortgage company subsidiary.

ChoiceOne's business is primarily concentrated in a single industry segment – banking. ChoiceOne Bank is a full-service banking institution that offers a variety of deposit, payment, credit and other financial services to all types of customers. These services include time, savings, and demand deposits, safe deposit services, and automated transaction machine services. Loans, both commercial and consumer, are extended primarily on a secured basis to corporations, partnerships and individuals. Commercial lending covers such categories as business, industry, agricultural, construction, inventory and real estate. ChoiceOne Bank's consumer loan department (and ChoiceOne Mortgage Company of Michigan through December 31, 2008) makes direct loans to consumers and purchasers of residential property.

The principal source of revenue for ChoiceOne is interest and fees on loans. On a consolidated basis, interest and fees on loans accounted for 70%, 74%, and 70% of total revenues in 2009, 2008, and 2007, respectively. Interest from securities accounted for 11%, 12%, and 11% of total revenues in 2009, 2008, and 2007, respectively.

### STOCK INFORMATION

Several brokers trade ChoiceOne's common shares in the over-the-counter bulletin board market. There is no well-established public trading market for the shares and trading activity is infrequent. ChoiceOne's trading volume and recent share price information can be viewed under the symbol 'COFS.OB' on certain financial websites.

The range of high and low bid prices for shares of common stock for each quarterly period during the past two years is as follows:

	2009		2008	
	Low	High	Low	High
First Quarter	\$ 4.25	\$ 10.01	\$ 10.65	\$ 13.95
Second Quarter	5.65	8.00	9.00	13.25
Third Quarter	7.75	9.50	8.50	11.50
Fourth Quarter	7.50	9.00	7.10	10.75

The prices listed above are over-the-counter market quotations reported to ChoiceOne by its market makers listed in this annual report. The over-the-counter market quotations reflect inter-dealer prices without retail markup, markdown or commission and may not necessarily represent actual transactions.

As of February 26, 2010, there were 3,266,948 shares of ChoiceOne Financial Services, Inc. common stock issued and outstanding. As of February 26, 2010, there were 840 shareholders of record of ChoiceOne Financial Services, Inc. common stock.

The following table summarizes cash dividends declared per share of common stock during 2009 and 2008:

	<u>2009</u>	<u>2008</u>
First Quarter	<b>\$ 0.12</b>	\$ 0.17
Second Quarter	<b>0.12</b>	0.17
Third Quarter	<b>0.12</b>	0.17
Fourth Quarter	<b>0.12</b>	0.17
Total	<b><u>\$ 0.48</u></b>	<u>\$ 0.68</u>

ChoiceOne's principal source of funds to pay cash dividends is the earnings and dividends paid by ChoiceOne Bank. ChoiceOne Bank is restricted in its ability to pay cash dividends under current banking regulations. See Note 22 to the consolidated financial statements for a description of these restrictions. Based on information presently available, management expects ChoiceOne to declare and pay regular quarterly cash dividends in 2010, although the amount of the quarterly dividends will be dependent on market conditions and ChoiceOne's requirements for cash and capital, among other things.

ChoiceOne Financial Services, Inc.  
**SELECTED FINANCIAL DATA**

(Dollars in thousands)

	<b>2009</b>	2008	2007	2006	2005
<b>For the year</b>					
Net interest income.....	\$ <b>15,996</b>	\$ 15,331	\$ 15,143	\$ 8,748	\$ 8,045
Provision for loan losses.....	<b>4,875</b>	3,475	2,035	200	495
Noninterest income.....	<b>5,421</b>	4,083	6,481	2,877	2,580
Noninterest expense.....	<b>15,259</b>	14,711	15,070	8,698	7,184
Income before income taxes.....	<b>1,283</b>	1,228	4,519	2,727	2,946
Income tax expense/(benefit).....	<b>(195)</b>	(207)	939	639	780
Net income.....	<b>1,478</b>	1,435	3,580	2,088	2,166
Cash dividends declared.....	<b>1,563</b>	2,202	2,200	1,397	1,105
<b>Per share *</b>					
Basic earnings.....	\$ <b>0.45</b>	\$ 0.44	\$ 1.11	\$ 1.09	\$ 1.31
Diluted earnings.....	<b>0.45</b>	0.44	1.10	1.09	1.31
Cash dividends declared.....	<b>0.48</b>	0.68	0.68	0.68	0.67
Shareholders' equity (at year end).....	<b>16.21</b>	16.08	16.45	15.85	13.16
<b>Average for the year</b>					
Securities.....	\$ <b>76,934</b>	\$ 85,086	\$ 84,059	\$ 57,407	\$ 44,741
Gross loans.....	<b>320,328</b>	326,420	328,335	205,851	180,100
Deposits.....	<b>347,007</b>	347,190	358,244	222,287	173,419
Federal Home Loan Bank advances.....	<b>28,857</b>	38,803	27,061	26,073	32,765
Shareholders' equity.....	<b>53,115</b>	53,411	52,205	27,349	21,338
Assets.....	<b>453,876</b>	465,741	465,143	288,407	237,864
<b>At year end</b>					
Securities.....	\$ <b>78,987</b>	\$ 81,941	\$ 87,725	\$ 81,417	\$ 47,211
Gross loans.....	<b>322,716</b>	325,977	328,358	331,631	185,832
Deposits.....	<b>365,010</b>	346,998	351,844	366,380	182,112
Federal Home Loan Bank advances.....	<b>21,980</b>	39,957	35,933	23,908	30,750
Shareholders' equity.....	<b>52,926</b>	52,185	53,142	51,519	21,717
Assets.....	<b>465,915</b>	463,551	470,155	466,650	248,110
<b>Selected financial ratios</b>					
Return on average assets.....	<b>0.33%</b>	0.31%	0.77%	0.72%	0.91%
Return on average shareholders' equity.....	<b>2.78</b>	2.69	6.86	7.63	10.15
Cash dividend payout as a percentage of net income.....	<b>105.75</b>	153.45	61.45	66.91	51.02
Shareholders' equity to assets (at year end).....	<b>11.36</b>	11.26	11.30	11.04	8.75

\* Per share amounts are retroactively adjusted for the effect of stock dividends and stock splits.

In November 2006, ChoiceOne merged with Valley Ridge Financial Corp. Accordingly, two months of combined operations are included in the 2006 results of operations and all assets acquired and liabilities assumed from Valley Ridge Financial Corp. are included in the 2006 year-end balance sheet.

## ChoiceOne Financial Services, Inc.

### 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 "Company"), and its wholly-owned subsidiaries, ChoiceOne Bank (the "Bank"), ChoiceOne Insurance Agencies, Inc. (the "Insurance Agency"), and ChoiceOne Mortgage Company of Michigan (the "Mortgage Company"). As of December 31, 2008, ChoiceOne consolidated the operations of the Mortgage Company into the Bank and eliminated the mortgage company subsidiary. This discussion should be read in conjunction with the consolidated financial statements and related footnotes.

### FORWARD-LOOKING STATEMENTS

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

Risk factors include, but are not limited to, the risk factors discussed in Item 1A of the Company's Annual Report on Form 10-K; 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 abilities 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 realized in full or at all or within the expected time frames; 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 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

The purpose of this section of the annual report is to provide a narrative discussion about the Company's financial condition and results of operations during 2009. Management's discussion and analysis of financial condition and results of operations as well as disclosures found elsewhere in the annual report are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses and loan servicing rights. Actual results could differ from those estimates.

#### Securities

Securities available for sale may be sold prior to maturity due to changes in interest rate, prepayment risks, yield, availability of alternative investments, liquidity needs, credit rating changes, or other factors. Securities classified as available for sale are reported at their fair value. Declines in the fair value of securities below their cost that are considered to be "other than temporary" are recorded as losses in the income statement. In estimating whether a fair value decline is considered to be "other than temporary," management considers the length of time and extent that the security's fair value has been less than its carrying value, the financial condition and near term prospects of the issuer, and the Bank's ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Market values for securities available for sale are obtained from outside sources and applied to individual securities within the portfolio. The difference between the amortized cost and the fair value of securities is recorded as a valuation adjustment and reported net of tax effect in other comprehensive income.

### 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.

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 current economic conditions and (2) the impact of recognizing an impairment or loan loss could have a material effect on the Company's assets reported on the balance sheet as well as its net income.

### Loan Servicing Rights

Loan servicing rights represent the estimated value of servicing loans that are sold with servicing retained by ChoiceOne. Servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues. Management's accounting treatment of loan servicing rights is estimated based on current prepayment speeds that are typically market driven.

Management believes the accounting estimate related to loan servicing rights is a "critical accounting estimate" because (1) the estimate is highly susceptible to change from period to period because of significant changes within long-term interest rates affecting the prepayment speeds for current loans being serviced and (2) the impact of recognizing an impairment loss could have a material effect on ChoiceOne's net income. Management has obtained a third-party valuation of its loan servicing rights to corroborate its current carrying value at the end of each reporting period.

### 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, 2009. Due to the impact of economic conditions on the market value of bank stocks, ChoiceOne engaged an outside consulting firm to perform a goodwill impairment analysis as of October 31, 2009. 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 accepting 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 0% for the first year and 2% 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 standards 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 3.5%. Based on this assessment, management believed that there was no indication of goodwill impairment.

### Taxes

Income taxes include both a current and deferred portion. Deferred tax assets and liabilities are recorded to account for differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. Generally accepted accounting principles require that deferred tax assets be reviewed to determine whether a valuation allowance should be established using a "more likely than not" standard. Based on its review of ChoiceOne's deferred tax assets as of December 31, 2009, management determined that no valuation allowance was necessary.

## MERGER WITH VALLEY RIDGE FINANCIAL CORP.

On November 1, 2006, ChoiceOne merged with Valley Ridge Financial Corp. (“VRFC”). At the time of the merger, VRFC was roughly equal in size in terms of assets with ChoiceOne. The 2006 results of operations include two months of combined financial results after the close of the merger and the 2006 year-end balance sheet includes all of the assets acquired and all of the liabilities assumed from VRFC in the merger. Therefore, a comparison of 2006 financial condition and results of operations to the financial condition and results of operations for any subsequent year is materially affected as a result of the merger. The increase in the total allowance for loan losses in 2006 was related to the allowance of \$1,751,000 acquired from the merger with VRFC in November 2006.

### RESULTS OF OPERATIONS

#### Summary

	Year ended December 31		
	2009	2008	2007
Net interest income.....	\$ 15,996	\$ 15,331	\$ 15,143
Provision for loan losses.....	(4,875)	(3,475)	(2,035)
Noninterest income.....	5,421	4,083	6,481
Noninterest expense.....	(15,259)	(14,711)	(15,070)
Income tax (expense)/benefit.....	195	207	(939)
Net income .....	\$ 1,478	\$ 1,435	\$ 3,580
	2009	2008	2007
Return on average assets.....	0.33%	0.31%	0.77%
Return on average equity.....	2.78%	2.69%	6.86%

Net income for 2009 was \$1,478,000, which represented a \$43,000 or 3% increase from 2008. The increase in net income resulted from increased net interest income and noninterest income in 2009, which was offset by a higher provision for loan losses and higher noninterest expense in 2009 than in 2008. The growth in net interest income was due to an increase in ChoiceOne’s net interest spread, which was partially offset by lower average earning assets in 2009 than in 2008. The expansion in noninterest income was due to an increase in gains on sales of loans and gains on sales of securities in 2009 compared to the prior year. Noninterest income was affected in 2008 by \$867,000 of securities losses related to money market preferred securities. The increase in the provision for loan losses was caused by a higher level of charge-offs in 2009 than in 2008. The growth in noninterest expense was due to increased FDIC insurance expense and costs related to carrying other real estate properties and loan collection expenses.

Net income for 2008 was \$1,435,000, which represented a \$2.1 million or 60% decrease from 2007. The decrease in net income was due to an elevated provision for loan losses in 2008 as well as a lower level of noninterest income compared to the prior year. The increased provision for loan losses was primarily due to a higher level of charge-offs in 2008 than in 2007. The reduction in noninterest income in 2008 compared to 2007 was principally due to nonrecurring events in both years. Noninterest income in 2007 included a gain of \$875,000 from the sale of ChoiceOne’s property and casualty lines of business in October 2007. As a result of the sale, insurance commission income was \$522,000 lower in 2008 than in 2007. Noninterest income was affected in 2008 by a \$435,000 loss recognized upon the conversion of a money market preferred security to preferred stock. Noninterest income was also affected by a \$432,000 loss on a money market preferred security when its decline in market value was considered to be an other than temporary impairment. The effect of the increase in the provision for loan losses and the decrease in noninterest income was partially offset by a reduction in noninterest expense in 2008 compared to 2007. The noninterest expense change was caused by reduced expenses from the sale of the property and casualty lines of business in late 2007.

#### Dividends

Cash dividends of \$1,563,000 or \$0.48 per common share were declared in 2009, compared to \$2,202,000 or \$0.68 per common share in 2008 and \$2,200,000 or \$0.68 per common share in 2007. Dividends declared were \$0.12 per share in each quarter in 2009, compared to \$0.17 per share in each quarter in 2008. The dividend reduction in 2009 was believed prudent based on ChoiceOne’s earnings forecast for 2009 and the Board of Directors’ desire to retain more capital due to the continued uncertainty of Michigan’s economy. The dividend yield on ChoiceOne’s common stock was 6.66% in 2009, compared to 6.50% in 2008 and 4.38% in 2007. The cash dividend payout as a percentage of net income was 106% in 2009, compared to 153% in 2008 and 61% in 2007.

ChoiceOne’s principal source of funds to pay cash dividends is the earnings of the Bank. The availability of these earnings is dependent upon the capital needs, regulatory constraints and other factors involving the Bank. Regulatory constraints include the maintenance of minimum capital ratios and limits based on net income and retained earnings of the Bank for the past three years. ChoiceOne expects to pay quarterly cash dividends in 2010 to shareholders based on the actual earnings of the Bank, although the amount of the quarterly dividends will be dependent on market conditions and ChoiceOne’s requirements for cash and capital, among other things.



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

(Dollars in thousands)

	Year ended December 31								
	2009			2008			2007		
	Average Balance	Average Interest	Average Rate	Average Balance	Average Interest	Average Rate	Average Balance	Average Interest	Average Rate
<b>Assets</b>									
Loans (1) (2) .....	\$ 320,328	\$ 19,944	6.23%	\$ 326,420	\$ 22,677	6.95%	\$ 328,335	\$ 24,839	7.57%
Taxable securities (3).....	34,115	1,390	4.07	39,160	2,105	5.38	43,525	2,237	5.14
Tax-exempt securities (1) .....	42,819	2,669	6.23	45,926	2,609	5.68	40,534	2,507	6.18
Other .....	2,695	7	0.26	2,527	66	2.61	1,472	79	5.39
Interest-earning assets .....	<u>399,957</u>	<u>24,010</u>	<u>6.00</u>	<u>414,033</u>	<u>27,457</u>	<u>6.63</u>	<u>413,866</u>	<u>29,662</u>	<u>7.17</u>
Noninterest-earning assets (4).....	<u>53,919</u>			<u>51,708</u>			<u>51,277</u>		
Total assets .....	<u>\$ 453,876</u>			<u>\$ 465,741</u>			<u>\$ 465,143</u>		
<b>Liabilities and Shareholders' Equity</b>									
<b>Interest-bearing</b>									
demand deposits.....	\$ 85,154	520	0.61%	\$ 89,035	1,295	1.45%	\$ 90,804	2,204	2.43%
Savings deposits.....	36,371	113	0.31	30,554	140	0.46	28,097	139	0.50
Certificates of deposit .....	167,065	4,920	2.94	173,963	7,497	4.31	187,648	9,113	4.86
Advances from FHLB .....	28,857	1,186	4.11	38,803	1,704	4.39	27,061	1,405	5.19
Other .....	19,435	351	1.81	19,928	567	2.85	20,069	761	3.79
Interest-bearing liabilities .....	<u>336,882</u>	<u>7,090</u>	<u>2.10</u>	<u>352,283</u>	<u>11,203</u>	<u>3.18</u>	<u>353,679</u>	<u>13,622</u>	<u>3.85</u>
Demand deposits.....	58,417			53,638			51,695		
<b>Other noninterest-bearing</b>									
liabilities .....	<u>5,462</u>			<u>6,409</u>			<u>7,564</u>		
Total liabilities .....	<u>400,761</u>			<u>412,330</u>			<u>412,938</u>		
Shareholders' equity .....	<u>53,115</u>			<u>53,411</u>			<u>52,205</u>		
Total liabilities and shareholders' equity .....	<u>\$ 453,876</u>			<u>\$ 465,741</u>			<u>\$ 465,143</u>		
<b>Net interest income</b>									
(tax-equivalent basis) –									
interest spread .....		<u>16,920</u>	<u>3.90%</u>		<u>16,254</u>	<u>3.45%</u>		<u>16,040</u>	<u>3.32%</u>
Tax-equivalent adjustment (1) .....		<u>(924)</u>			<u>(923)</u>			<u>(897)</u>	
Net interest income .....		<u>\$ 15,996</u>			<u>\$ 15,331</u>			<u>\$ 15,143</u>	
<b>Net interest income as a</b>									
percentage of earning assets									
(tax-equivalent basis).....		<u>4.23%</u>			<u>3.93%</u>			<u>3.88%</u>	

- (1) Interest on nontaxable securities and loans has been adjusted to a fully tax-equivalent basis to facilitate comparison to the taxable interest-earning assets. The adjustment uses an incremental tax rate of 34% for the years presented.
- (2) Interest on loans included net origination fees charged on loans of approximately \$783,000, \$758,000, and \$739,000 in 2009, 2008, and 2007, respectively.
- (3) Interest on taxable securities includes dividends on Federal Home Loan Bank and Federal Reserve Bank stock.
- (4) Noninterest-earning assets include loans on a nonaccrual status, which averaged approximately \$8,961,000, \$7,075,000, and \$6,063,000 in 2009, 2008, and 2007, respectively.

**Net Interest Income**

As shown in Tables 1 and 2, tax-equivalent net interest income increased \$666,000 in 2009 compared to 2008. The growth was due to a 45 basis point increase in ChoiceOne's net interest income spread in 2009 compared to 2008, partially offset by the effect of a decline of \$14.1 million in average earning assets in the same time period. The growth in net interest income spread contributed an additional \$765,000 in net interest income in 2009, while the effect of the decrease in average earning assets offset by a slightly larger decrease in average interest-bearing liabilities caused a reduction in net interest income of \$99,000 in 2009 compared to the prior year.

The average balance of loans declined \$6.1 million in 2009 compared to 2008. This decline, combined with a 72 basis point decrease in the average rate earned on loans, caused interest income on loans to fall \$2.7 million in 2009 compared to 2008. Part of the decrease in interest income from loans resulted from a reduction in accretion income from purchase accounting adjustments on loans acquired from the merger with VRFC in November 2006 from \$659,000 in 2008 to \$229,000 in 2009. The average balance of total securities fell by \$8.2 million in 2009 compared to the prior year. The average balance decline, coupled with a lower average rate earned on taxable securities, caused interest income from securities to decrease \$655,000 in 2009 compared to 2008. A reduction in the average rate earned on other interest-earning assets resulted in a decline in interest income of \$59,000 in 2009 compared to the prior year.

The average balance of interest-bearing demand deposits decreased \$3.9 million in 2009 compared to 2008. The effect of this decrease along with an 84 basis point decline in the average rate paid caused interest expense to be \$775,000 lower in 2009 than in the prior year. The effect of a 15 basis point decrease in the average rate paid on savings deposits in 2009 compared to 2008 was almost offset by the effect of growth of \$5.8 million in the average balance as interest expense dropped \$27,000. The average balance of certificates of deposit was \$6.9 million lower in 2009 than in 2008. Approximately \$3.8 million of the certificates of deposit decline was related to certificates from ChoiceOne's local markets, while the remaining \$3.1 million was a lower level of brokered certificates. The average balance decrease plus the effect of a 137 basis point decline in the average rate paid caused interest expense on certificates of deposit to fall \$2.6 million in 2009 compared to 2008. A \$10.0 million decrease in the average balance of Federal Home Loan Bank advances combined with a 28 basis point reduction in the average rate paid caused interest expense to decline \$518,000 in 2009 compared to 2008. Interest expense on other interest-bearing liabilities fell \$216,000 in 2009 compared to 2008 due to a 104 basis point decrease in the average rate paid.

ChoiceOne's net interest income spread was 3.90% (shown in Table 1) for 2009, compared to 3.45% in 2008. The average yield received on interest-earning assets in 2009 decreased 63 basis points to 6.00% while the average rate paid on interest-bearing liabilities in 2009 fell 108 basis points to 2.10%. The decline in general market interest rates in both 2008 and 2009 caused the reduction in rates between the two time periods.

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

(Dollars in thousands)

	Year ended December 31					
	2009 Over 2008			2008 Over 2007		
	Total	Volume	Rate	Total	Volume	Rate
Increase (decrease) in interest income (1)						
Loans (2).....	\$ (2,733)	\$ (417)	\$(2,316)	\$ (2,162)	\$ (143)	\$(2,019)
Taxable securities .....	(715)	(248)	(467)	(132)	(231)	99
Tax-exempt securities (2) .....	60	(184)	244	102	315	(213)
Other .....	(59)	4	(63)	(13)	40	(53)
Net change in tax-equivalent income .....	<b>(3,447)</b>	<b>(845)</b>	<b>(2,602)</b>	<b>(2,205)</b>	<b>(19)</b>	<b>(2,186)</b>
Increase (decrease) in interest expense (1)						
Interest-bearing demand deposits.....	(775)	(54)	(721)	(909)	(42)	(867)
Savings deposits.....	(27)	23	(50)	1	13	(12)
Certificates of deposit.....	(2,577)	(287)	(2,290)	(1,616)	(633)	(983)
Advances from Federal Home Loan Bank...	(518)	(414)	(104)	299	540	(241)
Other .....	(216)	(14)	(202)	(194)	(5)	(189)
Net change in interest expense.....	<b>(4,113)</b>	<b>(746)</b>	<b>(3,367)</b>	<b>(2,419)</b>	<b>(127)</b>	<b>(2,292)</b>
Net change in tax-equivalent net interest income	<b>\$ 666</b>	<b>\$ (99)</b>	<b>\$ 765</b>	<b>\$ 214</b>	<b>\$ 108</b>	<b>\$ 106</b>

- (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 tax-exempt securities and loans has been adjusted to a fully tax-equivalent basis using an incremental tax rate of 34% for the years presented.

Tax-equivalent net interest income increased \$214,000 in 2008 compared to 2007. The reasons for the increase were evenly split between small amounts due to the relationship between average interest-earning assets and interest-bearing liabilities and a slightly larger net interest spread. Average interest-earning assets grew \$167,000 in 2008 compared to 2007, while average interest-bearing liabilities declined \$1,396,000 when comparing the two years. The growth in assets and reduction of liabilities caused an increase of \$108,000 in net interest income in 2008 compared to 2007. ChoiceOne's net interest spread increased by 13 basis points in 2008 compared to 2007, which contributed \$106,000 toward the increase in net interest income in 2008. The decline in general market interest rates in 2008 caused almost all of the rates earned on assets and paid on liabilities to be lower than in the prior year.

Management anticipates that the level of net interest income in 2010 will depend upon the Bank's ability to grow or maintain interest-earning assets in the form of loans and securities as well as its ability to do the same with its base of core deposits. Growth in earning assets may prove to be difficult in 2010 given the continued weakness in the Michigan economy. Additionally, if general market interest rates continue to remain at relatively low levels, they may have an impact on ChoiceOne's net interest spread as new activity, maturities, and payments may have differing impacts on interest-earning assets and interest-bearing liabilities.

#### Allowance and Provision For Loan Losses

Information regarding the allowance and provision for loan losses can be found in Table 3 below:

**Table 3 – Provision and Allowance For Loan Losses**

(Dollars in thousands)

	<b>2009</b>	2008	2007	2006	2005
Allowance for loan losses at beginning of year .....	<b>\$ 3,600</b>	\$ 3,600	\$ 3,569	\$ 1,963	\$ 1,739
Charge-offs:					
Agricultural .....	—	—	33	—	—
Commercial and industrial.....	<b>1,558</b>	1,193	599	221	72
Real estate - commercial.....	<b>1,217</b>	816	841	—	25
Real estate - construction.....	<b>15</b>	—	—	—	20
Real estate - residential.....	<b>1,369</b>	1,252	191	92	120
Consumer.....	<b>535</b>	567	635	200	162
Total .....	<b>4,694</b>	3,828	2,299	513	399
Recoveries:					
Agricultural .....	—	—	3	—	—
Commercial and industrial.....	<b>102</b>	60	27	51	47
Real estate - commercial.....	<b>58</b>	35	1	—	—
Real estate - construction.....	<b>29</b>	—	—	—	—
Real estate - residential.....	<b>106</b>	6	10	—	—
Consumer.....	<b>246</b>	252	254	117	81
Total .....	<b>541</b>	353	295	168	128
Net charge-offs .....	<b>4,153</b>	3,475	2,004	345	271
Provision for loan losses.....	<b>4,875</b>	3,475	2,035	200	495
Allowance for loan losses acquired from VRFC ....	—	—	—	1,751	—
Allowance for loan losses at end of year .....	<b>\$ 4,322</b>	\$ 3,600	\$ 3,600	\$ 3,569	\$ 1,963
Allowance for loan losses as a percentage of:					
Total loans as of year end.....	<b>1.34%</b>	1.10%	1.10%	1.08%	1.06%
Nonaccrual loans, accrual loans past due 90 days or more and troubled debt restructurings .....	<b>31%</b>	39%	62%	53%	203%
Ratio of net charge-offs to average total loans outstanding during the year .....	<b>1.30%</b>	1.06%	0.61%	0.17%	0.15%
Loan recoveries as a percentage of prior year's charge-offs.....	<b>16%</b>	15%	58%	42%	14%

As shown in Table 3, the provision for loan losses was \$1,400,000 higher in 2009 than in 2008. The higher provision level resulted in part from an increase of \$678,000 in net charge-offs experienced in 2009 compared to 2008. The elevated level of net charge-offs in 2009 was believed to be caused by the continued economic challenges affecting borrowers in ChoiceOne's market areas. Net charge-offs of commercial and industrial loans were \$1,456,000 in 2009, which represented an increase of \$323,000 from 2008. Approximately \$737,000 of the commercial and industrial charge-offs in 2009 was related to an unsecured relationship with one borrower that was charged off in December 2009 due to the borrower's bankruptcy. Management reviewed the remaining unsecured commercial and industrial loans as of December 31, 2009 and did not find the same level of risk as the charged-off loan. Commercial real estate loan net charge-offs were \$1,159,000 in 2009, an increase of \$378,000 from 2008. Residential real estate loan net charge-offs were \$1,263,000 in 2009, which was virtually equal to \$1,246,000 of net charge-offs experienced in 2008. Consumer loan net charge-offs were \$289,000 in 2009, which represented a small decline from \$315,000 in 2008. The allowance for loan losses as a percentage of total loans increased from 1.10% as of the end of 2008 to 1.34% as of the end of 2009. The coverage ratio of the allowance for loan losses to nonperforming loans declined slightly from 39% as of December 31, 2008 to 31% as of December 31, 2009. ChoiceOne had \$1,112,000 of specific allowance allocations for problem loans as of the end of 2009, compared to \$545,000 as of the prior year end. Special allowance amounts have been allocated where the fair value of loans was considered to be less than their carrying value. ChoiceOne obtains valuations on collateral dependent loans when the loan is considered by management to be impaired and uses the valuation amounts in the determination of fair value. Management believes the specific reserves allocated to certain problem loans at the end of 2009 and 2008 were reasonable based on the circumstances surrounding each particular borrower.

The following schedule presents an allocation of the allowance for loan losses to the various loan categories as of the years ended December 31:

(Dollars in thousands)

	<b>2009</b>	2008	2007	2006	2005
Agricultural .....	\$ 123	\$ 242	\$ 397	\$ 314	\$ 202
Commercial and industrial.....	735	616	873	1,160	1,060
Real estate - commercial.....	1,547	996	886	1,029	254
Real estate - construction.....	3	5	10	12	19
Real estate - residential.....	1,590	1,124	881	575	229
Consumer.....	306	351	489	289	195
Unallocated.....	18	266	64	190	4
<b>Total allowance for loan losses .....</b>	<b>\$ 4,322</b>	<b>\$ 3,600</b>	<b>\$ 3,600</b>	<b>\$ 3,569</b>	<b>\$ 1,963</b>

The decrease in the allowance allocation to agricultural loans from 2008 to 2009 was based on the limited charge-off activity experienced by this loan category. The increase in the allocation to commercial and industrial loans in 2009 was due to the higher level of charge-off activity experienced in 2009 compared to 2008. The increase in the allocation to commercial real estate loans in 2009 was caused by an increase in specific allowance allocations from \$420,000 at the end of 2008 to \$1,031,000 at the end of 2009. The growth in the allowance allocation to residential real estate mortgage loans resulted from the continued high level of charge-offs in this loan category during 2009, along with an increase in nonaccrual loans in this loan category from \$2.5 million as of the end of 2008 to \$4.1 million as of the end of 2009. The increase in the total allowance in 2006 was related to the allowance of \$1,751,000 acquired from the merger with VRFC in November 2006.

Management maintains the allowance at a level at which it believes adequately provides for losses inherent in the loan portfolio. Such losses are estimated by a variety of factors, including specific examination of certain borrowing relationships and consideration of historical losses incurred on certain types of credits. Current economic conditions and declining collateral values affect loss estimates. Management focuses on early identification of problem credits through ongoing reviews by management and the independent loan review function. In order to better identify the risk in total commercial loans, management created separate loan categories for agricultural loans, commercial leases, and unsecured commercial loans in the December 2009 allowance computation from the commercial real estate loan and commercial and industrial loan categories that existed previously. Based on the current state of the economy and a recent review of the loan portfolio, management believes that the allowance for loan losses as of December 31, 2009 is adequate. As charge-offs, changes in the level of nonperforming loans, and changes within the composition of the loan portfolio occur, the provision and allowance for loan losses will be reviewed by the Bank's management and adjusted as necessary.

#### Noninterest Income

Total noninterest income increased \$1,338,000 in 2009 compared to 2008. Customer service charges were \$103,000 less in 2009 compared to 2008 due to a \$99,000 decrease in overdraft charges. Lower levels of life insurance commission income and mutual fund commission income in 2009 caused the decline in insurance and investment commission income from 2008. Gains on sales of loans increased \$386,000 in 2009 compared to 2008 due to a higher level of mortgage refinancing activity stimulated by low interest rates for long-term fixed rate mortgage loans. ChoiceOne sold \$28.0 million of mortgage loans in 2009 compared to \$12.2 million in 2008.

If rates for long-term fixed rate mortgage loans rise in 2010, management believes that mortgage refinancing activity may slow and resulting gains on sales of loans may be lower than the prior year. ChoiceOne had \$355,000 of net gains on sales of securities in 2009, compared to \$833,000 of net losses in 2008. The net gains in 2009 included \$245,000 of gains on sales of preferred stock that represented a recovery of losses recognized on money market preferred securities in 2008. Net losses from sales of securities in 2008 included a \$435,000 loss recognized when a money market preferred security was converted to preferred stock. A \$432,000 loss on other than temporary impairment of securities in 2008 resulted when a decline in the market value of another money market preferred security was considered to be other than temporary. The net loss on sales of other assets was \$230,000 larger in 2009 than in 2008 due to the sale of more real estate properties. An increase of \$184,000 in other noninterest income in 2009 compared to 2008 was caused in part by higher levels of check printing fees, rental income from foreclosed properties, and income from an investment in Michigan Bankers Title Company.

Total noninterest income decreased \$2,398,000 or 37% in 2008 compared to 2007. Insurance and investment commission income declined \$368,000 in 2008 compared to 2007. The decrease in commission income was due to the sale of ChoiceOne's property and casualty insurance lines of business in October 2007, which caused insurance commission income to be \$522,000 lower in 2008 than in the prior year. The sale of the insurance lines of business caused an \$875,000 gain to be recorded in the fourth quarter of 2007. Gains on sales of loans decreased \$72,000 in 2008 compared to 2007 due to a lower volume of residential mortgage loans sold into the secondary market. The \$401,000 loss on sales of securities in 2008 was due to a \$435,000 loss recognized when a money market preferred security was converted to preferred stock. The \$432,000 loss on other than temporary impairment of securities resulted when a decline in the market value of another money market preferred security was considered to be other than temporary. A decrease of \$150,000 in other noninterest income in 2008 compared to 2007 was caused by a number of small items.

Management anticipates that noninterest income will be affected in 2010 by recent regulatory changes regarding overdraft fee income. The changes, which become effective July 1, 2010, will serve to restrict ChoiceOne's ability to charge overdraft fees for certain types of transactions, which include automatic teller machine or one-time debit card usage, unless the depositors opt in for overdraft coverage for these types of transactions. As a result, ChoiceOne believes that this may cause overdraft fee income to decrease in the second half of 2010. Management plans to continue its emphasis of growth of checking and savings deposit accounts in 2010, which may generate additional fee income from debit card usage and other deposit related fees.

#### Noninterest Expense

Total noninterest expense increased \$548,000 in 2009 compared to 2008. The \$238,000 decrease in salaries and benefits expense in 2009 compared to the prior year was partly due to a \$141,000 reduction in 401(k) plan expense as no company contribution was made in 2009. Data processing expense grew \$213,000 in 2009 compared to 2008 as a result of increased numbers of accounts and increased volumes, especially in the form of electronic banking. FDIC insurance expense was \$518,000 higher in 2009 as a result of a special assessment of \$204,000 levied in the second quarter of 2009 and a doubling of assessment rates in 2009 compared to 2008. An increase of \$93,000 in other noninterest expense in 2009 included an increase of \$355,000 in costs of carrying other real estate properties and loan collection expenses in 2009 compared to 2008.

Total noninterest expense decreased \$359,000 or 2% in 2008 compared to 2007. Salaries and benefits expense was \$569,000 lower in 2008 than in 2007. Much of the reduction was due to the sale of ChoiceOne's property and casualty lines of business in October 2007, which eliminated the ongoing compensation costs related to this activity. Salaries and benefits expense was also impacted by a \$175,000 decrease in bonus expense from 2007 to 2008. Data processing expense declined \$84,000 in 2008 compared to 2007, which was primarily due to new contracts in 2008 for processing of automatic teller machine transactions. The increase in professional fees of \$56,000 in 2008 compared to the prior year was due to higher levels of legal fees related to loan matters and higher audit and tax fees. Advertising and promotional expense was \$154,000 lower in 2008 than in 2007 as ChoiceOne cut expenses in all advertising categories. An increase of \$204,000 in FDIC insurance expense was caused by assessment credits from the FDIC that the Bank used in 2007 being fully utilized in January 2008. Other noninterest expense grew \$187,000 in 2008 compared to the prior year. Foreclosed asset and loan collection expenses were up \$209,000 in 2008 due to problem loans. Training expense was \$109,000 higher in 2008 than in the prior year as an outside consultant was used for management, customer service, and sales training.

Management believes that noninterest expense in 2010 will continue to be affected by higher than normal levels of FDIC insurance expense and expenses related to nonperforming loans and foreclosed properties.

#### Income Taxes

Income taxes produced a benefit of \$195,000 in 2009, compared to a benefit of \$207,000 in 2008 and expense of \$939,000 in 2007. The significant decrease in tax expense in 2008 was caused by a \$3,291,000 decline in income before income tax in 2008 compared to the prior year. The tax benefit realized in both 2009 and 2008 was due to the level of ChoiceOne's tax exempt interest income, which was larger than income before income tax in both years.

## FINANCIAL CONDITION

### Summary

Total assets were \$465.9 million as of December 31, 2009, which represented an increase of \$2.4 million or 1% during 2009. Securities available for sale declined \$3.0 million or 4% in 2009 as purchases of new securities did not fully offset the effect of sales, maturities, payments, and calls. Loans decreased \$3.3 million or 1% in 2009 as a result of reductions in the balances of commercial and residential real estate loans. Total deposits grew \$18.0 million in 2009 due to increases in checking and savings deposits, which were partially offset by a decrease in certificates of deposit. Advances from the Federal Home Loan Bank of Indianapolis were reduced \$18.0 million in 2009 as the deposit growth was used to pay off maturing advances.

### Securities

The Bank's securities available for sale balances as of December 31 were as follows:

(Dollars in thousands)

		<u>2009</u>		2008
U.S. Government and federal agency .....	\$	<b>18,571</b>	\$	14,221
State and municipal .....		<b>44,599</b>		49,066
Mortgage-backed .....		<b>8,929</b>		11,902
Corporate .....		—		198
Equity securities .....		<b>2,314</b>		1,981
Total .....	\$	<b>74,413</b>	\$	<b>77,368</b>

The securities available for sale portfolio decreased \$3.0 million from December 31, 2008 to December 31, 2009. ChoiceOne purchased a mix of government agency, municipal, and mortgage-backed securities totaling \$31.3 million during 2009 to replace securities that matured or were called. Approximately \$24.3 million in various securities were called or matured in 2009. Principal payments for municipal and mortgage-backed securities totaling \$2.9 million were received during 2009. Various securities totaling approximately \$8.2 million were sold during 2009 for net gains totaling \$402,000. Approximately \$3.3 million of the sales that occurred in 2009 were sales of municipal securities in the fourth quarter as ChoiceOne moved to lessen the exposure to this category. The proceeds from the sales were reinvested into government agency securities. The Bank's Investment Committee continues to monitor the portfolio and purchases securities when deemed prudent. Also, certain securities are sold under agreements to repurchase and management plans to continue this practice as a low-cost source of funding.

State and municipal securities as of the end of 2009 included a security that matured on September 1, 2009 and was not redeemed by the issuer. A principal payment of \$29,000 was received in October 2009 on the par value of \$500,000. No further payments have been received. Legal counsel was engaged in September 2009 by the bondholders to work with the issuer on their behalf. ChoiceOne's third party investment advisor is a member of the bondholder executive committee and is working closely with the legal counsel. Due to the uncertainty of the timing as to when ChoiceOne will receive value for the remaining principal balance of the bond, an other than temporary impairment of \$47,000 or 10% of the remaining par value was recognized as of December 31, 2009.

Equity securities included preferred stock of \$954,000, a money market preferred security (MMP) of \$860,000, and a trust preferred security of \$500,000 as of December 31, 2009. Equity securities included MMPs of \$1,050,000, trust preferred securities of \$500,000, and preferred stock of \$431,000 as of December 31, 2008. A loss of \$435,000 was recognized upon a conversion from an MMP to preferred stock in November 2008 due to a market value that was less than its carrying value at time of conversion. An other than temporary impairment of \$432,000 was recorded in December 2008 for an MMP that converted to preferred stock in January 2009. Part of the losses that were recorded in 2008 were recovered in 2009 as approximately 40% of the par value of the two preferred stock issues were sold for a gain of \$245,000. The remaining MMP as of December 31, 2009 had a \$140,000 unrealized loss that was recorded to other comprehensive income. Auctions remain active for this security and interest continues to be received. Its decline in market value is not considered to be other than temporary as of the end of 2009.

Management will continue to monitor its equity securities closely in 2010. ChoiceOne plans to continue selling its preferred stock if certain pricing levels can be achieved.

## Loans

The Bank's loan portfolio as of December 31 was as follows:

(Dollars in thousands)

	<u>2009</u>	<u>2008</u>
Agricultural .....	\$ 31,322	\$ 23,408
Commercial and industrial.....	53,964	57,587
Consumer.....	16,285	16,047
Real estate - commercial.....	121,100	123,952
Real estate - construction.....	1,158	2,026
Real estate - residential.....	98,887	102,957
Total loans.....	<u>\$ 322,716</u>	<u>\$ 325,977</u>

The loan portfolio (excluding loans held for sale) decreased \$3.3 million from December 31, 2008 to December 31, 2009. Growth in the agricultural loans portfolio in 2009 was caused by new borrower relationships and increased borrowings by existing clients. The decline in commercial and industrial loans and commercial real estate loans was primarily due to sluggish loan demand in 2009 as the uncertain economy in Michigan affected the willingness of borrowers to assume debt. The reduction in residential real estate loans in 2009 was caused by adjustable rate mortgages held in the portfolio that were refinanced into fixed rate loans and sold in the secondary market.

Management anticipates loan demand in 2010 will depend upon the stability of the local and state economies and the confidence level of business and personal borrowers. The Bank intends to continue its calling program with commercial customers in its market areas.

Information regarding impaired loans can be found in Note 5 to the consolidated financial statements included in this report. In addition to its review of the loan portfolio for impaired loans, management also monitors various nonperforming loans. Nonperforming loans are comprised of (1) loans accounted for on a nonaccrual basis; (2) loans, not included in nonaccrual loans, which are contractually past due 90 days or more as to interest or principal payments; and (3) loans, not included in nonaccrual or past due 90 days or more, which are considered troubled debt restructurings.

The balances of these nonperforming loans as of December 31 were as follows:

(Dollars in thousands)

	<u>2009</u>	<u>2008</u>
Loans accounted for on a nonaccrual basis	\$ 11,881	\$ 8,305
Loans contractually past due 90 days or more as to principal or interest payments	202	333
Loans considered troubled debt restructurings which are not included above	1,919	605
Total	<u>\$ 14,002</u>	<u>\$ 9,243</u>

At December 31, 2009, nonaccrual loans included \$7,804,000 in commercial and industrial and commercial real estate loans, \$4,060,000 in residential real estate loans, and \$17,000 in consumer loans. At the end of the prior year, nonaccrual loans were comprised of \$5,836,000 in commercial and industrial and commercial real estate loans, \$2,450,000 in residential real estate loans, and \$19,000 in consumer loans. Approximately \$2.6 million of the increase in nonaccrual commercial loans was comprised of one borrower, of which the balance is 75% government guaranteed. The increase in nonaccrual residential real estate loans was comprised of a number of loans where the payment ability of the borrowers has been negatively affected by the current economic climate. Loans considered troubled debt restructurings which were not on a nonaccrual basis and were not 90 days or more past due on principal or interest payments consisted of \$134,000 in commercial and industrial loans and \$1,785,000 in residential real estate loans as of December 31, 2009, compared to \$605,000 in commercial real estate loans as of December 31, 2008. The increase in residential real estate loans considered troubled debt restructurings was caused by loans where the terms had been modified to assist the borrowers in making their payments. The modifications included capitalization of interest onto the principal balance, reduction in interest rate, and extension of loan term. ChoiceOne began making the modifications for residential real estate loans in September 2009 and plans to continue this process in 2010.

Management also maintains a list of loans that are not classified as nonperforming loans but where some concern exists as to the borrowers' abilities to comply with the original loan terms. These loans totaled \$17.1 million as of December 31, 2009, compared to \$17.9 million as of December 31, 2008.

### Deposits and Other Funding Sources

The Bank's deposit balances as of December 31 were as follows:

(Dollars in thousands)

	<b>2009</b>	2008
Noninterest-bearing demand deposits.....	<b>\$ 60,802</b>	\$ 54,511
Interest-bearing demand deposits .....	<b>43,731</b>	35,213
Money market deposits.....	<b>58,094</b>	46,900
Savings deposits .....	<b>36,791</b>	32,764
Local certificates of deposit.....	<b>159,217</b>	157,892
Brokered certificates of deposit.....	<b>6,375</b>	19,718
Total loans.....	<b>\$ 365,010</b>	<b>\$ 346,998</b>

Total deposits increased \$18.0 million from December 31, 2008 to December 31, 2009. The balance of local deposits grew \$31.4 million during 2009, while the balance of brokered certificates of deposit declined \$13.4 million. The balance in all local deposit categories grew in 2009 with money market deposits and interest-bearing demand deposits contributing more than 60% of the total increase. Management believes that the deposit growth was due in part to the attractiveness of FDIC-guaranteed deposits in contrast to the uncertainty of investments in the stock market. Deposit growth also resulted from new product offerings and calling efforts on business and municipal clients.

Securities sold under agreements to repurchase increased \$1.9 million during 2009. The change was due to a higher balance in sweep repurchase accounts used by the Bank's local customers. Advances from the Federal Home Loan Bank of Indianapolis ("FHLB") decreased \$18.0 million in 2009 as growth in deposits was used to replace maturing advances. A blanket collateral agreement covering residential real estate loans was pledged against all outstanding advances at the end of 2009. Approximately \$26.1 million of additional advances were available as of December 31, 2009 based on the collateral pledged.

In 2010, management will continue to focus its marketing efforts towards growing local deposits. If local deposit growth is insufficient to support asset growth during 2009, management believes that FHLB advances, repurchase agreements and brokered certificates of deposit can address corresponding funding needs.

### Shareholders' Equity

Total shareholders' equity increased \$741,000 from December 31, 2008 to December 31, 2009. The growth in equity resulted primarily from an increase in accumulated other comprehensive income and proceeds from the issuance of ChoiceOne's stock. Dividends paid in 2009 exceeded net income by \$85,000. ChoiceOne did not repurchase any of its common stock in 2008 or 2009, in contrast to 2007, when 32,700 shares were repurchased. Shares of common stock may be repurchased in the future if management deems it to be a prudent use of capital.

ChoiceOne applied for \$9.6 million in a capital investment as part of the U.S. Treasury's Capital Purchase Program in November 2008. Approval of the investment was received from the U.S. Treasury in March 2009. After considering the cost of the investment, the restrictions connected with receipt of the funds, and the potential dilution of existing shareholders, management decided not to accept the capital investment.

Note 22 to the consolidated financial statements presents regulatory capital information for the Bank at the end of 2009 and 2008. The Bank's capital ratios increased slightly from December 31, 2008 to December 31, 2009 due to growth in the shareholders' equity balance during 2009. Management will monitor these capital ratios closely during 2010 as they relate to asset growth and earnings retention. ChoiceOne's Board of Directors and management do not plan to allow capital to decrease below those levels necessary to be considered "well capitalized" by regulatory guidelines. The Board of Directors and management believe that ChoiceOne's capital level as of December 31, 2009 is adequate for the foreseeable future.



## Table 4 – Contractual Obligations

The following table discloses information regarding the maturity of ChoiceOne’s contractual obligations at December 31, 2009:

(Dollars in thousands)

Contractual Obligations	Total	Payment Due By Period			
		Less than 1 year	1-3 Years	3-5 Years	More than 5 Years
Time deposits .....	\$ 165,592	\$ 116,722	\$ 41,777	\$ 6,915	\$ 178
Repurchase agreements .....	20,684	15,684	5,000	–	–
Advances from Federal Home Loan Bank.....	21,980	13,507	5,053	3,057	363
Operating leases .....	46	46	–	–	–
Other obligations .....	1,438	276	210	135	817
Total .....	<u>\$ 209,740</u>	<u>\$ 146,235</u>	<u>\$ 52,040</u>	<u>\$ 10,107</u>	<u>\$ 1,358</u>

### Liquidity and Interest Rate Risk

Net cash from operating activities was \$9.2 million for 2009 compared to \$7.2 million for 2008. The effect of the increased provision for loan losses and a higher level of proceeds from sales of other real estate owned were partially offset by the effect of gains on sales of securities in 2009 compared to losses on sales and impairment in 2008 and the net change in other assets and other liabilities. Cash used in investing activities was \$0.3 million less in 2009 than in 2008. Net cash provided by financing activities was \$0.5 million in 2009, compared to \$5.8 million used in financing activities in 2008. Growth in deposits and repurchase agreements was partially offset by net payments of FHLB advances in 2009 compared to net borrowings in 2008.

ChoiceOne's primary market risk exposure occurs in the form of interest rate risk. Liquidity risk also can have an impact but to a lesser extent. ChoiceOne's business is transacted in U.S. dollars with no foreign exchange risk exposure. Agricultural loans comprise a small portion of ChoiceOne's total assets. Management believes that ChoiceOne's exposure to changes in commodity prices is insignificant.

Management believes that the current level of liquidity is sufficient to meet the Bank's normal operating needs. This belief is based upon the availability of deposits from both the local and national markets, maturities of securities, normal loan repayments, income retention, federal funds purchased lines from correspondent banks, and advances available from the FHLB. Liquidity risk deals with ChoiceOne's ability to meet its cash flow requirements. These requirements include depositors desiring to withdraw funds and borrowers seeking credit. Relatively short-term liquid funds exist in the form of lines of credit to purchase federal funds at three of the Bank’s correspondent banks. As of December 31, 2009, the amount of federal funds available for purchase from the Bank's correspondent banks totaled approximately \$18.5 million. ChoiceOne had no federal funds purchased at the end of 2009 or 2008. The Bank also has a line of credit secured by ChoiceOne’s commercial loans with the Federal Reserve Bank of Chicago for \$40 million, which is designated for nonrecurring short-term liquidity needs. Longer-term liquidity needs may be met through local deposit growth, maturities of securities, normal loan repayments, advances from the FHLB, brokered certificates of deposit, and income retention. Approximately \$26.1 million of borrowing capacity was available from the FHLB based on residential real estate loans pledged as collateral at year-end 2009. The acceptance of brokered certificates of deposit is not limited as long as the Bank’s capital to assets ratio is considered to be “well capitalized” under regulatory guidelines.

Interest rate risk is related to liquidity because each is affected by maturing assets and sources of funds. ChoiceOne’s Asset/Liability Management Committee (the "ALCO") attempts to stabilize the interest rate spread and avoid possible adverse effects when unusual or rapid changes in interest rates occur. The ALCO uses a simulation model to measure the Bank’s interest rate risk. The model incorporates changes in interest rates on rate-sensitive assets and liabilities. The degree of rate sensitivity is affected by prepayment assumptions that exist in the assets and liabilities. One method the ALCO uses of measuring interest rate sensitivity is the ratio of rate-sensitive assets to rate-sensitive liabilities. An asset or liability is considered to be rate-sensitive if it matures or otherwise reprices within a given time frame.

Table 5 documents the maturity or repricing schedule for ChoiceOne’s rate-sensitive assets and liabilities for selected time periods.

**Table 5 – Maturities and Repricing Schedule**

(Dollars in thousands)

	As of December 31, 2009				
	0-3 Months	3-12 Months	1-5 Years	Over 5 Years	Total
<b>Assets</b>					
Federal funds sold .....	\$ 9,793	\$ –	\$ –	\$ –	\$ 9,793
Securities available for sale .....	9,507	12,215	22,978	29,713	74,413
Federal Home Loan Bank stock .....	–	3,304	–	–	3,304
Federal Reserve Bank stock .....	–	–	1,270	–	1,270
Loans held for sale .....	322	–	–	–	322
Loans .....	81,002	83,024	135,453	23,237	322,716
Cash surrender value of life insurance policies .....	–	–	9,201	–	9,201
Rate-sensitive assets .....	<b>100,624</b>	<b>98,543</b>	<b>168,902</b>	<b>52,950</b>	<b>421,019</b>
<b>Liabilities</b>					
Interest-bearing demand deposits .....	43,731	–	–	–	43,731
Savings deposits .....	36,791	–	–	–	36,791
Money market deposits .....	58,094	–	–	–	58,094
Certificates of deposit .....	59,843	60,384	45,365	–	165,592
Repurchase agreements .....	15,513	–	5,171	–	20,684
Advances from FHLB .....	3,510	9,990	7,982	498	21,980
Rate-sensitive liabilities .....	<b>217,482</b>	<b>70,374</b>	<b>58,518</b>	<b>498</b>	<b>346,872</b>
Rate-sensitive assets less rate-sensitive liabilities:					
Asset (liability) gap for the period .....	<b>\$ (116,858)</b>	<b>\$ 28,169</b>	<b>\$ 110,384</b>	<b>\$ 52,452</b>	<b>\$ 74,147</b>
Cumulative asset (liability) gap .....	<b>\$ (116,858)</b>	<b>\$ (88,689)</b>	<b>\$ 21,695</b>	<b>\$ 74,147</b>	

Under this method, the ALCO measures interest rate sensitivity by focusing on the one-year repricing gap. ChoiceOne's ratio of rate-sensitive assets to rate-sensitive liabilities that matured or repriced within a one-year time frame was 69% at December 31, 2009, compared to 67% at December 31, 2008. Table 5 above shows the entire balance of interest-bearing demand deposits, savings deposits, money market deposits, and overnight repurchase agreements in the shortest repricing term. Although these categories have the ability to reprice immediately, management has some control over the actual timing or extent of the changes in interest rates on these liabilities. The ALCO plans to continue to monitor the ratio of rate-sensitive assets to rate-sensitive liabilities on a quarterly basis in 2010. As interest rates change during 2010, the ALCO will attempt to match its maturing assets with corresponding liabilities to maximize ChoiceOne's net interest income.

Another method the ALCO uses to monitor its interest rate sensitivity is to subject rate-sensitive assets and liabilities to interest rate shocks. At December 31, 2009, management used a simulation model to subject its assets and liabilities up to an immediate 300 basis point increase. Management limited the immediate interest rate decrease to a maximum of 25 basis points due to the very low general market rates that existed as of the end of 2009. The maturities of loans and mortgage-backed securities were affected by certain prepayment assumptions. Maturities for interest-bearing core deposits were based on an estimate of the period over which they would be outstanding. The maturities of advances from the FHLB were based on their contractual maturity dates. In the case of variable rate assets and liabilities, repricing dates were used to determine their values. The simulation model measures the effect of immediate interest rate changes on both net interest income and shareholders' equity. ChoiceOne's Interest Rate Risk Policy states that the changes in interest rates cannot cause net interest income to decrease more than 10% if rates are instantaneously shocked 200 basis points upward or downward. ChoiceOne's Interest Rate Risk Policy states that the changes in interest rates cannot cause the market value of shareholders' equity to decrease more than 20% if rates are instantaneously shocked 200 basis points upward or downward.

Table 6 provides an illustration of hypothetical interest rate changes as of December 31, 2009 and 2008, respectively:

**Table 6 – Sensitivity to Changes in Interest Rates**

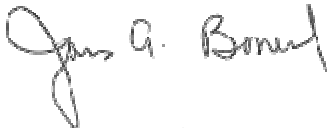
(Dollars in thousands)	2009			
	Net Interest Income	Percent Change	Market Value of Equity	Percent Change
Change in Interest Rates				
300 basis point rise .....	\$ 16,620	+ 3%	\$ 66,959	- 16%
200 basis point rise .....	16,467	+ 2%	70,620	- 11%
100 basis point rise .....	16,313	+ 1%	74,682	- 6%
Base rate scenario .....	16,147	–%	79,513	–%
15 basis point decline .....	16,056	- 1%	79,871	+ 1%
20 basis point decline .....	16,023	- 1%	80,086	+ 1%
25 basis point decline .....	15,986	- 1%	80,250	+ 1%
2008				
(Dollars in thousands)	Net Interest Income	Percent Change	Market Value of Equity	Percent Change
Change in Interest Rates				
300 basis point rise .....	\$ 16,279	+ 5%	\$ 53,676	- 18%
200 basis point rise .....	16,040	+ 3%	57,190	- 12%
100 basis point rise .....	15,797	+ 2%	61,001	- 6%
Base rate scenario .....	15,552	–%	65,086	–%
100 basis point decline .....	14,796	- 5%	69,594	+ 6%
200 basis point decline .....	14,053	- 10%	74,283	+ 14%
300 basis point decline .....	14,053	- 10%	79,119	+ 22%

As of both December 31, 2009 and December 31, 2008, the Bank was within its guidelines for immediate rate shocks up and down for both net interest income and the market value of shareholders' equity. The ALCO plans to continue to monitor the effect of changes in interest rates on both net interest income and shareholders' equity and will make changes in the duration of its rate-sensitive assets and rate-sensitive liabilities where necessary.

ChoiceOne Financial Services, Inc.  
**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of ChoiceOne Financial Services, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting that is designed to produce reliable financial statements in conformity with United States generally accepted accounting principles. The system of internal control over financial reporting as it relates to the financial statements is evaluated for effectiveness by management and tested for reliability through a program of internal audits. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Management assessed the effectiveness of the Company's system of internal control over financial reporting as of December 31, 2009, as required by Section 404 of the Sarbanes-Oxley Act of 2002. Management's assessment is based on the criteria for effective internal control over financial reporting as described in "Internal Control – Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management has concluded that, as of December 31, 2009, its system of internal control over financial reporting was effective and meets the criteria of the "Internal Control – Integrated Framework." This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.



James A. Bosserd  
President and Chief Executive Officer

March 26, 2010



Thomas L. Lampen  
Treasurer

March 26, 2010



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders and Board of Directors  
of ChoiceOne Financial Services, Inc.

We have audited the accompanying consolidated balance sheet of ChoiceOne Financial Services, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of income, shareholders' equity, and cash flows for each year in the three-year period ended December 31, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ChoiceOne Financial Services, Inc. as of December 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for each year in the three-year period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

Plante & Moran, PLLC

Grand Rapids, Michigan  
March 26, 2010

ChoiceOne Financial Services, Inc.  
**CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

	December 31	
	2009	2008
<b>Assets</b>		
Cash and due from banks.....	\$ 9,957	\$ 9,252
Federal funds sold .....	9,793	1,908
Cash and cash equivalents .....	19,750	11,160
Securities available for sale (Note 2).....	74,413	77,368
Federal Home Loan Bank stock .....	3,304	3,304
Federal Reserve Bank stock .....	1,270	1,269
Loans held for sale .....	322	316
Loans (Note 3).....	322,716	325,977
Allowance for loan losses (Note 5) .....	(4,322)	(3,600)
Loans, net .....	318,394	322,377
Premises and equipment, net (Note 6).....	11,918	11,745
Other real estate owned, net (Note 8).....	2,201	3,692
Loan servicing rights, net (Note 4).....	491	580
Cash value of life insurance policies .....	9,201	8,873
Intangible assets, net (Note 7) .....	3,068	3,537
Goodwill (Note 7) .....	13,728	13,728
Other assets .....	7,855	5,602
Total assets .....	\$ 465,915	\$ 463,551
<b>Liabilities</b>		
Deposits – noninterest-bearing (Note 9).....	\$ 60,802	\$ 54,511
Deposits – interest-bearing (Note 9).....	304,208	292,487
Total deposits .....	365,010	346,998
Repurchase agreements (Note 10).....	20,684	18,786
Advances from Federal Home Loan Bank (Note 11) .....	21,980	39,957
Other liabilities (Notes 12 and 14) .....	5,315	5,625
Total liabilities.....	412,989	411,366
<b>Shareholders' Equity</b>		
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: 3,265,714 in 2009 and 3,246,109 in 2008 (Note 15) .....	46,326	46,171
Retained earnings .....	5,813	5,898
Accumulated other comprehensive income, net (Note 17) .....	787	116
Total shareholders' equity .....	52,926	52,185
Total liabilities and shareholders' equity.....	\$ 465,915	\$ 463,551

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.  
**CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except per share data)

	Years ended December 31		
	2009	2008	2007
<b>Interest income</b>			
Loans, including fees.....	\$ 19,915	\$ 22,641	\$ 24,794
Securities			
Taxable.....	1,390	2,105	2,237
Tax exempt.....	1,774	1,722	1,655
Other.....	7	66	79
<b>Total interest income</b> .....	<b>23,086</b>	26,534	28,765
<b>Interest expense</b>			
Deposits.....	5,553	8,932	11,456
Advances from Federal Home Loan Bank.....	1,186	1,704	1,405
Other borrowings.....	351	567	761
<b>Total interest expense</b> .....	<b>7,090</b>	11,203	13,622
<b>Net interest income</b> .....	<b>15,996</b>	15,331	15,143
<b>Provision for loan losses</b> (Note 5).....	<b>4,875</b>	3,475	2,035
<b>Net interest income after provision for loan losses</b> .....	<b>11,121</b>	11,856	13,108
<b>Noninterest income</b>			
Customer service charges.....	3,177	3,280	3,321
Insurance and investment commissions.....	690	769	1,137
Gain on sale of insurance book of business.....	—	—	875
Gains on sales of loans (Note 4).....	601	215	287
Gains (losses) on sales of securities (Note 2).....	402	(401)	13
Loss on other than temporary impairment of securities (Note 2).....	(47)	(432)	—
Losses on sales of other assets (Note 8).....	(434)	(204)	(149)
Earnings on life insurance policies.....	365	373	364
Other income.....	667	483	633
<b>Total noninterest income</b> .....	<b>5,421</b>	4,083	6,481
<b>Noninterest expense</b>			
Salaries and benefits (Notes 14 and 15).....	6,902	7,140	7,709
Occupancy and equipment (Note 6).....	2,227	2,163	2,190
Data processing.....	1,599	1,386	1,470
Professional fees.....	629	645	589
Supplies and postage.....	504	537	505
Advertising and promotional.....	124	152	306
Intangible asset amortization (Note 7).....	469	494	498
FDIC insurance.....	785	267	63
Other expense.....	2,020	1,927	1,740
<b>Total noninterest expense</b> .....	<b>15,259</b>	14,711	15,070
<b>Income before income tax</b> .....	<b>1,283</b>	1,228	4,519
<b>Income tax expense/(benefit)</b> (Note 12).....	<b>(195)</b>	(207)	939
<b>Net income</b> .....	<b>\$ 1,478</b>	\$ 1,435	\$ 3,580
<b>Basic earnings per common share</b> (Note 16).....	<b>\$ 0.45</b>	\$ 0.44	\$ 1.11
<b>Diluted earnings per common share</b> (Note 16).....	<b>\$ 0.45</b>	\$ 0.44	\$ 1.10
<b>Dividends declared per common share</b> .....	<b>\$ 0.48</b>	\$ 0.68	\$ 0.68

See accompanying notes to consolidated financial statements.

ChoiceOne Financial Services, Inc.  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(Dollars in thousands, except per share data)

	Number of Shares	Common Stock and Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Total
Balance, January 1, 2007	3,250,629	\$ 46,253	\$ 5,285	\$ (19)	\$ 51,519
Comprehensive income:					
Net income			3,580		3,580
Net change in unrealized gain (loss) on securities available for sale, net of tax of \$198				384	384
Net change in funded status of post-retirement benefit plan				156	156
Total comprehensive income					<u>4,120</u>
Shares issued	11,885	169			169
Shares repurchased	(32,700)	(537)			(537)
Change in ESOP repurchase obligation		28			28
Effect of stock options granted		31			31
Effect of employee stock purchases		12			12
Cash dividends declared (\$0.68 per share)			(2,200)		(2,200)
Balance, December 31, 2007	3,229,814	\$ 45,956	\$ 6,665	\$ 521	\$ 53,142
Comprehensive income:					
Net income			1,435		1,435
Net change in unrealized gain (loss) on securities available for sale, net of tax of (\$228)				(442)	(442)
Net change in funded status of post-retirement benefit plan				37	37
Total comprehensive income					<u>1,030</u>
Shares issued	16,295	147			147
Change in ESOP repurchase obligation		23			23
Effect of stock options granted		33			33
Effect of employee stock purchases		12			12
Cash dividends declared (\$0.68 per share)			(2,202)		(2,202)
Balance, December 31, 2008	3,246,109	\$ 46,171	\$ 5,898	\$ 116	\$ 52,185
Comprehensive income:					
Net income			1,478		1,478
Net change in unrealized gain (loss) on securities available for sale, net of tax of \$343				665	665
Net change in funded status of post-retirement benefit plan				6	6
Total comprehensive income					<u>2,149</u>
Shares issued	19,605	126			126
Change in ESOP repurchase obligation		(4)			(4)
Effect of stock options granted		22			22
Effect of employee stock purchases		11			11
Cash dividends declared (\$0.48 per share)			(1,563)		(1,563)
Balance, December 31, 2009	<u>3,265,714</u>	<u>\$ 46,326</u>	<u>\$ 5,813</u>	<u>\$ 787</u>	<u>\$ 52,926</u>

See accompanying notes to consolidated financial statements.



ChoiceOne Financial Services, Inc.  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

	Years ended December 31		
	2009	2008	2007
<b>Cash flows from operating activities:</b>			
Net income .....	\$ 1,478	\$ 1,435	\$ 3,580
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses.....	4,875	3,475	2,035
Depreciation .....	974	844	832
Amortization.....	1,102	996	978
Compensation expense on stock options and employee purchases.....	33	45	43
Losses (gains) on sales of securities .....	(402)	401	(13)
Loss on other than temporary impairment of securities .....	47	432	—
Gains on sales of loans .....	(601)	(215)	(287)
Loans originated for sale .....	(27,598)	(12,249)	(15,700)
Proceeds from loan sales .....	27,983	12,198	16,015
Earnings on bank-owned life insurance .....	(365)	(373)	(364)
Losses on sales of other real estate owned .....	449	213	162
Write-downs of other real estate owned .....	442	205	96
Proceeds from sales of other real estate owned .....	3,758	1,065	1,241
Deferred federal income tax expense/(benefit).....	(410)	(644)	274
Net change in:			
Other assets .....	(2,289)	372	45
Other liabilities .....	(241)	(970)	(2,423)
Net cash from operating activities .....	<b>9,235</b>	<b>7,230</b>	<b>6,514</b>
<b>Cash flows from investing activities:</b>			
Sales of securities available for sale .....	8,171	2,540	3,897
Maturities, prepayments and calls of securities available for sale .....	27,180	22,206	23,196
Purchases of securities available for sale.....	(31,269)	(20,603)	(32,294)
Purchase of Federal Reserve Bank stock.....	(1)	(4)	(588)
Loan originations and payments, net .....	(4,381)	(4,760)	371
Additions to premises and equipment.....	(816)	(764)	(528)
Purchase of investment book of business .....	—	—	(347)
Purchase of bank-owned life insurance .....	—	—	(150)
Net cash from investing activities.....	<b>(1,116)</b>	<b>(1,385)</b>	<b>(6,443)</b>
<b>Cash flows from financing activities:</b>			
Net change in deposits.....	18,012	(4,846)	(14,536)
Net change in repurchase agreements.....	1,898	(2,924)	6,697
Net change in federal funds purchased .....	—	—	(460)
Proceeds from Federal Home Loan Bank advances .....	37,000	50,000	31,000
Payments on Federal Home Loan Bank advances .....	(55,002)	(46,000)	(19,000)
Issuance of common stock.....	126	147	169
Repurchase of common stock.....	—	—	(537)
Cash dividends and fractional shares from stock dividends .....	(1,563)	(2,202)	(2,200)
Net cash from financing activities .....	<b>471</b>	<b>(5,825)</b>	<b>1,133</b>
Net change in cash and cash equivalents .....	<b>8,590</b>	<b>20</b>	<b>1,204</b>
Beginning cash and cash equivalents.....	<b>11,160</b>	<b>11,140</b>	<b>9,936</b>
Ending cash and cash equivalents.....	<b>\$ 19,750</b>	<b>\$ 11,160</b>	<b>\$ 11,140</b>

**Supplemental disclosures:**

Cash paid for interest.....	\$ 7,288	\$ 11,519	\$ 13,971
Cash paid for income taxes.....	31	575	945
Loans transferred to other real estate owned .....	3,489	3,666	898
Other real estate owned transferred to premises and equipment.....	331	—	—

See accompanying notes to consolidated financial statements.

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

**Note 1 – Summary of Significant Accounting Policies**

**Principles of Consolidation**

The consolidated financial statements include ChoiceOne Financial Services, Inc., its wholly-owned subsidiary, ChoiceOne Bank, and ChoiceOne Bank's wholly-owned subsidiary, ChoiceOne Insurance Agencies, Inc., and its former wholly-owned subsidiary, ChoiceOne Mortgage Company of Michigan, (together referred to as "ChoiceOne"). Intercompany transactions and balances have been eliminated in consolidation.

**Nature of Operations**

ChoiceOne Bank (the "Bank") is a full-service community bank that offers commercial, consumer, and real estate loans as well as traditional demand, savings and time deposits to both commercial and consumer clients in portions of Kent, Muskegon, Newaygo, and Ottawa counties in Michigan. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and real estate. Commercial loans are expected to be repaid from the cash flows from operations of businesses. Real estate loans are collateralized by either residential or commercial real estate.

ChoiceOne Mortgage Company of Michigan (the "Mortgage Company") originated and sold a full line of conventional type mortgage loans for 1-4 family and multi-family residential real estate properties. It also originated second mortgages on residential real estate with home equity term loans and lines of credit. Effective December 31, 2008, ChoiceOne consolidated the operations of the Mortgage Company into the Bank and eliminated the mortgage company subsidiary.

ChoiceOne Insurance Agencies, Inc. (the "Insurance Agency") is a wholly-owned subsidiary of the Bank. The Insurance Agency sells insurance policies such as life and health for both commercial and consumer clients. The Insurance Agency also offers alternative investment products such as annuities and mutual funds through a registered broker.

Together, the Bank, the former Mortgage Company, and the Insurance Agency, account for substantially all of ChoiceOne's assets, revenues and operating income.

**Use of Estimates**

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, ChoiceOne's management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided. Actual results may differ from these estimates. Estimates associated with the allowance for loan losses, other real estate owned, core deposit intangible assets, loan servicing rights, goodwill, and fair values of certain financial instruments are particularly susceptible to change.

**Cash and Cash Equivalents**

Cash and cash equivalents are defined to include cash on hand, demand deposits with other banks, and federal funds sold. Cash flows are reported on a net basis for customer loan and deposit transactions, deposits with other financial institutions, and short-term borrowings with original terms of 90 days or less.

**Securities**

Securities are classified as available for sale because they might be sold before maturity. Securities classified as available for sale are carried at fair value, with unrealized holding gains and losses reported separately in the accumulated other comprehensive income or loss section of shareholders' equity, net of tax effect. Restricted investments in Federal Reserve Bank stock and Federal Home Loan Bank stock are carried at cost. Equity securities consist of investments in preferred stock, trust-preferred securities, and investments in common stock of other financial institutions.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized using the level-yield method without anticipating prepayments. Gains or losses on sales are recorded on the trade date based on the amortized cost of the security sold.

Declines in the fair value of securities below their cost that are other than temporary are reflected as recognized losses. In estimating other than temporary losses, management considers: the length of time and extent that fair value has been less than cost, the financial condition and near-term prospects of the issuer, and ChoiceOne's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

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

**Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loans held for sale are reported at the lower of cost or market, on an aggregate basis.

Interest income on loans is reported on the interest method and includes amortization of net deferred loan fees and costs over the estimated loan term. Interest on loans is accrued based upon the principal balance outstanding. The accrual of interest is discontinued at the time at which commercial loans are 90 days past due unless the loan is secured by sufficient collateral and in the process of collection. Interest on consumer or real estate secured loans is discontinued at the time at which the loan is 120 days past due unless the credit is secured by sufficient collateral and in the process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed into nonaccrual status or charged off at an earlier date if collection of principal or interest is considered doubtful. Interest accrued but not received is reversed against interest income when the loans are placed into nonaccrual status. Interest received on such loans is applied to principal until qualifying for return to accrual. Loans are returned to accrual basis when all the principal and interest amounts contractually due are brought current and future payment is reasonably assured.

**Allowance for Loan Losses**

The allowance for loan losses is a valuation allowance for probable incurred credit losses. The allowance is increased by the provision for loan losses and decreased by loans charged off less any recoveries of charged off loans. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the collectibility of a loan balance is not possible.

The allowance consists of general and specific components. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful.

A loan is impaired when full payment under the loan terms is not expected. Commercial loans are evaluated for impairment on an individual loan basis. If a loan is considered impaired, a portion of the allowance for loan losses is allocated to the loan so that it is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans such as consumer and real estate mortgage loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

**Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation. Land is carried at cost. Land improvements are depreciated using the straight-line method with useful lives ranging from 7 to 15 years. Building and related components are depreciated using the straight-line method with useful lives ranging from 5 to 39 years. Leasehold improvements are depreciated over the shorter of the estimated life or the lease term. Furniture and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Fixed assets are periodically reviewed for impairment when events indicate their carrying amounts may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

**Other Real Estate Owned**

Real estate properties acquired in the collection of a loan are initially recorded at fair value at acquisition establishing a new cost basis. Any reduction to fair value from the carrying value of the related loan is accounted for as a loan loss. After acquisition, a valuation allowance reduces the reported amount to the lower of the initial amount or fair value less costs to sell. Expenses to repair or maintain properties are included within other noninterest expenses. Gains and losses upon disposition and changes in the valuation allowance are reported net within other noninterest income.

**Loan Servicing Rights**

Servicing rights represent the allocated value of servicing rights on loans sold with servicing retained. Servicing rights are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the rights, using groupings of the underlying loans as to interest rates and then, secondarily, as to geographic and prepayment characteristics. Fair value is determined using prices for similar assets with similar characteristics when available or based upon discounted cashflows using market-based assumptions. Any impairment of a grouping is reported as a valuation allowance.

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

**Goodwill**

Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of the acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment will be recognized in the period identified.

**Loan Commitments and Related Financial Instruments**

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit issued to meet financing needs of customers. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

**Employee Benefit Plans**

ChoiceOne's 401(k) plan allows participants to contribute up to the IRS maximum. Contributions from ChoiceOne to its 401(k) plan are discretionary. ChoiceOne also allows retired employees to participate in its health insurance plan. Employees who have attained age 55 and completed at least ten years of service to ChoiceOne are eligible to participate as a retiree until they are eligible for Medicare. These postretirement benefits are accrued during the years in which the employee provides service.

**Employee Stock Ownership Plan**

The cost of shares issued to the Employee Stock Ownership Plan (the "ESOP") but not yet allocated to participants is presented as a reduction of shareholders' equity. Compensation expense is recorded based on the market price of the shares as they are committed to be released for allocation to participant accounts. The difference between the market price and the cost of shares committed to be released is recorded as an adjustment to additional paid-in capital. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings while dividends on unallocated ESOP shares are reflected as a reduction of debt and accrued interest. Upon distribution of shares to a participant, the participant has the right to require the Company to purchase his or her shares at fair value in accordance with the terms and conditions of the ESOP. As such, these shares are not classified in shareholders' equity as permanent equity.

**Income Taxes**

Income tax expense is the sum of the current year income tax due and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

**Earnings Per Share**

Basic earnings per common share ("EPS") is based on weighted-average common shares outstanding. The weighted-average number of shares used in the computation of basic and diluted EPS includes shares allocated to the ESOP. Diluted EPS further assumes issue of any dilutive potential common shares issuable under stock options. Earnings and dividends per share are restated for stock dividends and splits through the issue date of the financial statements.

**Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income or loss. Other comprehensive income or loss includes unrealized gains and losses on securities available for sale, net of tax, and changes in the funded status of postretirement plans which are also recognized as a separate component of shareholders' equity.

**Loss Contingencies**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe that there are any such matters that may have a material effect on the financial statements.

**Cash Restrictions**

Cash on hand or on deposit with the Federal Reserve Bank of \$221,000 and \$172,000 was required to meet regulatory reserve and clearing requirements at December 31, 2009 and 2008, respectively. The balance in excess of the amount required was interest-bearing as of December 31, 2009 and December 31, 2008.

**Stock Dividends**

Dividends issued in stock are reported by transferring the market value of the stock issued from retained earnings to common stock and additional paid-in capital. Fractional shares resulting from stock dividends are paid in cash.

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

**Stock-Based Compensation**

ChoiceOne records stock-based compensation cost using the fair value method. Compensation costs related to stock options granted is disclosed in Note 15.

**Dividend Restrictions**

Banking regulations require the maintenance of certain capital levels and may limit the amount of dividends that may be paid by the Bank to ChoiceOne (see Note 22).

**Fair Value of Financial Instruments**

Fair values of financial instruments are estimated using relevant market information and other assumptions, which are more fully documented in Note 19 to the consolidated financial statements. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

**Operating Segments**

While ChoiceOne's management monitors the revenue streams of various products and services for the Bank and Insurance Agency, operations and financial performance are evaluated on a company-wide basis. Accordingly, all of the financial service operations are considered by management to be aggregated into one reportable operating segment.

**Recent Accounting Pronouncements**

The Financial Accounting Standards Board issued new guidance in 2009 on the accounting for transfers of financial assets. The new guidance eliminates the concept of a qualifying special-purpose entity. Other changes from current accounting standards include new de-recognition criteria for a transfer to be accounted for as a sale, and a change to the amount of recognized gain/loss on transfers accounted for as a sale when beneficial interests are received by the transferor. This new standard will be applied prospectively to new transfers of financial assets and will be effective in the first quarter of 2010. Early application is prohibited. ChoiceOne believes that the impact of this new standard is not likely to have a material impact on its financial statements.

**Reclassifications**

Certain amounts presented in prior year consolidated financial statements have been reclassified to conform to the current year's presentation.

**Note 2 – Securities**

The fair value of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) at December 31 were as follows:

(Dollars in thousands)

	2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agency .....	\$ 18,550	\$ 108	\$ (87)	\$ 18,571
State and municipal .....	44,230	699	(330)	44,599
Mortgage-backed .....	8,672	285	(28)	8,929
Equity securities .....	2,069	385	(140)	2,314
Total .....	\$ 73,521	\$ 1,477	\$ (585)	\$ 74,413

(Dollars in thousands)

	2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agency .....	\$ 13,999	\$ 222	\$ –	\$ 14,221
State and municipal .....	49,148	529	(611)	49,066
Mortgage-backed .....	11,705	253	(56)	11,902
Corporate .....	199	–	(1)	198
Equity securities .....	2,433	66	(518)	1,981
Total .....	\$ 77,484	\$ 1,070	\$ (1,186)	\$ 77,368

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Information regarding sales of securities available for sale follows:

(Dollars in thousands)

	<u>2009</u>		<u>2008</u>		<u>2007</u>
Proceeds from sales of securities.....	\$ 8,171	\$	2,540	\$	3,897
Gross realized gains.....	414		39		23
Gross realized losses .....	12		440		10
Loss on other than temporary impairment ...	47		432		-

Contractual maturities of securities available for sale at December 31, 2009 were as follows:

(Dollars in thousands)

	<u>Fair Value</u>
Due within one year.....	\$ 21,282
Due after one year through five years.....	22,917
Due after five years through ten years .....	17,879
Due after ten years.....	1,092
Total debt securities .....	63,170
Mortgage-backed securities, not due at a specific date.....	8,929
Equity securities .....	2,314
Total .....	<u>\$ 74,413</u>

Various securities were pledged as collateral for securities sold under agreements to repurchase and for Treasury, Tax, and Loan accounts. The carrying amount of securities pledged as collateral at December 31 was as follows:

(Dollars in thousands)

	<u>2009</u>		<u>2008</u>
Securities pledged for securities sold under agreements to repurchase .....	\$ 24,800	\$	19,309
Securities pledged for Treasury, Tax, and Loan accounts .....	521		529
Total securities pledged as collateral.....	<u>\$ 25,321</u>	\$	<u>19,838</u>

Securities with unrealized losses at year-end 2009 and 2008, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position, were as follows:

(Dollars in thousands)

	<u>2009</u>					
	<u>Less than 12 months</u>		<u>More than 12 months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
U.S. Government and federal agency.....	\$ 8,033	\$ (87)	\$ -	\$ -	\$ 8,033	\$ (87)
State and municipal .....	9,211	(244)	1,771	(86)	10,982	(330)
Mortgage-backed.....	1,465	(28)	-	-	1,465	(28)
Equity .....	-	-	860	(140)	860	(140)
Total temporarily impaired.....	<u>\$ 18,709</u>	<u>\$ (359)</u>	<u>\$ 2,631</u>	<u>\$ (226)</u>	<u>\$ 21,340</u>	<u>\$ (585)</u>

(Dollars in thousands)

	<u>2008</u>					
	<u>Less than 12 months</u>		<u>More than 12 months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
State and municipal .....	\$ 15,103	\$ (526)	\$ 2,427	\$ (85)	\$ 17,530	\$ (611)
Mortgage-backed.....	1,959	(47)	194	(9)	2,153	(56)
Corporate.....	-	-	198	(1)	198	(1)
Equity .....	482	(518)	-	-	482	(518)
Total temporarily impaired.....	<u>\$ 17,544</u>	<u>\$ (1,091)</u>	<u>\$ 2,819</u>	<u>\$ (95)</u>	<u>\$ 20,363</u>	<u>\$ (1,186)</u>

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One municipal security with a fair value of \$325,000 was considered to be other than temporary impaired as of December 31, 2009. The security defaulted upon its maturity of September 1, 2009. An impairment loss of \$47,000 was recorded in December 2009 due to uncertainty as to when principal repayment will be received. In the case of the remaining state and municipal securities, ChoiceOne does not intend to sell the securities prior to a recovery in their value nor is it likely that ChoiceOne would be forced to sell them. Equity securities included a Money Market Preferred auction rate security (MMP) with a fair value of \$860,000 as of December 31, 2009. Auctions remain active for the MMP and interest payments have remained current.

An impairment loss of \$432,000 was recorded in December 2008 when a decline in the market value of an MMP was considered to be other than temporary. The MMP was converted to 40,000 shares of preferred stock in January 2009 when auction activity ceased and the collateral supporting the MMP was unwound. A gain of \$32,000 was recognized upon the conversion. Subsequent to the conversion, ChoiceOne sold 15,000 shares in 2009 for a gain of \$92,000. An unrealized gain of \$199,000 on the remaining shares was recorded as other comprehensive income as of December 31, 2009.

ChoiceOne evaluates all securities for other than temporary impairment at least on a semi-annual basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of ChoiceOne to retain its investment in the issue for a period of time sufficient to allow for any anticipated recovery in fair value. Except for the impairments described in the previous paragraphs, no other than temporary impairments were recorded in 2009 or 2008.

**Note 3 – Loans**

The Bank's loan portfolio as of December 31 was as follows:

(Dollars in thousands)

	<u>2009</u>	<u>2008</u>
Agricultural .....	\$ 31,322	\$ 23,408
Commercial and industrial.....	53,964	57,587
Consumer.....	16,285	16,047
Real estate – commercial.....	121,100	123,952
Real estate - construction.....	1,158	2,026
Real estate - residential.....	98,887	102,957
Loans, gross .....	<u>322,716</u>	<u>325,977</u>
Allowance for loan losses.....	<u>(4,322)</u>	<u>(3,600)</u>
Loans, net .....	<u>\$ 318,394</u>	<u>\$ 322,377</u>

**Note 4 – Mortgage Banking**

Activity during the year was as follows:

(Dollars in thousands)

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Loans originated for resale, net of principal payments .....	\$ 27,598	\$ 12,249	\$ 15,700
Proceeds from loan sales .....	27,983	12,198	16,015
Net gains on sales of loans held for sale.....	601	215	287
Loan servicing fees, net of amortization.....	4	67	85

Loans serviced for others are not reported as assets in the accompanying consolidated balance sheets. The unpaid principal balances of these loans were \$117 million and \$121 million at December 31, 2009 and 2008, respectively. The Bank maintains custodial escrow balances in connection with these serviced loans; however, such escrows were immaterial at December 31, 2009 and 2008.

Activity for loan servicing rights was as follows:

(Dollars in thousands)

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Balance, beginning of year .....	\$ 580	\$ 792	\$ 992
Capitalized.....	210	51	108
Amortization.....	(299)	(263)	(308)
Balance, end of year .....	<u>\$ 491</u>	<u>\$ 580</u>	<u>\$ 792</u>

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The fair value of loan servicing rights was \$1,048,000 and \$1,405,000 as of December 31, 2009 and 2008, respectively. Consequently, a valuation allowance was not necessary at year-end 2009 or 2008. The fair value of servicing rights at December 31, 2009 was determined using a discount rate of 7.6% and prepayment speeds ranging from 0% to 17%. The fair value of servicing rights at December 31, 2008 was determined using a discount rate of 7.9% and prepayment speeds ranging from 0% to 14%.

**Note 5 – Allowance for Loan Losses**

Activity in the allowance for loan losses was as follows:

(Dollars in thousands)

	2009		2008		2007
Balance, beginning of year .....	\$ 3,600	\$	3,600	\$	3,569
Provision charged to expense .....	4,875		3,475		2,035
Recoveries credited to the allowance .....	541		353		295
Loans charged off .....	(4,694)		(3,828)		(2,299)
Balance, end of year .....	<u>\$ 4,322</u>	\$	<u>3,600</u>	\$	<u>3,600</u>

Information regarding nonperforming loans for the years ended December 31 follows:

(Dollars in thousands)

	2009		2008
Nonaccrual loans .....	\$ 11,881	\$	8,305
Loans past due over 90 days still on accrual .....	202		333
Loans considered troubled debt restructurings which are not included above...	1,919		605
Total .....	<u>\$ 14,002</u>	\$	<u>9,243</u>

Nonperforming loans includes both smaller balance homogenous loans that are collectively evaluated for impairment and loans individually classified as impaired loans. Information regarding impaired loans as of and for the year ended December 31 follows:

(Dollars in thousands)

	2009		2008		2007
Loans with no allowance allocated at year end.....	\$ 5,062	\$	5,576	\$	7,381
Loans with allowance allocated at year end.....	4,685		2,087		2,160
Amount of allowance for loan losses allocated at year end .....	1,096		520		854
Average balance during the year .....	8,248		5,540		7,026
Interest income recognized thereon.....	77		142		237
Cash-basis interest income recognized .....	-		1		12

**Note 6 – Premises and Equipment**

As of December 31, premises and equipment consisted of the following:

(Dollars in thousands)

	2009		2008
Land and land improvements.....	\$ 3,918	\$	3,576
Leasehold improvements .....	37		47
Buildings .....	10,595		10,110
Furniture and equipment.....	3,312		3,650
Total cost.....	<u>17,862</u>		<u>17,383</u>
Accumulated depreciation .....	(5,944)		(5,638)
Premises and equipment, net .....	<u>\$ 11,918</u>	\$	<u>11,745</u>

Depreciation expense was \$974,000, \$844,000, and \$832,000 for 2009, 2008 and 2007, respectively.



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The Bank leases certain branch properties and automated-teller machine locations in its normal course of business. Rent expense totaled \$71,000, \$70,000, and \$69,000 for 2009, 2008 and 2007, respectively. Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that generally are present (dollars in thousands):

2010.....	<u>\$</u>	<u>46</u>
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**Note 7 - Goodwill and Intangible Assets**

**Goodwill**

There were no changes in the goodwill balance in 2009 or 2008. ChoiceOne performed its annual evaluation of goodwill for impairment as of June 30, 2009 and determined that no impairment existed. As a result of market conditions that caused the market value of bank stocks to decline in the second half of 2009, the evaluation was updated as of October 31, 2009. Based on the testing performed, which included review of acquisition values of Midwest area banks during 2009, no impairment of goodwill was deemed to exist as of December 31, 2009.

**Acquired Intangible Assets**

Information for acquired intangible assets at December 31 follows:

(Dollars in thousands)

	2009		2008	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Core deposit intangible.....	\$ 4,134	\$ 1,309	\$ 4,134	\$ 896
Other intangible assets.....	473	230	473	174
Totals.....	<u>\$ 4,607</u>	<u>\$ 1,539</u>	<u>\$ 4,607</u>	<u>\$ 1,070</u>

The core deposit intangible is being amortized on a straight-line basis over ten years and other intangible assets are being amortized over periods ranging from two to ten years. Aggregate amortization expense was \$469,000, \$494,000 and \$498,000 for 2009, 2008 and 2007, respectively. The estimated amortization expense for the next five years ending December 31 is as follows:

(Dollars in thousands)

	Core Deposit Intangible	Other Intangible Assets	Total
2010.....	\$ 413	\$ 35	\$ 448
2011.....	413	35	448
2012.....	413	35	448
2013.....	413	35	448
2014.....	413	35	448
Thereafter.....	760	68	828
Total.....	<u>\$ 2,825</u>	<u>\$ 243</u>	<u>\$ 3,068</u>

**Note 8 – Other Real Estate Owned**

Other real estate owned represents residential and commercial properties owned and is reported net of a valuation allowance. Activity within other real estate owned was as follows:

(Dollars in thousands)

	2009	2008
Balance, beginning of year.....	\$ 3,692	\$ 1,509
Transfers from loans.....	3,489	3,666
Reclassification to buildings.....	(331)	—
Proceeds from sales.....	(3,758)	(1,065)
Losses on sales.....	(449)	(213)
Write-downs.....	(442)	(205)
Balance, end of year.....	<u>\$ 2,201</u>	<u>\$ 3,692</u>

ChoiceOne Financial Services, Inc.  
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Activity in the valuation allowance on other real estate owned was as follows:

(Dollars in thousands)

	2009		2008		2007
Balance, beginning of year .....	\$ 206	\$	30	\$	223
Write-downs charged to expense .....	442		205		96
Deletions from sales of other real estate owned .....	(210)		(29)		(289)
Balance, end of year .....	<u>\$ 438</u>	\$	<u>206</u>	\$	<u>30</u>

**Note 9 – Deposits**

Deposit balances as of December 31 consisted of the following:

(Dollars in thousands)

	2009		2008
Noninterest-bearing demand deposits .....	\$ 60,802	\$	54,511
Interest-bearing demand deposits .....	43,731		35,213
Money market deposits .....	58,094		46,900
Savings deposits .....	36,791		32,764
Local certificates of deposit .....	159,217		157,892
Brokered certificates of deposit .....	6,375		19,718
Total deposits .....	<u>\$ 365,010</u>	\$	<u>346,998</u>

Scheduled maturities of certificates of deposit at December 31 were as follows:

(Dollars in thousands)

2010 .....	\$ 116,722
2011 .....	30,226
2012 .....	11,551
2013 .....	3,926
2014 .....	2,989
2015 .....	178
Total .....	<u>\$ 165,592</u>

The Bank had certificates of deposit issued in denominations of \$100,000 or greater totaling \$68.4 million and \$76.6 million at December 31, 2009 and 2008, respectively. The Bank had brokered certificates of deposit totaling \$6.4 million at December 31, 2009 compared to \$19.7 million at December 31, 2008. As of December 31, 2009, the weighted average interest rate on these brokered certificates of deposit was 1.16% with maturities ranging from February 2010 to May 2011. In addition, the Bank had \$20.0 million of certificates of deposit as of December 31, 2009 that had been issued through the Certificate of Deposit Account Registry Service (CDARS). Although certificates of deposit issued through CDARS are issued to local customers, this type of deposit is classified as brokered deposits for regulatory purposes.

**Note 10 – Repurchase Agreements**

Securities sold under agreements to repurchase are advances to the Bank by customers or another bank. These agreements are direct obligations of the Bank and are secured by securities held in safekeeping at a correspondent bank. Most repurchase agreements with Bank customers mature daily. The Bank had a \$500,000 term repurchase agreement with a Bank customer as of December 31, 2009 that matures in 2010. As of December 31, 2009, the Bank had a \$5 million structured repurchase agreement with a correspondent bank maturing on July 31, 2012 with a fixed interest rate of 4.55%. The repurchase agreement is puttable by the correspondent quarterly starting July 1, 2009. Information regarding repurchase agreements follows:

ChoiceOne Financial Services, Inc.  
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(Dollars in thousands)

	<u>2009</u>		<u>2008</u>
Outstanding balance at December 31 .....	\$ 20,684	\$	18,786
Average interest rate at December 31 .....	1.64%		2.13%
Average balance during the year .....	\$ 18,419	\$	18,632
Average interest rate during the year .....	1.88%		2.93%
Maximum month end balance during the year .....	\$ 20,684	\$	19,754

**Note 11 – Federal Home Loan Bank Advances**

At December 31, advances from the Federal Home Loan Bank (the “FHLB”) were as follows:

(Dollars in thousands)

	<u>2009</u>		<u>2008</u>
Maturities ranging from January 2010 to November 2024, fixed interest rates ranging from 3.98% to 5.95%, with an average rate of 4.55% .....	\$ 21,980		
Maturities ranging from March 2009 to January 2013, fixed interest rates ranging from 2.54% to 5.95%, with an average rate of 4.69% .....		\$	27,957
Maturities ranging from February 2009 to June 2009, floating interest rates, ranging from 0.46% to 0.65%, with an average rate of 0.60% .....			12,000
Total advances outstanding at year-end .....	<u>\$ 21,980</u>	<u>\$</u>	<u>39,957</u>

Penalties are charged on fixed rate advances that are paid prior to maturity. No fixed rate advances were paid prior to maturity in 2009, 2008 or 2007. An advance maturing in 2012 may be converted to a variable rate by the FHLB. If the FHLB exercises its option the Bank may prepay the advance without penalty. Advances were secured by residential real estate loans with a carrying value of approximately \$83.3 million at December 31, 2009 and by residential real estate loans with a carrying value of approximately \$77.5 million at December 31, 2008. Based on this collateral, the Bank was eligible to borrow an additional \$26.1 million at year-end 2009. The scheduled maturities of advances from the FHLB at December 31, 2009 were as follows (dollars in thousands):

2010 .....	\$ 13,507
2011 .....	26
2012 .....	5,027
2013 .....	3,028
2014 .....	29
Thereafter .....	363
Total .....	<u>\$ 21,980</u>

**Note 12 – Income Taxes**

Information as of December 31 and for the year follows:

(Dollars in thousands)

	<u>2009</u>		<u>2008</u>		<u>2007</u>
<u>Provision for Income Taxes</u>					
Current federal income tax expense .....	\$ 215	\$	437	\$	665
Deferred federal income tax expense/(benefit) .....	(410)		(644)		274
Income tax expense/(benefit) .....	<u>\$ (195)</u>	<u>\$</u>	<u>(207)</u>	<u>\$</u>	<u>939</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

	2009	2008	2007
<u>Reconciliation of Income Tax Provision to Statutory Rate</u>			
Income tax computed at statutory federal rate of 34% .....	\$ 436	\$ 418	\$ 1,537
Tax exempt interest income.....	(608)	(644)	(569)
Tax exempt earnings on bank-owned life insurance.....	(124)	(126)	(124)
Nondeductible interest expense.....	44	72	86
Other items.....	57	73	9
Income tax expense/(benefit).....	\$ (195)	\$ (207)	\$ 939
Effective income tax rate.....	(15)%	(17)%	21%

	2009	2008
<u>Components of Deferred Tax Assets and Liabilities</u>		
Deferred tax assets:		
Allowance for loan losses.....	\$ 1,214	\$ 908
Deferred compensation.....	426	522
Alternative minimum tax credit carryforward .....	399	241
Purchase accounting adjustments from merger with VRFC .....	184	328
Capital losses on securities.....	179	295
Nonaccrual loan interest.....	154	128
Write downs on other real estate owned.....	113	70
Postretirement benefits obligation.....	—	47
Unrealized losses on securities available for sale.....	—	40
Other.....	121	113
Total deferred tax assets.....	2,790	2,692
Deferred tax liabilities:		
Depreciation.....	1,132	1,252
Purchase accounting adjustments from merger with VRFC .....	1,057	1,236
Unrealized gains on securities available for sale.....	303	—
Loan servicing rights.....	140	138
Stock dividends from Federal Home Loan Bank stock .....	111	111
Postretirement benefits obligation.....	64	—
Other.....	90	129
Total deferred tax liabilities.....	2,897	2,866
Net deferred tax assets (liabilities).....	\$ (107)	\$ (174)

A deferred tax asset of \$295,000 was recorded in 2008 as a result of other than temporary impairment losses recorded on two of ChoiceOne's Money Market Preferred auction rate securities (MMP). If ChoiceOne sells these securities, any loss sustained would be considered a capital loss, which would need to be recovered through offsetting capital gains. Capital losses of \$109,000 were incurred in 2009 upon the sale of the MMPs, of which \$72,000 can be carried back to the 2007 tax year. ChoiceOne's management has identified tax strategies that could be used to generate capital gains to offset any remaining capital losses, if the value of these securities does not recover. Management has not decided if, or when, it would implement these tax strategies.

A valuation allowance related to deferred taxes is recognized when it is considered more likely than not that part or all of the deferred tax benefits will not be realized. Management has determined that no such allowance was required at December 31, 2009 and 2008.

**Note 13 – Related Party Transactions**

Loans to executive officers, directors and their affiliates were as follows at December 31:

(Dollars in thousands)

	2009	2008
Balance, beginning of year .....	\$ 6,266	\$ 5,322
New loans.....	574	2,190
Repayments.....	(1,054)	(1,246)
Balance, end of year.....	\$ 5,786	\$ 6,266

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Deposits from executive officers, directors, and their affiliates were \$11.1 million and \$9.9 million at December 31, 2009 and 2008, respectively.

**Note 14 – Employee Benefit Plans**

401(k) Plan:

The 401(k) plan allows employees to contribute up to the IRS maximum. Matching company contributions to the plan are discretionary. Expense of this plan was \$0, \$141,000, and \$113,000 in 2009, 2008, and 2007, respectively.

Employee Stock Ownership Plan:

Employees participate in an Employee Stock Ownership Plan (the "ESOP"). ChoiceOne makes discretionary contributions to the ESOP. Shares of ChoiceOne common stock are allocated to participants based on relative compensation earned and compensation expense is recorded when allocated. Dividends on allocated shares increase the participant accounts. Participants become fully vested upon completing six years of qualifying service. Participants receive the shares at the end of employment. A participant may require stock received to be repurchased by ChoiceOne at any time. ChoiceOne did not contribute to the ESOP nor was any expense recorded in 2009, 2008, or 2007.

Shares held by the ESOP as of December 31 were as follows:

(Dollars in thousands)

	2009	2008	2007
Shares allocated to participants .....	5,355	5,355	5,355
Shares unallocated .....	–	–	–
Total shares of ChoiceOne stock held by ESOP.....	5,355	5,355	5,355
Fair value of allocated shares, subject to repurchase obligation, recorded in other liabilities.....	\$ 48	\$ 44	\$ 67

Postretirement Benefits Plan:

ChoiceOne maintains an unfunded postretirement health care plan, which permits employees (and their dependents) the ability to participate upon retirement from ChoiceOne. ChoiceOne does not pay any portion of the health care premiums charged to its retired participants. A liability has been accrued for the obligation under this plan. ChoiceOne incurred negative postretirement benefit expense of \$17,000 in 2009 and \$6,000 in 2008. The postretirement obligation liability was \$113,000 as of December 31, 2008 and \$139,000 as of December 31, 2008.

Deferred Compensation Plans:

A deferred director compensation plan covers former directors of Valley Ridge Bank. Under the plan, ChoiceOne pays each former director the amount of director fees deferred plus interest at rates ranging from 2.00% to 5.84% over various periods as elected by each director. The payout periods range from 1 month to 10 years beginning with the individual's termination of service. A liability has been accrued for the obligation under this plan. ChoiceOne incurred deferred compensation plan expense of \$28,000 in 2009 and \$49,000 in 2008. The deferred compensation liability was \$476,000 as of December 31, 2009 and \$802,000 as of December 31, 2008.

A supplemental retirement plan covers four former executive officers of Valley Ridge Bank. Under the plan, ChoiceOne pays these individuals a specific amount of compensation plus interest at 7.50% over a 15-year period commencing upon early retirement age (as defined in the plan) or normal retirement age (as defined in the plan). A liability has been accrued for the obligation under this plan. ChoiceOne incurred deferred compensation plan expense of \$76,000 in 2009 and \$104,000 in 2008. Deferred compensation liabilities of \$778,000 and \$734,000 were outstanding as of December 31, 2009 and December 31, 2008, respectively.

**Note 15 - Stock Options**

Options to buy stock are granted to key employees under an incentive stock option plan to provide them with an additional equity interest in ChoiceOne. The plan provides for the issuance of up to 147,376 shares of common stock. ChoiceOne recognized compensation expense of \$22,000 in 2009, \$33,000 in 2008, and \$31,000 in 2007 in connection with stock options that vested for current participants during these years. The maximum option term is 10 years and options vest over 3 years. At December 31, 2009, there were 98,144 options available for future grants.

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

A summary of the activity in the plan follows:

	2009		2008		2007	
	<b>Weighted average exercise price</b>		Weighted average exercise price		Weighted average exercise price	
	<b>Shares</b>	<b>price</b>	Shares	price	Shares	price
Options outstanding, beginning of year .....	<b>49,232</b>	<b>\$16.46</b>	37,732	\$17.36	30,414	\$17.27
Options granted .....	–	–	11,500	13.50	9,500	17.95
Options exercised .....	–	–	–	–	–	–
Options forfeited or expired .....	–	–	–	–	(2,182)	18.77
Options outstanding, end of year .....	<b>49,232</b>	<b>\$16.46</b>	49,232	\$16.46	37,732	\$17.36
Options exercisable at December 31 .....	<b>41,107</b>	<b>\$16.78</b>	34,357	\$16.89	25,901	\$16.75

The range of prices for options outstanding and exercisable at the end of 2009 ranged from \$13.04 to \$21.43 per share. The weighted average remaining contractual life of options outstanding and exercisable at the end of 2009 was approximately 5.3 years. The exercise price of all options outstanding was higher than ChoiceOne's closing stock price as of the end of 2009. As a result, the aggregate intrinsic value of both options outstanding and options exercisable was \$0 as of December 31, 2009. The numbers of options, weighted average exercise prices, and fair value of options granted have been adjusted for all stock dividends and splits. Information pertaining to options outstanding at December 31, 2009 was as follows:

Exercise price of stock options:	Number of options outstanding at year-end	Number of options exercisable at year-end	Average remaining contractual life (in years)
\$ 13.04 .....	<b>3,857</b>	<b>3,857</b>	<b>2.14</b>
\$ 13.50 .....	<b>11,500</b>	<b>5,750</b>	<b>8.07</b>
\$ 13.70 .....	<b>5,250</b>	<b>5,250</b>	<b>2.99</b>
\$ 16.31 .....	<b>6,299</b>	<b>6,299</b>	<b>4.06</b>
\$ 17.95 .....	<b>9,500</b>	<b>7,125</b>	<b>7.05</b>
\$ 18.85 .....	<b>6,000</b>	<b>6,000</b>	<b>6.05</b>
\$ 21.43 .....	<b>6,826</b>	<b>6,826</b>	<b>5.05</b>

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the weighted average assumptions noted in the following table. ChoiceOne uses historical data to estimate the volatility of the option exercise price and employee terminations within the valuation model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	2009	2008	2007
Expected stock price volatility .....	–	21.96%	24.96%
Dividend yield .....	–	4.41%	3.78%
Expected option life (in years) .....	–	7	7
Risk-free interest rate .....	–	3.02%	4.75%
Fair value of options granted during year .....	\$ –	\$ 1.91	\$ 3.92

During 2009, shares totaling 6,751 were vested at an average exercise price of \$16.26. As of December 31, 2009, there was approximately \$20,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plan. That cost is expected to be recognized by ChoiceOne through 2011.

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

**Note 16 - Earnings Per Share**

(Dollars in thousands, except per share data)

	<u>2009</u>	2008	<u>2007</u>
<u>Basic</u>			
Net income .....	\$ <b>1,478</b>	\$ 1,435	\$ 3,580
Weighted average common shares outstanding .....	<b>3,255,984</b>	3,236,984	3,238,837
Basic earnings per common share .....	<u>\$ <b>0.45</b></u>	<u>\$ 0.44</u>	<u>\$ 1.11</u>
<u>Diluted</u>			
Net income .....	\$ <b>1,478</b>	\$ 1,435	\$ 3,580
Weighted average common shares outstanding .....	<b>3,255,984</b>	3,236,984	3,238,837
Plus: dilutive effect of assumed exercises of stock options .....	-	-	1,178
Average shares and dilutive potential common shares .....	<u><b>3,255,984</b></u>	<u>3,236,984</u>	<u>3,240,015</u>
Diluted earnings per common share .....	<u>\$ <b>0.45</b></u>	<u>\$ 0.44</u>	<u>\$ 1.10</u>

There were 49,232 stock options as of December 31, 2009 and December 31, 2008 considered to be anti-dilutive to earnings per share and thus have been excluded from the calculations above.

**Note 17 - Other Comprehensive Income (Loss)**

Other comprehensive income (loss) components and related taxes follow:

(Dollars in thousands)

	<u>2009</u>	2008	<u>2007</u>
Unrealized holding gains (losses) on available for sale securities .....	\$ <b>1,364</b>	\$ (1,502)	\$ 595
Less reclassification adjustments for gains (losses) included in net income ..	<b>355</b>	(833)	13
Net unrealized gains (losses) .....	<b>1,009</b>	(669)	582
Less tax effect .....	<b>344</b>	(227)	198
Net-of-tax amount .....	<b>665</b>	(442)	384
Change in funded status of postretirement benefit plan .....	<b>9</b>	56	237
Tax effect .....	<b>3</b>	19	81
Net-of-tax amount .....	<b>6</b>	37	156
Total .....	<u>\$ <b>671</b></u>	<u>\$ (405)</u>	<u>\$ 540</u>

Accumulated other comprehensive income, a component of equity, was comprised of the following at December 31:

(Dollars in thousands)

	<u>2009</u>	2008
Unrealized holding gains (losses) on available for sale securities .....	\$ <b>892</b>	\$ (116)
Unrecognized actuarial gains on postretirement benefit plan .....	<b>301</b>	292
Tax effect .....	<b>(406)</b>	(60)
Net accumulated other comprehensive income .....	<u>\$ <b>787</b></u>	<u>\$ 116</u>

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

**Note 18 – Condensed Financial Statements of Parent Company**

**Condensed Balance Sheets**

(Dollars in thousands)	December 31	
	<u>2009</u>	2008
<b>Assets</b>		
Cash.....	\$ 81	\$ 54
Securities available for sale.....	202	736
Other assets.....	59	62
Investment in ChoiceOne Bank.....	52,655	51,379
Total assets.....	<u>\$ 52,997</u>	<u>\$ 52,231</u>
<b>Liabilities</b>		
Mandatory redeemable shares under ESOP, at fair value.....	\$ 48	\$ 44
Other liabilities.....	23	2
Total liabilities.....	<u>71</u>	<u>46</u>
Shareholders' equity.....	<u>52,926</u>	<u>52,185</u>
Total liabilities and shareholders' equity.....	<u>\$ 52,997</u>	<u>\$ 52,231</u>

**Condensed Statements of Income**

(Dollars in thousands)	Years Ended December 31		
	<u>2009</u>	2008	2007
Interest and dividends from ChoiceOne Bank.....	\$ 938	\$ 2,017	\$ 2,347
Interest and dividends from other securities.....	17	27	27
Gains on sales of securities.....	17	18	—
Total income.....	<u>972</u>	<u>2,062</u>	<u>2,374</u>
Other expenses.....	67	61	149
Income before income tax and equity in undistributed net income of subsidiary.....	905	2,001	2,225
Income tax benefit.....	17	26	39
Income before equity in undistributed net income of subsidiary.....	<u>922</u>	<u>2,027</u>	<u>2,264</u>
Equity in undistributed net income (distributions in excess of net income) of subsidiary.....	556	(592)	1,316
Net income.....	<u>\$ 1,478</u>	<u>\$ 1,435</u>	<u>\$ 3,580</u>



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

**Condensed Statements of Cash Flows**

(Dollars in thousands)	Years Ended December 31		
	<b>2009</b>	2008	2007
<b>Cash flows from operating activities:</b>			
Net income .....	\$ 1,478	\$ 1,435	\$ 3,580
Adjustments to reconcile net income to net cash from operating activities:			
Equity in (undistributed net income) distributions in excess of net income of subsidiary.....	(556)	592	(1,316)
Amortization.....	2	2	2
Gains on sales of securities.....	(17)	(18)	—
Changes in other assets.....	3	3	53
Changes in other liabilities .....	30	(13)	7
Net cash from (used in) operating activities .....	<b>940</b>	2,001	2,326
<b>Cash flows from investing activities:</b>			
Sales of securities .....	524	40	—
Net cash from investing activities.....	<b>524</b>	40	—
<b>Cash flows from financing activities:</b>			
Issuance of common stock.....	126	147	169
Repurchase of common stock .....	—	—	(537)
Cash dividends paid.....	(1,563)	(2,202)	(2,200)
Net cash used in financing activities.....	<b>(1,437)</b>	(2,055)	(2,568)
Net change in cash and cash equivalents .....	27	(14)	(242)
Beginning cash and cash equivalents.....	54	68	310
Ending cash and cash equivalents.....	<b>\$ 81</b>	\$ 54	\$ 68

**Note 19 – Financial Instruments**

Financial instruments as of December 31 were as follows:

(Dollars in thousands)	2009		2008	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Assets:</b>				
Cash and due from banks.....	\$ 9,957	\$ 9,957	\$ 9,252	\$ 9,252
Federal funds sold .....	9,793	9,793	1,908	1,908
Securities available for sale .....	74,413	74,413	77,368	77,368
Federal Home Loan Bank and Federal Reserve				
Bank stock.....	4,574	4,574	4,573	4,573
Loans held for sale .....	322	322	316	316
Loans, net .....	318,394	314,491	322,377	318,730
Accrued interest receivable .....	2,091	2,091	2,263	2,263
<b>Liabilities:</b>				
Demand, savings and money market deposits .....	199,418	199,418	169,387	169,387
Time deposits .....	165,592	165,597	177,611	178,050
Repurchase agreements .....	20,684	20,686	18,786	18,811
Advances from Federal Home Loan Bank.....	21,980	21,986	39,957	40,759
Accrued interest payable .....	377	377	575	575

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

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 20. The estimated fair value for loans is based on the rates charged at December 31 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 FHLB advances are based on the rates paid at December 31 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 20 – Fair Value Measurements**

The following tables present information about the Bank's assets and liabilities measured at fair value on a recurring basis at December 31, 2009 and December 31, 2008, 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 December 31, 2009 or December 31, 2008. 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)	Total Balance
<u>Investment securities, available for sale</u>				
<b>December 31, 2009</b>	<b>\$ 30,358</b>	<b>\$ 41,248</b>	<b>\$ 2,807</b>	<b>\$ 74,413</b>
December 31, 2008	\$ 27,908	\$ 46,230	\$ 3,230	\$ 77,368

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

<u>Investment Securities, Available for Sale</u>	
Balance at December 31, 2008	\$ 3,230
Total realized and unrealized gains (losses) included in income	-
Total unrealized gains (losses) included in other comprehensive income	12
Net purchases, sales, calls, and maturities	(273)
Net transfers in (out) of Level 3	<u>(162)</u>
Balance at December 31, 2009	<u>\$ 2,807</u>

Of the Level 3 assets that were still held by the Bank at December 31, 2009, the net unrealized gain for the twelve months ended December 31, 2009 was \$12,000, which is recognized in other comprehensive income in the consolidated balance sheet. There were no sales or purchases of Level 3 securities in 2009.

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

Both observable and unobservable inputs may be used to determine the fair value of positions classified as Level 3 assets 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 consist of bonds issued by local municipalities and a trust preferred security. The Bank estimates the fair value of these assets 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 End of Period	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Change in Fair Value for the Period Ended December 31,
<u>Impaired loans</u>					
<b>December 31, 2009</b>	<b>\$ 9,747</b>	\$ –	\$ –	<b>\$ 9,747</b>	<b>\$ 1,855</b>
December 31, 2008	\$ 7,663	\$ –	\$ –	\$ 7,663	\$ 1,200
<u>Other real estate</u>					
<b>December 31, 2009</b>	<b>\$ 2,201</b>	\$ –	\$ –	<b>\$ 2,201</b>	<b>\$ 319</b>

Impaired loans 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 losses indicated for the periods ended December 31, 2009 and December 31, 2008 consisted of charge-downs that were posted to the allowance for loan losses and write-downs of other real estate that were posted to a valuation account.

**Note 21 – Off-Balance Sheet Activities**

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customers' financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance sheet risk was as follows at December 31:

(Dollars in thousands)

	2009		2008	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Unused lines of credit and letters of credit .....	\$ 4,246	\$ 41,575	\$ 7,087	\$ 39,989
Commitments to fund loans (at market rates) .....	4,683	1,190	1,397	460

Commitments to fund loans are generally made for periods of 180 days or less. The fixed rate loan commitments have interest rates ranging from 4.63% to 7.90% and maturities ranging from 1 year to 15 years.

**Note 22 – Regulatory Capital**

ChoiceOne Bank is subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items

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

calculated under regulatory accounting practices. The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If only adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as are asset growth and expansion, and plans for capital restoration are required. At year-end 2009 and 2008, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's categories.

Actual capital levels and minimum required levels for ChoiceOne Bank were as follows:

(Dollars in thousands)	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	<b>December 31, 2009</b>					
Total capital (to risk weighted assets).....	\$ 39,130	11.9%	\$ 26,278	8.0%	\$ 32,847	10.0%
Tier 1 capital (to risk weighted assets).....	35,073	10.7	13,139	4.0	19,708	6.0
Tier 1 capital (to average assets).....	35,073	8.0	17,450	4.0	21,812	5.0
<b>December 31, 2008</b>						
Total capital (to risk weighted assets).....	\$ 36,941	11.1%	\$ 26,524	8.0%	\$ 33,155	10.0%
Tier 1 capital (to risk weighted assets).....	33,563	10.1	13,262	4.0	19,893	6.0
Tier 1 capital (to average assets).....	33,563	7.5	17,914	4.0	22,392	5.0

Banking regulations limit capital distributions by state-chartered banks. Generally, capital distributions are limited to undistributed net income for the current and prior two years. At December 31, 2009, approximately \$1,279,000 was available for ChoiceOne Bank to pay dividends to ChoiceOne Financial Services, Inc. ChoiceOne's ability to pay dividends to shareholders is dependent on the Bank, which is restricted by state law and regulations.

**Note 23 – Quarterly Financial Data (Unaudited)**

(Dollars in thousands)	Interest Income	Net Interest Income	Net Income	Earnings Per Share	
				Basic	Fully Diluted
<b>2009</b>					
<b>First Quarter</b>	\$ 5,913	\$ 3,898	\$ 741	\$ 0.23	\$ 0.23
<b>Second Quarter</b>	5,816	4,018	305	0.09	0.09
<b>Third Quarter</b>	5,794	4,084	409	0.13	0.13
<b>Fourth Quarter</b>	5,563	3,996	23	0.00	0.00
<b>2008</b>					
First Quarter	\$ 6,928	\$ 3,698	\$ 759	\$ 0.23	\$ 0.23
Second Quarter	6,583	3,728	723	0.23	0.23
Third Quarter	6,600	3,986	612	0.19	0.19
Fourth Quarter	6,423	3,919	(659)	(0.21)	(0.21)

The low net income in the fourth quarter of 2009 resulted from a higher provision for loan losses. The provision for loan losses in the fourth quarter of 2009 was \$1,700,000, compared to a provision of \$3,175,000 for the first three quarters of 2009. The net loss and related negative earnings per share experienced in the fourth quarter of 2008 were due to a higher provision for loan losses and securities losses. The provision for loan losses in the fourth quarter of 2008 was \$1,725,000, compared to a provision of \$1,750,000 for the first three quarters of 2008 and \$1,000,000 for the fourth quarter of 2007. The securities losses were comprised of a \$435,000 loss when a money market preferred security converted to preferred stock and a \$432,000 loss when the decline in a security's market value was considered to be an other than temporary impairment.

ChoiceOne Financial Services, Inc.  
**CORPORATE AND SHAREHOLDER INFORMATION**

**Corporate Headquarters**

ChoiceOne Financial Services, Inc.  
109 East Division Street  
Sparta, Michigan 49345  
Phone: (616) 887-7366  
Fax: (616) 887-7990  
Website: [www.choiceone.com](http://www.choiceone.com)

**Market Makers in ChoiceOne Financial Services, Inc. Stock**

Howe Barnes Hoefler & Arnett  
Chicago, Illinois  
(800) 800-4693

Kent King Securities, Division of Royal Securities, Inc.

Grand Rapids, Michigan  
(616) 459-3317  
(800) 321-9171

Stifel Nicolaus & Company, Inc.

Grand Rapids, Michigan  
(616) 942-1717  
(800) 676-0477

**Stock Registrar and Transfer Agent**

Registrar and Transfer Company  
10 Commerce Drive  
Cranford, New Jersey 07016  
(800) 368-5948

**Annual Shareholder Meeting**

The 2010 Annual Shareholder Meeting of ChoiceOne Financial Services, Inc., will be held at 11:00 a.m. local time on Thursday, April 29, 2010, at Moss Ridge Golf Club in Ravenna, Michigan.

**ChoiceOne Bank**

Alpine Office  
5050 Alpine Avenue NW  
Comstock Park, Michigan 49321

Cedar Springs Office  
4170 – 17 Mile Road  
Cedar Springs, Michigan 49319

Coopersville Office  
661 West Randall Street  
Coopersville, Michigan 49404

Egelston Office  
5475 East Apple Avenue  
Muskegon, Michigan 49442

Fremont Office  
1423 West Main Street  
Fremont, Michigan 49412

Grant Office  
10 West Main Street  
Grant, Michigan 49327

Kent City Office  
450 West Muskegon Street  
Kent City, Michigan 49330

Newaygo Office  
246 West River Drive  
Newaygo, Michigan 49337

Ravenna Office  
3069 Slocum Road  
Ravenna, Michigan 49451

Rockford Office  
6795 Courtland Drive  
Rockford, Michigan 49341

Sparta - Main Office  
109 East Division Street  
Sparta, Michigan 49345

Sparta - Appletree Office  
416 West Division Street  
Sparta, Michigan 49345

White Cloud Office  
47 South Charles Street  
White Cloud, Michigan 49349

**ChoiceOne Insurance Agencies, Inc.**

Sparta Office  
109 East Division Street  
Sparta, Michigan 49345

ChoiceOne Financial Services, Inc.

**DIRECTORS AND OFFICERS**

**Directors**

*ChoiceOne Financial Services, Inc.*

**Jerome B. Arends**

Former President and Chief Executive Officer of Ravenna Farm Equipment (Agricultural Equipment Supplier)

**Frank G. Berris**

President and Chief Executive Officer, American Gas & Oil Co., Inc. (Distributor of Petroleum Products)

**James A. Bosserd**

President and Chief Executive Officer, ChoiceOne Financial Services, Inc. and ChoiceOne Bank

**K. Timothy Bull**

President, Moon Lake Orchards, Inc. (Fruit Producer)

**William F. Cutler, Jr.**

Former Vice President, H. H. Cutler Co. (Apparel Manufacturer)

**Lewis G. Emmons**

President, Emmons Development; President, Brat Development (Real Estate Development)

**Stuart Goodfellow**

Owner, Goodfellow Blueberry Farms and Former Owner, Goodfellow Vending Services (Vending Company)

**Gary Gust**

Former President, Gust Construction Company (General Contractor)

**Paul L. Johnson**

Former President, Falcon Resources, Inc. (Automotive and Furniture Design)

**Directors**

*ChoiceOne Financial Services, Inc.*  
(continued)

**Dennis C. Nelson, DDS**

General Dentistry

**Nels W. Nyblad**

President, Nyblad Orchards (Fruit Producer)

**Jon E. Pike**

CPA and Chairman, Beene Garter LLP (Certified Public Accountants)

**Donald VanSingel**

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