

MACATAWA BANK CORP
Form 10-Q
November 08, 2006

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

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 000-25927

MACATAWA BANK CORPORATION
(Exact name of issuer as specified in its charter)

Michigan
(State or other jurisdiction of
incorporation or organization)

38-3391345
(I.R.S. Employer
Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes No

Indicate by check whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes No

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

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 16,224,604 shares of the Company's Common Stock (no par value) were outstanding as of November 2, 2006.

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Part I Financial Information**Item 1.**

MACATAWA BANK CORPORATION
 CONSOLIDATED BALANCE SHEETS
 As of September 30, 2006 (unaudited) and December 31, 2005

| (dollars in thousands) | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents | | |
| Cash and due from banks | \$ 36,916 | \$ 49,101 |
| Federal funds sold | 5,457 | -- |
| Total cash and cash equivalents | 42,373 | 49,101 |
| Securities available for sale | 192,864 | 156,696 |
| Securities held to maturity | 2,713 | 3,907 |
| Federal Home Loan Bank stock | 12,915 | 13,910 |
| Loans held for sale | 2,232 | 2,331 |
| Total loans | 1,682,359 | 1,547,879 |
| Allowance for loan losses | (22,427) | (20,992) |
| | 1,659,932 | 1,526,887 |
| Premises and equipment - net | 57,853 | 53,028 |
| Accrued interest receivable | 10,651 | 8,366 |
| Goodwill | 23,915 | 23,915 |
| Acquisition intangibles | 1,656 | 1,941 |
| Bank-owned life insurance | 21,558 | 20,814 |
| Other assets | 12,369 | 9,094 |
| Total assets | \$ 2,041,031 | \$ 1,869,990 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing | \$ 168,438 | \$ 188,762 |
| Interest-bearing | 1,464,378 | 1,319,010 |
| Total deposits | 1,632,816 | 1,507,772 |
| Federal funds purchased | -- | 25,809 |
| Other borrowed funds | 202,055 | 145,161 |
| Long-term debt | 41,238 | 41,238 |
| Accrued expenses and other liabilities | 9,797 | 8,266 |
| Total liabilities | 1,885,906 | 1,728,246 |
| Shareholders' equity | | |
| Preferred stock, no par value, 500,000 shares authorized; no shares issued and outstanding | | |
| Common stock, no par value, 40,000,000 shares authorized; 16,221,682 shares and 10,227,992 issued and outstanding as of September 30, 2006 and December 31, 2005, respectively | 153,333 | 136,583 |

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| (dollars in thousands) | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| Retained earnings | 4,105 | 8,040 |
| Accumulated other comprehensive (loss) | (2,313) | (2,879) |
| Total shareholders' equity | <u>155,125</u> | <u>141,744</u> |
| Total liabilities and shareholders' equity | <u>\$ 2,041,031</u> | <u>\$ 1,869,990</u> |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Three and Nine Month Periods Ended September 30, 2006 and 2005
(unaudited)

| (dollars in thousands, except per share data) | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--|--|--|---|---|
| Interest income | | | | |
| Loans, including fees | \$ 32,581 | \$ 25,665 | \$ 91,849 | \$ 70,789 |
| Securities | 1,914 | 1,666 | 5,397 | 4,820 |
| FHLB Stock | 99 | 166 | 462 | 433 |
| Other | 185 | 255 | 208 | 266 |
| Total interest income | 34,779 | 27,752 | 97,916 | 76,308 |
| Interest expense | | | | |
| Deposits | 14,340 | 8,884 | 38,654 | 22,220 |
| Other | 3,356 | 2,763 | 8,890 | 7,652 |
| Total interest expense | 17,696 | 11,647 | 47,544 | 29,872 |
| Net interest income | 17,083 | 16,105 | 50,372 | 46,436 |
| Provision for loan losses | 490 | 855 | 1,990 | 2,880 |
| Net interest income after provision for loan losses | 16,593 | 15,250 | 48,382 | 43,556 |
| Noninterest income | | | | |
| Service charges and fees | 1,256 | 1,259 | 3,642 | 3,138 |
| Gain on sales of loans | 365 | 697 | 1,288 | 1,792 |
| Trust fees | 871 | 746 | 2,493 | 2,177 |
| Other | 1,011 | 947 | 2,903 | 2,584 |
| Total noninterest income | 3,503 | 3,649 | 10,326 | 9,691 |
| Noninterest expense | | | | |
| Salaries and benefits | 6,193 | 5,755 | 18,524 | 16,590 |
| Occupancy of premises | 910 | 797 | 2,630 | 2,387 |
| Furniture and equipment | 790 | 759 | 2,362 | 2,182 |
| Legal and professional fees | 213 | 209 | 694 | 595 |
| Marketing and promotion | 319 | 283 | 996 | 746 |
| Data processing fees | 440 | 417 | 1,304 | 1,186 |
| Other | 2,392 | 2,468 | 7,166 | 6,925 |
| Total noninterest expenses | 11,257 | 10,688 | 33,676 | 30,611 |
| Income before income tax expense | 8,839 | 8,211 | 25,032 | 22,636 |
| Income tax expense | 2,830 | 2,661 | 8,046 | 7,289 |

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| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|--|--|---|---|
| (dollars in thousands, except per share data) | | | | |
| Net income | \$ 6,009 | \$ 5,550 | \$ 16,986 | \$ 15,347 |
| Basic earnings per share | \$.37 | \$.35 | \$ 1.05 | \$.96 |
| Diluted earnings per share | .36 | .34 | 1.03 | .93 |
| Cash dividends per share | .12 | .10 | .35 | .28 |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 Three and Nine Month Periods Ended September 30, 2006 and 2005
 (unaudited)

(dollars in thousands)

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|--|--|---|---|
| Net income | \$ 6,009 | \$ 5,550 | \$ 16,986 | \$ 15,347 |
| Other comprehensive income/(loss), net of tax: | | | | |
| Net change in unrealized gains/(losses) on securities available for sale | 2,022 | (213) | 437 | (415) |
| Net change in unrealized gains/(losses) on derivative instruments | 759 | (764) | 129 | (1,150) |
| Comprehensive income | \$ 8,790 | \$ 4,573 | \$ 17,552 | \$ 13,782 |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Nine Month Periods Ended September 30, 2006 and 2005
(unaudited)

(dollars in thousands, except per share data)

| | <u>Common Stock</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|--|-------------------------|------------------------------|--|---|
| Balance, January 1, 2005 | \$ 124,389 | \$ 4,277 | \$ 408 | \$ 129,074 |
| Net income for nine months ended September 30, 2005 . | | 15,347 | | 15,347 |
| Other comprehensive income/(loss), net of tax: | | | | |
| Net change in unrealized gain/(loss) on securities available for sale | | | (415) | (415) |
| Net change in unrealized gain/(loss) on derivative instruments | | | (1,150) | (1,150) |
| Comprehensive income | | | | 13,782 |
| Shares earned (5,000) under Stock Compensation Plan . | 176 | | | 176 |
| Issued 59,307 shares for stock option exercises (net of 4,426 shares exchanged and including \$41 of tax benefit | 722 | | | 722 |
| Issued 1,328,409 shares in payment of 15% stock dividend | 10,863 | (10,898) | | (35) |
| Cash dividends at \$.28 per share | | (4,388) | | (4,388) |
| Balance, September 30, 2005 | <u>\$ 136,150</u> | <u>\$ 4,338</u> | <u>(\$1,157)</u> | <u>\$ 139,331</u> |
| Balance, January 1, 2006 | \$ 136,583 | \$ 8,040 | \$ (2,879) | \$ 141,744 |
| Net income for nine months ended September 30, 2006 | | 16,986 | | 16,986 |
| Other comprehensive income/(loss), net of tax: | | | | |
| Net change in unrealized gain/(loss) on securities available for sale | | | 437 | 437 |
| Net change in unrealized gain/(loss) on derivative instruments | | | 129 | 129 |
| Comprehensive income | | | | 17,552 |
| Issued 79,217 shares for stock option exercises (net of 4,994 shares exchanged and including \$79 of tax benefit | 1,075 | | | 1,075 |
| Issued 513,283 shares in payment of 5% stock dividend | 15,127 | (15,180) | | (53) |
| Issued 5,401,190 shares in payment of 3-for-2 stock split | | | | |
| Stock option compensation expense | 548 | | | 548 |

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| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|------------------------------------|-------------------------|------------------------------|--|---|
| Cash dividends at \$.35 per share | | (5,741) | | (5,741) |
| Balance, September 30, 2006 | \$ 153,333 | \$ 4,105 | \$ (2,313) | \$ 155,125 |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Nine Month Periods Ended September 30, 2006 and 2005
(unaudited)

| (dollars in thousands) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--|--|--|
| Cash flows from operating activities | | |
| Net income | \$ 16,986 | \$ 15,347 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization | 2,561 | 2,261 |
| Stock option compensation expense | 548 | 176 |
| Provision for loan losses | 1,990 | 2,880 |
| Origination of loans for sale | (76,602) | (105,321) |
| Proceeds from sales of loans originated for sale | 77,989 | 105,919 |
| Gain on sales of loans | (1,288) | (1,792) |
| Net change in: | | |
| Accrued interest receivable and other assets | (2,915) | (6,111) |
| Bank-owned life insurance | (744) | (497) |
| Accrued expenses and other liabilities | 1,305 | 4,043 |
| Net cash from operating activities | 19,830 | 16,905 |
| Cash flows from investing activities | | |
| Loan originations and payments, net | (137,481) | (114,008) |
| Purchases of securities available for sale | (37,692) | (39,001) |
| Purchases of FHLB stock | -- | (1,422) |
| Repurchases by FHLB of FHLB stock | 995 | -- |
| Maturities and calls of securities available for sale | 1,990 | 15,298 |
| Principal paydowns on securities | 1,355 | 119 |
| Additions to premises and equipment | (7,056) | (7,555) |
| Net cash used in investing activities | (177,889) | (146,569) |
| Cash flows from financing activities | | |
| Net increase in deposits | 125,044 | 105,968 |
| Net increase/(decrease) in short term borrowings | (25,809) | 9,283 |
| Proceeds from FHLB advances | 75,000 | 395,000 |
| Repayments of FHLB advances | (38,106) | (371,789) |
| Proceeds from securities sold under agreements to repurchase | 20,000 | -- |
| Cash dividends paid | (5,794) | (4,423) |
| Proceeds from exercises of stock options | 996 | 681 |
| Net cash from financing activities | 151,331 | 134,720 |
| Net change in cash and cash equivalents | (6,728) | 5,056 |
| Cash and cash equivalents at beginning of period | 49,101 | 31,711 |
| Cash and cash equivalents at end of period | \$ 42,373 | \$ 36,767 |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION
 CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
 Nine Month Periods Ended September 30, 2006 and 2005 (unaudited)

| (dollars in thousands) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| Supplemental cash flow information | | |
| Interest paid | \$ 46,885 | \$ 28,537 |
| Income taxes paid | 9,265 | 5,900 |
| Supplemental noncash disclosures: | | |
| Transfers from loans to other real estate | 2,446 | 2,568 |

See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Macatawa Bank, and its wholly-owned subsidiary, Macatawa Bank Mortgage Company; and Macatawa Investment Services, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company also owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company per FASB Interpretation No. 46.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's 2005 Annual Report containing financial statements for the year ended December 31, 2005.

All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 30, 2006, the 3-for-2 stock split distributed on June 29, 2006, and the 15% stock dividend distributed on May 27, 2005.

Stock Compensation: On January 1, 2006, the Company adopted FAS 123, Revised, which requires all public companies to record compensation cost for stock options provided to employees in return for employee service. The cost is measured at the fair value of the options when granted, and this cost is expensed over the employee service period, which is normally the vesting period of the options. As amended, this applies to awards granted or modified beginning with the first quarter of 2006. Compensation cost was also recorded for prior option grants that vested after the date of adoption. For the three months ended September 30, 2006, the Company recorded compensation cost for stock options of \$174,000, or \$138,000 after tax, representing \$0.01 per share. For the nine month period ended September 30, 2006 the Company recorded compensation cost for stock options of \$548,000, or \$434,000 after tax, representing \$0.03 per share. Future compensation cost for stock options is expected to be recognized as follows (in thousands):

| | | |
|-------------------|----|-------|
| Remainder of 2006 | \$ | 109 |
| 2007 | | 319 |
| 2008 | | 276 |
| 2009 | | 3 |
| | | <hr/> |
| Total | \$ | 707 |
| | | <hr/> |

Employee compensation expense under stock option plans was reported using the intrinsic value method for the three and nine month periods ended September 30, 2005. No compensation cost related to stock options was recognized during the three and nine month periods ended September 30, 2005, as all options granted had an exercise price equal to or greater than the market price of the underlying common stock at date of grant. Had compensation cost for stock options been measured using the fair value method, net income and basic and diluted earnings per share would have been the pro forma amounts indicated below (dollars in thousands, except per share data).

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (Unaudited)

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|--|---|
| Net income as reported | \$ 5,550 | \$ 15,347 |
| Stock-based compensation cost, net of tax | (38) | (184) |
| Pro forma net income | 5,512 | 15,163 |
| Basic earnings per share as reported | .35 | 0.96 |
| Pro forma basic earnings per share | .34 | 0.94 |
| Diluted earnings per share as reported | .34 | 0.93 |
| Pro forma diluted earnings per share | .33 | 0.92 |

NOTE 2 ACQUISITION

On October 11, 2006, Macatawa Bank Corporation (Macatawa) entered into an Agreement and Plan of Merger with Benj. A. Smith & Associates, Ltd. (Smith & Associates) and Benj. A. Smith, III (Mr. Smith). On October 11, 2006, Macatawa also entered into a Noncompetition Agreement with Mr. Smith.

Smith & Associates is an investment advisory firm based in Holland, Michigan. Mr. Smith is the owner of Smith & Associates. Mr. Smith is also the founder and Chairman of Macatawa Bank Corporation. The transaction is structured as a merger of Smith & Associates into Macatawa, which in turn will contribute the business to Macatawa Bank.

The purchase price is \$3,150,000, less any liabilities of Smith & Associates as of the closing date. In addition, one \$300,000 contingent payment will be made if revenue from transferred account balances, principal additions to transferred account balances generated by Mr. Smith and new accounts generated by Mr. Smith exceeds \$1,600,000 in 2007 and an additional \$300,000 contingent payment will be paid if such revenue exceeds \$1,700,000 in 2008. The purchase price and the contingent payments will be paid in common stock of Macatawa valued at the average closing price during the month of September, 2006 (\$23.0035 per share).

Mr. Smith will provide assistance with transitioning clients as reasonably requested from time to time. Under the Noncompetition Agreement, Mr. Smith agrees to a six year covenant not to compete with the acquired business.

Assuming all closing conditions are satisfied, the transaction is expected to close effective as of December 31, 2006.

NOTE 3 SECURITIES

The amortized cost and fair values of securities were as follows (in thousands):

| | <u>Amortized Cost</u> | <u>Gross Unrealized Gains</u> | <u>Gross Unrealized Losses</u> | <u>Fair Values</u> |
|---|---------------------------|---------------------------------------|--|------------------------|
| <u>September 30, 2006</u> | | | | |
| Available for Sale: | | | | |
| U.S. Treasury and federal agency securities | \$ 144,772 | \$ 134 | \$ (2,431) | \$ 142,475 |
| State and municipal bonds | 48,704 | 817 | (114) | 49,407 |
| Other equity securities | 1,000 | -- | (18) | 982 |
| | <u>\$ 194,476</u> | <u>\$ 951</u> | <u>\$ (2,563)</u> | <u>\$ 192,864</u> |
| Held to Maturity: | | | | |
| State and municipal bonds | \$ 2,713 | \$ 59 | \$ (8) | \$ 2,764 |
| | <u>\$ 2,713</u> | <u>\$ 59</u> | <u>\$ (8)</u> | <u>\$ 2,764</u> |
| <u>December 31, 2005</u> | | | | |
| Available for Sale: | | | | |
| U.S. Treasury and federal agency securities | \$ 111,102 | \$ 103 | \$ (2,644) | \$ 108,561 |
| State and municipal bonds | 46,878 | 609 | (345) | 47,142 |
| Other equity securities | 1,000 | -- | (7) | 993 |
| | <u>\$ 158,980</u> | <u>\$ 712</u> | <u>\$ (2,996)</u> | <u>\$ 156,696</u> |
| Held to Maturity: | | | | |
| State and municipal bonds | \$ 3,907 | \$ 80 | \$ (13) | \$ 3,974 |
| | <u>\$ 3,907</u> | <u>\$ 80</u> | <u>\$ (13)</u> | <u>\$ 3,974</u> |

Securities with unrealized losses at September 30, 2006 and December 31, 2005, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (in thousands):

| <u>Description of Securities</u> | <u>Less than 12 Months</u> | | <u>12 Months or More</u> | | <u>Total</u> | |
|---|----------------------------|------------------------|--------------------------|------------------------|-------------------|------------------------|
| | <u>Fair Value</u> | <u>Unrealized Loss</u> | <u>Fair Value</u> | <u>Unrealized Loss</u> | <u>Fair Value</u> | <u>Unrealized Loss</u> |
| <u>September 30, 2006</u> | | | | | | |
| U.S. Treasury and federal agency securities | \$ 7,069 | \$ (30) | \$ 102,343 | \$ (2,401) | \$ 109,412 | \$ (2,431) |
| State and municipal bonds | 3,150 | (18) | 5,933 | (104) | 9,083 | (122) |
| Other equity securities | 982 | (18) | -- | -- | 982 | (18) |
| | <u>\$ 11,201</u> | <u>\$ (66)</u> | <u>\$ 108,276</u> | <u>\$ (2,505)</u> | <u>\$ 119,477</u> | <u>\$ (2,571)</u> |

NOTE 3 SECURITIES (Continued)

| Description of Securities | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| December 31, 2005 | | | | | | |
| U.S. Treasury and federal agency securities | \$ 70,531 | \$ (1,299) | \$ 33,654 | \$ (1,345) | \$ 104,185 | \$ (2,644) |
| State and municipal bonds | 16,419 | (153) | 5,842 | (205) | 22,261 | (358) |
| Other equity securities | 993 | (7) | --- | --- | 993 | (7) |
| Total temporarily impaired | \$ 87,943 | \$ (1,459) | \$ 39,496 | \$ (1,550) | \$ 127,439 | \$ (3,009) |

For unrealized losses on securities, no loss has been recognized into income because management has the intent and ability to hold these securities for the foreseeable future and the declines are largely due to differences in market interest rates as compared to those of the underlying securities. The declines in fair value are considered temporary and are expected to recover as the bonds approach their maturity date.

Contractual maturities of debt securities at September 30, 2006 were as follows (dollars in thousands):

| | Held-to-Maturity Securities | | Available-for-Sale Securities | |
|----------------------------|-----------------------------|------------|-------------------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$ 715 | \$ 709 | \$ 7,500 | 7,428 |
| Due from one to five years | 383 | 381 | 137,870 | 135,711 |
| Due from five to ten years | --- | --- | 19,807 | 20,219 |
| Due after ten years | 1,615 | 1,674 | 28,299 | 28,524 |
| | \$ 2,713 | \$ 2,764 | \$ 193,476 | \$ 191,882 |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (Unaudited)

NOTE 4 - LOANS

Loans were as follows (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---------------------------|-------------------------------|------------------------------|
| Commercial | \$ 398,273 | \$ 359,036 |
| Commercial mortgage | 865,748 | 793,919 |
| Residential mortgage | 230,438 | 223,390 |
| Consumer | 187,900 | 171,534 |
| | <u>1,682,359</u> | <u>1,547,879</u> |
| Allowance for loan losses | (22,427) | (20,992) |
| | <u>\$ 1,659,932</u> | <u>\$ 1,526,887</u> |

Activity in the allowance for loan losses was as follows (in thousands):

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine months Ended September 30, 2006 | Nine months Ended September 30, 2005 |
|--------------------------------|--|--|---|---|
| Balance at beginning of period | \$ 22,145 | \$ 20,010 | \$ 20,992 | \$ 19,251 |
| Provision for loan losses | 490 | 855 | 1,990 | 2,880 |
| Charge-offs | (278) | (534) | (858) | (1,884) |
| Recoveries | 70 | 195 | 303 | 279 |
| | <u>\$ 22,427</u> | <u>\$ 20,526</u> | <u>\$ 22,427</u> | <u>\$ 20,526</u> |

NOTE 5 - DEPOSITS.

Deposits are summarized as follows (in thousands):

| | September 30, 2006 | December 31, 2005 |
|----------------------------|-------------------------------|------------------------------|
| Noninterest-bearing demand | \$ 168,438 | \$ 188,762 |
| Money market | 446,921 | 380,216 |
| NOW and Super NOW | 274,123 | 207,947 |
| Savings | 39,208 | 40,612 |
| Certificates of deposit | 704,126 | 690,235 |
| | <u>\$ 1,632,816</u> | <u>\$ 1,507,772</u> |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (Unaudited)

NOTE 6 OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and securities sold under agreements to repurchase, and were as follows (in thousands):

Federal Home Loan Bank Advances

| <u>Principal Terms</u> | <u>Advance Amount</u> | <u>Range of Maturities</u> | <u>Weighted Average Interest Rate</u> |
|-------------------------------------|---------------------------|---------------------------------|---|
| September 30, 2006 | | | |
| Single maturity fixed rate advances | \$ 142,000 | Oct. 2006 to May 2010 | 4.51% |
| Putable advances | 31,000 | September 2009 to December 2010 | 5.80% |
| Amortizable mortgage advances | 9,055 | February 2008 to July 2018 | 3.87% |
| | <u>\$ 182,055</u> | | |
| December 31, 2005 | | | |
| Single maturity fixed rate advances | \$ 104,200 | January 2006 to May 2010 | 3.25% |
| Putable advances | 31,000 | September 2009 to December 2010 | 5.80% |
| Amortizable mortgage advances | 9,961 | February 2008 to July 2018 | 3.90% |
| | <u>\$ 145,161</u> | | |

Each advance is payable at its maturity date and contains a prepayment penalty. These advances were collateralized by securities totaling \$107,581,000 at December 31, 2005, and residential and commercial real estate loans totaling \$574,382,726 and \$526,066,000 under a blanket lien arrangement at September 30, 2006 and December 31, 2005. Maturities as of September 30, 2006 were as follows (in thousands):

| | |
|------------|------------------|
| 2006 | \$10,000 |
| 2007 | 47,000 |
| 2008 | 70,712 |
| 2009 | 5,343 |
| 2010 | 41,000 |
| Thereafter | 8,000 |
| | <u>\$182,055</u> |

Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase (repo borrowings) are financing arrangements secured by U.S. federal agency securities. On August 16, 2006, the company secured two \$10 million repo borrowings at a floating rate of three-month LIBOR plus a margin. These borrowings were secured by securities that had a carrying amount of approximately \$21,322,000 at September 30, 2006. At maturity, the securities underlying the arrangements are returned to the company. These borrowings at September 30, 2006 were as follows (in thousands):

| <u>Principal Terms</u> | <u>Amount</u> | <u>Maturity</u> | <u>Interest Rate</u> |
|------------------------------|------------------|-----------------|----------------------|
| Floating rate repo borrowing | \$ 10,000 | August 16, 2009 | 5.75% |
| Floating rate repo borrowing | 10,000 | August 16, 2010 | 5.81% |
| | <u>\$ 20,000</u> | | |

The company had no repo borrowings at December 31, 2005.

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (Unaudited)

NOTE 7 STOCK OPTIONS

Options to buy stock are granted to officers and employees under Employee Stock Option Plans (the Employees' Plans), which provide for issue of up to 1,825,890 options. Options are also granted to directors under Directors' Stock Option Plans (the Directors' Plans), which provide for issuance of up to 450,741 options. The exercise price is the market price at the date of grant for all plans. The maximum option term is ten years. The vesting schedule is over a one-year period for both the Employees' Plans and the Directors' Plans for all grants through the third quarter of 2005. Beginning with grants in the fourth quarter of 2005, the vesting schedule was increased to three years. Upon exercise of stock options, the Company issues new shares from its authorized but unissued shares. The amount of options available for future grant at September 30, 2006 is 1,027,231. All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 30, 2006, the 3-for-2 stock split distributed on June 29, 2006, and the 15% stock dividend distributed on May 27, 2005.

A summary of option activity in the plans is as follows (dollars in thousands, except per option data):

| Options | Number Outstanding | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life in Years | Aggregate Intrinsic Value |
|-----------------------------------|-----------------------|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2006 | 1,019,559 | \$ 13.75 | | |
| Granted | 4,487 | 23.28 | | |
| Exercised | (123,314) | 9.66 | | |
| Forfeited | (3,127) | 16.12 | | |
| Outstanding at September 30, 2006 | 897,605 | \$ 14.36 | 6.70 | \$ 7,832 |
| Exercisable at September 30, 2006 | 723,221 | \$ 12.06 | 5.41 | \$ 7,832 |

There were no options granted during the three months ended September 30, 2006. The weighted-average fair value of the 4,487 options granted during the nine months ended September 30, 2006 was \$5.93 per option. The weighted-average fair value of the 55,123 and 62,368 options granted during the three and nine months ended September 30, 2005 was \$5.40 and \$5.29 per option, respectively.

The total intrinsic value of options exercised during the three months and nine months ended September 30, 2006 was \$169,000 and \$1.6 million, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2005 was \$462,000 and \$1.4 million, respectively.

The total fair value of options vested during the three and nine months ended September 30, 2006 was \$298,000 and \$330,000 respectively. The total fair value of options vested during the three and nine months ended September 30, 2005 was \$8,000 for both periods.

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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NOTE 8 EARNINGS PER SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per share for the three and nine month periods ended September 30, 2006 and 2005 are as follows (dollars in thousands, except per share data):

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|--|--|--|---|---|
| Basic earnings per share | | | | |
| Net income | \$ 6,009 | \$ 5,550 | \$ 16,986 | \$ 15,347 |
| Weighted average common shares outstanding | 16,214,390 | 16,076,699 | 16,192,727 | 16,047,294 |
| Basic earnings per share | \$ 0.37 | \$ 0.35 | \$ 1.05 | \$ 0.96 |
| Diluted earnings per share | | | | |
| Net income | \$ 6,009 | \$ 5,550 | \$ 16,986 | \$ 15,347 |
| Weighted average common shares outstanding | 16,214,390 | 16,076,699 | 16,192,727 | 16,047,294 |
| Add: Dilutive effects of assumed exercise of stock options | 343,459 | 430,490 | 375,906 | 410,373 |
| Weighted average common and dilutive potential common shares outstanding | 16,557,849 | 16,507,189 | 16,568,633 | 16,457,667 |
| Diluted earnings per share | \$ 0.36 | \$ 0.34 | \$ 1.03 | \$ 0.93 |

Stock options for 229,507 shares of common stock were not considered in computing diluted earnings per share for the three months ended September 30, 2006 because they were antidilutive. There were no antidilutive shares for the three months ended September 30, 2005. Stock options for 229,507 and 55,125 shares of common stock were not considered in computing diluted earnings per share for the nine months ended September 30, 2006 and 2005, respectively, because they were antidilutive.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

NOTE 9 CONTINGENCIES

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business.

On July 8, 2003, the Company filed a Form 8-K (dated July 1, 2003) with the Securities and Exchange Commission reporting events related to a former trust customer, Trade Partners, Inc. (Trade Partners), of the former Grand Bank, which the Company acquired effective April 1, 2002. Trade Partners was involved in purchasing and selling interests in viaticals, which are interests in life insurance policies of the terminally ill or elderly. Beginning in 1996, Grand Bank served as a custodian and escrow agent with respect to viaticals purchased by Trade Partners and sold to investors. Two lawsuits were filed, one in December 2002 and another in March 2003, against Trade Partners, Grand Bank and the Company alleging that Grand Bank breached certain escrow agreements related to viatical settlement contracts. Both of these lawsuits have been dismissed although the plaintiffs reserved the right to pursue the claims in the future. A third lawsuit was filed in April 2003 by two individual investors against Grand Bank, the Company, Trade Partners and certain individuals and entities associated with Trade Partners. The claims against Grand Bank and the Company in this lawsuit have been settled and dismissed with prejudice. In May 2003 a purported class action complaint was filed against the Company. As amended, this suit alleges that Grand Bank breached escrow agreements and fiduciary duties and violated the Michigan Uniform Securities Act with respect to the investments secured by the purported class in viaticals and in interests in limited partnerships which made loans to Trade Partners secured by viaticals, and with respect to loans made by purported class members directly to Trade Partners. The Company has answered the complaint denying the material allegations and raising certain affirmative defenses. Management believes the Company has strong defenses and will vigorously defend the cases.

Trade Partners is now in receivership. The supervising court authorized the receiver to borrow money from Macatawa Bank to pay premiums, if needed. Macatawa Bank extended a \$4 million line of credit to the receiver, conditioned upon obtaining a security interest in the viaticals. No draws were made against the line, and the line expired during the fourth quarter of 2004.

It is possible that one or more additional legal actions may be initiated involving the custodial and escrow agent services provided by Grand Bank in connection with Trade Partners. If any such legal actions are commenced, the Company intends to defend them vigorously. To the extent any pending or future claims allege errors or omissions on the part of Grand Bank or Macatawa Bank, management believes that some or all liability, if any is proven or established, will be covered by errors and omissions insurance maintained by Grand Bank and Macatawa Bank. The Company has reported the Trade Partners matter to its two insurance carriers. Federal Insurance Company has assumed the Company's defense and has advanced a portion of its defense costs pursuant to a reservation of rights letter asserting certain coverage defenses, and an Interim Funding Agreement. Federal Insurance Company on July 21, 2006 notified the Company that it had filed an Arbitration Demand with the American Arbitration Association, seeking a declaration that based on its asserted coverage defenses its policy does not cover this matter. The Company and Federal Insurance Company have agreed to defer any proceedings with respect to this Arbitration Demand. The Company believes that Federal Insurance Company is obligated to provide coverage, and the Company intends to vigorously pursue its rights under the insurance policy. The other carrier has taken the position that the duty of defense rests solely with the first carrier, and reserves its rights with respect to indemnity.

The legal actions involving Trade Partners have not progressed to trial and the outcome of such actions is uncertain. While we are therefore unable to determine at this time whether or to what extent these actions may impact the Company, the Company believes it has strong defenses and fully intends to defend any and all such actions vigorously.

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (Unaudited)

NOTE 10 HEDGING ACTIVITIES

The Company's asset/liability management policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using simulation analysis. The policies provide for the use of derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters.

The Company's assets are comprised of a large portion of loans on which the interest rates are variable. As such, the Company may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates. Interest rate swap arrangements may be utilized to hedge against these fluctuations in cash flows.

The Company has entered into interest rate swap arrangements (swaps), all of which are classified as cash flow hedges that convert the variable rate cash inflows on certain of its loans to fixed rates of interest. These swaps pay interest to the Company at a fixed rate and require interest payments from the Company at a variable rate. All of these swaps were fully effective during 2005 and the first nine months of 2006. At September 30, 2006, it is anticipated that approximately \$614,000, net of tax, of net unrealized losses on these cash flow hedges will be reclassified to earnings over the next twelve months.

Summary information about interest rate swaps were as follows (dollars in thousands).

| | <u>September 30, 2006</u> | <u>December 31, 2005</u> |
|--|-------------------------------|------------------------------|
| Notional amounts | \$ 80,000 | \$ 80,000 |
| Weighted average pay rates | 8.25% | 7.25% |
| Weighted average receive rates | 6.42% | 6.42% |
| Weighted average maturity | 2.2 years | 3.0 years |
| Unrealized loss related to interest rate swaps | \$ (1,947) | \$ (2,146) |

NOTE 11 NEW ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition and measurement threshold for a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not completed its evaluation of the impact of the adoption of FIN 48.

In September 2006, the Securities and Exchange Commission released Staff Accounting Bulletin (SAB) 108. This SAB provides detailed guidance to registrants in the determination of what is material to their financial statements. This SAB is required to be applied to financial statements issued after November 15, 2006. Upon adoption, the cumulative effect of applying the new guidance is to be reflected as an adjustment to opening retained earnings as of the beginning of the current fiscal year. The Company has not completed its evaluation of the impact of SAB 108.

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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NOTE 12 REGULATORY MATTERS

The Company and the Bank are 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 calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

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 the Bank is only adequately capitalized, regulatory approval is required to accept brokered deposits; and if the Bank is undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

At September 30, 2006 and December 31, 2005, actual capital levels and minimum required levels were (in thousands):

| | Actual | | Minimum Required For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Regulations | |
|--|------------|-------|--|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <u>September 30, 2006</u> | | | | | | |
| Total capital (to risk weighted assets) | | | | | | |
| Consolidated | \$ 194,673 | 11.0% | \$ 142,163 | 8.0% | \$ 177,703 | 10.0% |
| Bank | 187,618 | 10.6 | 141,862 | 8.0 | 177,328 | 10.0 |
| Tier 1 capital (to risk weighted assets) | | | | | | |
| Consolidated | 170,460 | 9.6 | 71,081 | 4.0 | 106,622 | 6.0 |
| Bank | 165,452 | 9.3 | 70,931 | 4.0 | 106,397 | 6.0 |
| Tier 1 capital (to average assets) | | | | | | |
| Consolidated | 170,460 | 8.6 | 79,578 | 4.0 | 99,472 | 5.0 |
| Bank | 165,452 | 8.3 | 79,434 | 4.0 | 99,293 | 5.0 |
| <u>December 31, 2005</u> | | | | | | |
| Total capital (to risk weighted assets) | | | | | | |
| Consolidated | \$ 179,756 | 11.1% | \$ 129,959 | 8.0% | \$ 162,448 | 10.0% |
| Bank | 173,481 | 10.7 | 129,733 | 8.0 | 162,167 | 10.0 |
| Tier 1 capital (to risk weighted assets) | | | | | | |
| Consolidated | 157,450 | 9.7 | 64,979 | 4.0 | 97,469 | 6.0 |
| Bank | 153,210 | 9.5 | 64,867 | 4.0 | 97,300 | 6.0 |
| Tier 1 capital (to average assets) | | | | | | |
| Consolidated | 157,450 | 8.7 | 72,799 | 4.0 | 90,999 | 5.0 |
| Bank | 153,210 | 8.4 | 72,677 | 4.0 | 90,846 | 5.0 |

The Company and the Bank were categorized as well capitalized at September 30, 2006 and December 31, 2005. There are no conditions or events since September 30, 2006 that management believes have changed either institution's category.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Macatawa Bank Corporation is a Michigan corporation and is the holding company for two wholly owned subsidiaries, Macatawa Bank and Macatawa Investment Services, Inc. and for two trusts, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank Corporation is a financial holding company pursuant to Title I of the Gramm-Leach-Bliley Act. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The bank operates twenty-four branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Investment Services is a broker/dealer that provides various services including discount brokerage and consultation regarding mutual funds and annuities. As discussed more fully in the company's Form 8-K dated October 11, 2006, Macatawa Investment Services, Inc. will cease doing business as a registered broker-dealer. Beginning November 1, 2006, Macatawa Bank will offer brokerage services to its customers through an arrangement with Infinex Investments, Inc. (Infinex). Infinex is a full service investment provider, a registered broker-dealer and a member of the National Association of Securities Dealers (NASD) and the Securities Investor Protection Corporation (SIPC). As also more fully discussed in the company's Form 8-K dated October 11, 2006, on October 11, 2006, Macatawa Bank Corporation entered into an Agreement and Plan of Merger with Benj. A. Smith & Associates, Ltd. and Benj. A. Smith, III. Smith & Associates is an investment advisory firm based in Holland, Michigan. The transaction is structured as a merger of Smith & Associates into Macatawa, which in turn will contribute the business to Macatawa Bank. Assuming all closing conditions are satisfied, the transaction is expected to close effective as of December 31, 2006. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in the Corporation's financial statements. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements included herein. Macatawa Bank Mortgage Company, a subsidiary of Macatawa Bank, originates and sells residential mortgage loans into the secondary market on a servicing released basis.

While maintaining asset quality and improving profitability, we have experienced rapid and substantial growth since opening Macatawa Bank in November of 1997. We first became profitable in 1999 and have increased earnings each year since then with 2005 net income reaching \$20.9 million. Since our inception in 1997, we have raised approximately \$100.6 million in capital through private and public common stock offerings and trust preferred offerings to facilitate our growth and progress over these years.

We believe that growth in core deposits is key to our long-term success and is our primary funding source for asset growth. Establishing a branching network in our markets has been of high importance in order to facilitate this core deposit growth. We have gained community awareness and acceptance in our markets through this expanding branch network and our high service quality standards.

The West Michigan markets within which we operate continue to provide significant expansion opportunities for us. We opened our twenty-fourth branch on the west side of the greater Grand Rapids area during the second quarter of 2006. Because of the significance of the greater Grand Rapids market and the great opportunity for market share growth, we anticipate additional branch openings in this market. We also continue to enjoy success in building new and existing relationships in both our Holland/Zeeland and Grand Haven markets. We anticipate that we will continue to experience growth in our balance sheet and in our earnings due to these expansion opportunities.

RESULTS OF OPERATIONS

Summary: Net income for the quarter ended September 30, 2006 was \$6.0 million, an increase of 8% as compared to third quarter 2005 net income of \$5.6 million. Earnings per share on a diluted basis were \$0.36 for the third quarter of 2006 compared to \$0.34 for the same period in 2005. Net income for the nine months ended September 30, 2006 was \$17.0 million, an increase of 11% over the \$15.3 million for the same period in the prior year. Earnings per share on a diluted basis were \$1.03 for the nine months ended September 30, 2006 compared to \$0.93 for the same period in the prior year.

The increase in net income for the three months ended September 30, 2006 compared to the same period in the prior year was primarily due to an increase in net interest income and partially offset by an increase in noninterest expense. The increase in net income for the nine months ended September 30, 2006 compared to the same period in the prior year was primarily due to an increase in net interest income and noninterest income and partially offset by an increase in noninterest expense. Also contributing to the overall increases in net income for both the three and nine months ended September 30, 2006 was a decrease in the provision for loan losses.

Net Interest Income: Net interest income totaled \$17.1 million for the third quarter of 2006, an increase of \$978,000 compared to the third quarter of 2005. Net interest income for the first nine months of 2006 totaled \$50.4 million, an increase of 8% as compared to \$46.4 million for the same period in 2005. The improvement in net interest income for both the three and nine month periods was the result of strong growth in average earning assets offset by a decline in net interest margin. Average earning assets increased \$168.5 million to \$1.87 billion for the third quarter of 2006 compared to \$1.70 billion for the third quarter of 2005. Average earning assets increased \$176.4 million to \$1.81 billion for the nine month period ended September 30, 2006 compared to \$1.64 billion for the same period of the prior year. The increases in average earning assets for the three and nine months ended September 30, 2006 represent a 10% and 11% increase, respectively, when compared to the same periods of the prior year. The net interest margin decreased 14 basis points to 3.62% for the third quarter of 2006 and 10 basis points to 3.71% for the first nine months of 2006 when compared to the same periods in the prior year.

During both the three and nine month periods, the increase in the cost of funds exceeded the increase in the yield on earning assets and is the primary reason for the decrease in the net interest margin. The yield on earning assets increased by 88 basis points and 97 basis points, respectively, for the three and nine months ended September 30, 2006 as compared to the same periods in the prior year. The cost of funds increased 115 basis points and 119 basis points, respectively, for the three and nine months ended September 30, 2006 as compared to the same periods in the prior year. The increases in short-term rates that began in mid-2004 and continued into 2006 caused an increase in the yield on our variable rate loan portfolio and are the primary reasons for the increase in the yield on earning assets. An increase in the rates paid on our deposit accounts, the rollover of time deposits at higher rates and a shift to higher costing sources of funds are the primary reasons for the increase in the cost of funds. The rates paid on time deposits and other rate sensitive products have reached attractive levels causing deposit customers to shift funds from transaction accounts, primarily non-interest demand and money market accounts, into these higher rate accounts.

Anticipated growth in earning assets is expected to continue to increase levels of net interest income. We do, however, expect the continued shift in our funding sources to higher costing funds, and the current indifference between short-term and long-term rates to place continued downward pressure on our net interest margin.

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The following table shows an analysis of net interest margin for the three-month periods ending September 30, 2006 and 2005.

| | For the three months ended September 30, | | | | | |
|---|--|-------------------------------|--------------------------------|--------------------|-------------------------------|-----------------------------|
| | 2006 | | | 2005 | | |
| | Average Balance | Interest Earned or paid | Average Yield or cost | Average Balance | Interest Earned or paid | Average Yield or cost |
| | (Dollars in thousands) | | | | | |
| <u>Assets</u> | | | | | | |
| Taxable securities | \$ 130,103 | \$ 1,378 | 4.23% | \$ 113,125 | \$ 1,136 | 4.02% |
| Tax-exempt securities (1) | 50,833 | 536 | 6.49% | 50,176 | 530 | 6.52% |
| Loans | 1,665,239 | 32,581 | 7.68% | 1,498,344 | 25,665 | 6.72% |
| Federal Home Loan Bank stock | 13,045 | 99 | 2.98% | 13,910 | 166 | 4.67% |
| Federal funds sold | 13,971 | 185 | 5.19% | 29,105 | 255 | 3.43% |
| | 1,873,191 | 34,779 | 7.35% | 1,704,660 | 27,752 | 6.47% |
| Noninterest earning assets: | | | | | | |
| Cash and due from banks | 37,700 | | | 32,709 | | |
| Other | 99,949 | | | 96,202 | | |
| | \$ 2,010,840 | | | \$ 1,833,571 | | |
| <u>Liabilities</u> | | | | | | |
| NOWs and MMDAs | \$ 681,927 | 6,008 | 3.50% | \$ 599,805 | 3,091 | 2.05% |
| Savings | 41,385 | 61 | 0.58% | 41,763 | 51 | 0.48% |
| IRAs | 37,380 | 409 | 4.34% | 30,953 | 285 | 3.65% |
| Time deposits | 670,587 | 7,862 | 4.65% | 592,887 | 5,457 | 3.65% |
| Other borrowed funds | 192,443 | 2,337 | 4.75% | 175,581 | 1,742 | 3.88% |
| Long-term debt | 41,238 | 879 | 8.34% | 41,238 | 677 | 6.43% |
| Federal funds borrowed | 11,408 | 140 | 4.80% | 37,792 | 344 | 3.56% |
| | 1,676,368 | 17,696 | 4.18% | 1,520,019 | 11,647 | 3.03% |
| Noninterest bearing liabilities: | | | | | | |
| Noninterest bearing demand accounts | 174,287 | | | 168,387 | | |
| Other noninterest bearing liabilities . | 7,038 | | | 6,609 | | |
| Shareholders' equity | 153,147 | | | 138,556 | | |
| | \$ 2,010,840 | | | \$ 1,833,571 | | |
| Net interest income | | \$ 17,083 | | | \$ 16,105 | |
| Net interest spread (1) | | | 3.17% | | | 3.44% |
| Net interest margin (1) | | | 3.62% | | | 3.76% |
| Ratio of average interest earning assets to average interest bearing liabilities | 111.74% | | | 112.15% | | |

(1) Yield adjusted to fully tax equivalent.

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The following table shows an analysis of net interest margin for the nine-month periods ending September 30, 2006 and 2005.

For the nine months ended September 30,

| | 2006 | | | 2005 | | |
|---|---------------------|-------------------------------|--------------------------------|---------------------|-------------------------------|-----------------------------|
| | Average Balance | Interest Earned or paid | Average Yield or cost | Average Balance | Interest Earned or paid | Average Yield or cost |
| (Dollars in thousands) | | | | | | |
| <u>Assets</u> | | | | | | |
| Taxable securities | \$ 122,116 | \$ 3,789 | 4.13% | \$ 107,985 | \$ 3,268 | 4.04% |
| Tax-exempt securities (1) | 50,904 | 1,608 | 6.48% | 48,838 | 1,552 | 6.54% |
| Loans | 1,619,458 | 91,849 | 7.50% | 1,454,678 | 70,789 | 6.43% |
| Federal Home Loan Bank stock | 13,619 | 462 | 4.47% | 13,093 | 433 | 4.36% |
| Federal funds sold | 5,360 | 208 | 5.11% | 10,478 | 266 | 3.35% |
| Total interest earning assets (1) | 1,811,457 | 97,916 | 7.21% | 1,635,072 | 76,308 | 6.24% |
| Noninterest earning assets: | | | | | | |
| Cash and due from banks | 36,629 | | | 34,414 | | |
| Other | 98,056 | | | 93,088 | | |
| Total assets | \$ 1,946,142 | | | \$ 1,762,574 | | |
| <u>Liabilities</u> | | | | | | |
| NOWs and MMDAs | \$ 638,227 | 14,987 | 3.14% | \$ 622,064 | 8,480 | 1.82% |
| Savings | 41,411 | 179 | 0.58% | 40,796 | 132 | 0.43% |
| IRAs | 35,774 | 1,119 | 4.18% | 29,991 | 785 | 3.50% |
| Time deposits | 677,545 | 22,369 | 4.41% | 520,667 | 12,823 | 3.30% |
| Other borrowed funds | 170,294 | 5,761 | 4.46% | 175,340 | 4,997 | 3.76% |
| Long-term debt | 41,238 | 2,474 | 7.91% | 41,238 | 1,869 | 5.98% |
| Federal funds borrowed | 17,929 | 655 | 4.82% | 32,610 | 786 | 3.18% |
| Total interest bearing liabilities | 1,622,418 | 47,544 | 3.91% | 1,462,706 | 29,872 | 2.72% |
| Noninterest bearing liabilities: | | | | | | |
| Noninterest bearing demand accounts | 167,278 | | | 158,359 | | |
| Other noninterest bearing liabilities | 7,406 | | | 6,614 | | |
| Shareholders' equity | 149,040 | | | 134,895 | | |
| Total liabilities and shareholders' equity | \$ 1,946,142 | | | \$ 1,762,574 | | |
| Net interest income | | \$ 50,372 | | | \$ 46,436 | |
| Net interest spread (1) | | | 3.30% | | | 3.52% |
| Net interest margin (1) | | | 3.71% | | | 3.81% |
| Ratio of average interest earning assets to average interest bearing liabilities | 111.65% | | | 111.78% | | |

(1) Yield adjusted to fully tax equivalent.

Provision for Loan Losses: The provision for loan losses for the three and nine month periods ended September 30, 2006 was \$490,000 and \$2.0 million compared to \$855,000 and \$2.9 million for the same periods in the prior year. The provision for loan losses was down partially due to lower levels of net charge-offs in the current three and nine month periods ended when compared to the same periods in the prior year. The amounts of loan loss provision in both the current and prior year periods were a byproduct of establishing our allowance for loan losses at levels deemed necessary in our methodology for determining the adequacy of the allowance. For more information about our allowance for loan losses and our methodology for establishing its level, see the discussion below under Portfolio Loans and Asset Quality.

Noninterest Income: Noninterest income for the three and nine month periods ended September 30, 2006 was \$3.5 million and \$10.3 million, respectively, from \$3.6 million and \$10.0 million for the same periods in the prior year. Included in other income for the three and nine months ended September 30, 2005 was a \$148,000 gain on the sale of a commercial property. In addition, the nine month period ended September 30, 2005 included a \$200,000 gain on the sale of a commercial property held as other real estate. An increase in revenue from service charges on deposits accounted for the majority of the increase for the nine month period. Continued growth in the number of demand deposit accounts and an overdraft privilege service implemented for deposit customers during the second quarter of 2005 were the primary reasons for the \$505,000 increase for the nine month period end September 30, 2006. Gains on loans sold decreased \$332,000 and \$504,000, respectively, during the three and nine month periods due to a decline in mortgage loan origination volume as mortgage interest rate levels have increased. These declines were offset by increases in trust fees and other income, including brokerage fees and other financial service fees, during the three and nine month periods as a result of continued expansion of our customer base.

Noninterest Expense: Noninterest expense for the three and nine month periods ended September 30, 2006 increased to \$11.3 million and \$33.7 million, respectively, from \$10.7 million and \$30.6 for the same periods in the prior year. Salaries and benefits increased by \$438,000 and \$1.9 million, respectively, compared to the same periods in the prior year. Effective January 1, 2006, we adopted FAS 123, Revised, and accordingly, we recorded stock option compensation expense of \$174,000 and \$548,000 for the three and nine months ended September 30, 2006. The remaining increase related to additional staffing for new branch locations and in each line of business and in support departments consistent with growth of the Bank. These increased costs reflect our attention to properly managing and supporting our growth and our interest in creating a platform for strong future growth. Occupancy and furniture and equipment expense has increased along with our branch expansion, which included one new location and a relocation of one of our branch sites since the second quarter of last year. In general, other expense categories have remained relatively flat or increased consistent with growth of the Bank. Although we expect noninterest expense levels to generally rise with our growth, we expect efficiency to improve by better utilizing our capacity as we grow. We believe the additional capacity within our branch network will continue to provide future growth opportunities without significant additional costs.

FINANCIAL CONDITION

Summary: Total assets were \$2.04 billion at September 30, 2006, an increase of \$171.0 million from \$1.87 billion at December 31, 2005. The growth in assets was primarily from an increase of \$134.5 million in total portfolio loans and \$36.2 million in securities available for sale. Cash and cash equivalents decreased \$6.7 million slightly offsetting the increases in portfolio loans and securities available for sale. Cash levels were higher than normal at December 31, 2005 due to a large inflow of customer deposits that occurred at year-end. The growth in assets was funded by an increase of \$125.0 million in deposits and \$31.1 million in borrowed funds.

Securities Available for Sale: Securities available for sale were \$192.9 million at September 30, 2006 compared to \$156.7 million at December 31, 2005. The increase was from purchases of U.S. Government Agency bonds with maturities of five years or less. The purchases did not include any mortgage-backed securities. The investment portfolio, as a percentage of assets, had declined through the second quarter of 2006. We determined it would be appropriate to raise this percentage, primarily for liquidity management purposes. The recent changes in the rate environment provided good buying opportunities and allowed us to increase the portfolio, as a percentage of total assets, to a more desirable level.

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Portfolio Loans and Asset Quality: Total portfolio loans were \$1.68 billion at September 30, 2006 compared to \$1.55 billion at December 31, 2005. Commercial loans continue to lead our loan portfolio growth. Of the \$134.5 million in growth during the first nine months of 2006, \$111.1 million or 83% was from our commercial loan portfolios. Commercial and commercial real estate loans accounted for approximately 75% of the total loan portfolio at September 30, 2006 and approximately 74% at December 31, 2005. A further breakdown of the composition of the commercial real estate loans is shown in the table below (in thousands):

| | September 30, 2006 | December 31, 2005 |
|--|-------------------------------|------------------------------|
| Construction/Land Development | \$ 375,758 | \$ 305,066 |
| Farmland and Agriculture | 34,253 | 35,309 |
| Nonfarm, Nonresidential | 423,940 | 423,388 |
| Multi-family | 31,797 | 30,156 |
| Total Commercial Real Estate Loans | \$ 865,748 | \$ 793,919 |

Approximately two-thirds of the balance in the construction and land development category and the entire balance in the multi-family category are comprised of non-owner occupied loans as of both September 30, 2006 and December 31, 2005.

Residential mortgage loans comprised 14% of the portfolio, while consumer loans were 11% of total loans at September 30, 2006.

The loan growth we have experienced continues to reflect the acceptance of our community banking philosophy in the communities we serve. Loans grew by \$42.3 million, \$62.9 million, and \$29.3 million, respectively, in the first, second and third quarters of 2006. The slower loan growth in the recent quarter reflects continued softness in the West Michigan economy and our interest in maintaining the quality of our loan portfolio. We are, however, optimistic of our future prospects and expect our growth rates to continue.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. Our nonperforming loans include loans on non-accrual status, restructured loans, as well as loans delinquent more than 90 days, but still accruing. Foreclosed and repossessed assets include assets acquired in settlement of loans. Nonperforming loans to total loans increased to 0.34% at September 30, 2006 from 0.27% at December 31, 2005 and nonperforming assets to total assets increased to 0.42% at September 30, 2006 from 0.26% at December 31, 2005. The balance in nonperforming loans at September 30, 2006 is comprised of a number of smaller commercial relationships for which we are considered to be well collateralized or adequately reserved. The balance in foreclosed assets at September 30, 2006 is comprised of a number of smaller commercial and residential properties for which carrying values are considered to be fully collectible.

The following table shows the composition and amount of our nonperforming assets.

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| (Dollars in thousands) | September 30, 2006 | December 31, 2005 |
|---|--------------------|-------------------|
| Nonaccrual loans | \$ 5,248 | \$ 3,977 |
| Loans 90 days past due and still accruing | 520 | 227 |
| Total nonperforming loans | 5,768 | 4,204 |
| Foreclosed assets | 2,675 | 527 |
| Reposessed Assets | 83 | 165 |
| Total nonperforming assets | \$ 8,526 | \$ 4,896 |

| | | |
|--------------------------------------|-------|-------|
| Nonperforming loans to total loans | 0.34% | 0.27% |
| Nonperforming assets to total assets | 0.42% | 0.26% |

Allowance for loan losses: The allowance for loan losses as of September 30, 2006 was \$22.4 million, or 1.33% of total portfolio loans, compared to \$21.0 million, or 1.36% of total portfolio loans at December 31, 2005. The provision for loan losses declined \$890,000 to \$2.0 million for the nine months ended 2006 compared to \$2.9 million for the same period of the prior year primarily due to a decline in net charge-offs. Net charge-offs for the nine months ended September 30, 2006 totaled \$554,000 as compared to \$1.6 million for the same period in 2005. The ratio of net charge-offs to average loans was 0.05% on an annualized basis for the first nine months of 2006 compared to 0.15% for the first nine months of 2005.

Our allowance for loan losses is maintained at a level management considers appropriate based upon our regular, quarterly assessments of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance relies on several key elements, including the allocation of specific portions of the allowance to loans designated as impaired and general allocations of the allowance, based on historical trends and other factors, to pools of loans with similar risk characteristics.

Specific allowances are established in cases where senior credit management has identified significant conditions or circumstances related to an individually impaired credit that we believe indicates the probability that a loss has been incurred. This amount is determined by methods prescribed by SFAS No. 114, Accounting by Creditors for Impairment of a Loan. The specific allowance for impaired loans was \$212,000 at September 30, 2006 and \$333,000 at December 31, 2005.

The allowance allocated to commercial loans that are not considered to be impaired is calculated by applying loss factors to outstanding loans based on the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are assigned a loss allocation factor for each loan classification category. The lower the grade assigned to a loan category, the greater the allocation percentage that is applied. Changes in risk grade of loans affect the amount of the allowance allocation. Our loan portfolio has grown rapidly since our inception. As a result, a significant portion of our loan portfolio remains relatively unseasoned and our actual historical loan loss experience is limited. Accordingly, the determination of our loss factors includes consideration of the banking industry's historical loan loss experience by loan type and the historical loan loss experience within our geographic markets, as well as our own loan loss experience and trends. These factors are regularly monitored and adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the analysis date. The commercial loan allowance was \$20.5 million at September 30, 2006 compared to \$18.6 million at December 31, 2005 and increased primarily in response to the continuing growth in the commercial loan portfolio.

Groups of homogeneous loans, such as residential real estate, open- and closed-end consumer loans, etc., receive allowance allocations based on loan type. As with commercial loans, the determination of the allowance allocation percentage includes consideration of historical loss trends based on industry and peer experience as well as our historical loss experience. General economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience are considered in connection with allocation factors for these similar pools of loans. The homogeneous loan allowance was \$1.7 million at September 30, 2006 compared to \$2.1 million at December 31, 2005. The decline was due to improvement in past due consumer loan balances.

Deposits and Other Borrowings: Total deposits increased \$125.0 million to \$1.63 billion at September 30, 2006 compared to \$1.51 billion at December 31, 2005. The growth for the first nine months of 2006 has been primarily in certain interest bearing checking and money market accounts and certificates of deposit, as market rates on these deposit types have begun to increase from historic lows and become more attractive to our customers. We opened approximately 8,607 new checking accounts during the first nine months of 2006. It is expected that as these new accounts develop into more full relationships, they will further contribute to deposit growth. With our continued focus on quality customer service, the desire of customers to deal with a local bank, and the convenience of our expanding and maturing branch network, we expect further growth in our core transaction deposits.

The increase in borrowed funds of \$31.1 million was related to an increase of \$56.9 million in Federal Home Loan Bank advances and securities sold under agreements to repurchase (repo borrowings), offset by a reduction in federal funds purchased, to support the asset growth we experienced during the first nine months of 2006. During the third quarter of 2006, the bank introduced repo borrowings to diversify its alternative sources of funds. The terms and structure of these instruments are similar to Federal Home Loan Bank advances and will allow us more pricing options for funding.

CAPITAL RESOURCES AND LIQUIDITY

Capital Resources: Total shareholders' equity increased \$13.4 million during the first nine months to \$155.1 million at September 30, 2006, primarily due to the retention of earnings.

Net income generated during the first nine months of 2006 of \$17.0 million was partially offset by cash dividends of \$5.7 million, or \$.35 per share. We began paying cash dividends at the end of 2000 and have increased the amount of the dividend each year since then. It is anticipated that we will continue to pay quarterly cash dividends in the future. We have also paid a stock dividend each year beginning in 2001. On May 30, 2006, a 5% stock dividend was paid to shareholders of record as of May 12, 2006, representing our sixth consecutive annual stock dividend. In addition, a 3-for-2 stock split was paid June 29, 2006 to shareholders of record as of June 9, 2006. All per share and average share information in this report has been adjusted to reflect the effect of the dividend and the split.

At September 30, 2006 and December 31, 2005, our total capital to risk-weighted assets was 11.0% and 11.1%, respectively. Our Tier 1 Capital as a percent of average assets was 8.6% and 8.7% at September 30, 2006 and December 31, 2005, respectively. Both ratios continue to be maintained at levels in excess of the regulatory minimums for *well capitalized* institutions. The ratios remained relatively stable since the beginning of the year because our strong earnings have kept pace with the growth in our assets.

Liquidity: The liquidity of a financial institution reflects its ability to measure and monitor a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for growing our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the Federal Home Loan Bank, structured repo borrowings and federal funds purchased lines with our correspondent banks, loan payments by our borrowers, maturities and sales of our securities available for sale, growth of our deposits and deposit equivalents, federal funds sold, and the various capital resources discussed above. Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. We feel our liquidity position is sufficient to meet these needs.

Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us or our management, are intended to identify forward-looking statements. The presentation and discussion of the provision and allowance for loan losses, statements concerning future profitability or future growth or increases, and statements about the adequacy of our capital resources are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our filings with the Securities and Exchange Commission.

Item 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKMarket Risk Analysis

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity (EVE) resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of September 30, 2006 (dollars in thousands).

| Interest Rate Scenario | Economic Value of Equity | Percent Change | Net Interest Income | Percent Change |
|--------------------------------------|-------------------------------------|---------------------------|----------------------------|---------------------------|
| Interest rates up 200 basis points | \$ 190,280 | (10.45)% | \$ 71,452 | 2.20% |
| Interest rates up 100 basis points | 201,436 | (5.20) | 70,782 | 1.24 |
| No change in interest rates | 212,480 | --- | 69,916 | --- |
| Interest rates down 100 basis points | 219,415 | 3.26 | 68,888 | (1.47) |
| Interest rates down 200 basis points | 223,338 | 5.11 | 67,772 | (3.07) |

If interest rates were to increase, this analysis suggests that we are positioned for a slight improvement in net interest income over the next twelve months. Further, our balanced sensitivity in time horizons beyond one year results in little fluctuation in EVE under the various rate shock scenarios.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; and client preferences.

Item 4: CONTROLS AND PROCEDURES

- (a) Evaluation of Disclosure Controls and Procedures. The Company's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would be made known to them by others within the company, particularly during the period in which this Form 10-Q Quarterly Report was being prepared.
- (b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Please refer to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, (Part II, Item 1 Legal Proceedings) for information concerning legal proceedings related to Trade Partners, Inc.

A lawsuit was filed in April 2003 by John and Kathryn Brand in Oklahoma state court against Grand Bank, the Company, Trade Partners and certain individuals and entities associated with Trade Partners. The complaint seeks damages for the asserted breach of certain escrow agreements for which Grand Bank served as custodian and escrow agent. The claims asserted against the Company and Grand Bank in this action have been settled and dismissed with prejudice.

In May 2003, a purported class action complaint was filed by Forrest W. Jenkins and Russell S. Vail against the Company in the United States District Court for the District of Western Michigan. As amended, this suit alleges that Grand Bank breached escrow agreements and fiduciary duties and violated the Michigan Uniform Securities Act with respect to the investments secured by the purported class in viaticals and in interests in limited partnerships which made loans to Trade Partners secured by viaticals, and with respect to loans made by purported class members directly to Trade Partners. The class has not been certified. A hearing on plaintiffs' motion for certification was held in October 2006, but no ruling has yet been issued. The Company has answered this complaint denying the material allegations and raising certain affirmative defenses.

In late July 2005 counsel to the Trade Partners receiver filed another purported class action on behalf of Kelly Priest and certain trusts controlled by Gary Towle and his wife, making substantially the same allegations as in the Jenkins complaint, but on behalf of a class which was asserted to comprise all investors who are holders of allowed claims in the Trade Partners receivership. This case has been subsumed within and superseded by the Jenkins case, described above, and the operative class allegations are those now set forth in the Jenkins case. Counsel to the Trade Partners receiver has withdrawn from this litigation, though the Trade Partners receiver has stated that he is cooperating with class counsel.

The Company believes it has meritorious defenses and intends to vigorously defend these cases.

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On April 15, 2003, the United States District Court for the Western District of Michigan appointed a receiver for Trade Partners. In order to prevent or minimize any loss to investors in the viaticals sold by Trade Partners to investors, the court-appointed receiver has been coordinating the payment of premiums on the approximately 1,000 outstanding viaticated insurance policies in the Trade Partners portfolio so that the policies do not lapse. The receiver informed the Company that nine policies with a total face value of approximately \$1.4 million lapsed for failure to pay premiums prior to the receiver's coordination efforts. In addition, the receiver unsuccessfully contested a partial lapse totaling about \$700,000.

The receiver has received court permission to pool the death benefits of any of the Trade Partners viaticated policies that mature and use the benefits to pay premiums on other viaticated policies. As of October 15, 2006, the receiver reported that he has received since the inception of the receivership cash payments for death benefit claims aggregating approximately \$31 million. He reported at the same time that all premium payments were current. He also reported at that time that he had paid premiums on the portfolio approximating \$14.1 million since the inception of the receivership. As of October 15, 2006 the receiver reported cash on hand of approximately \$44.1 million. As additional viaticated policies mature, death benefits from those policies could provide a source of funding for continued premium payments, though the receiver's ability to so use such benefits may be limited or eliminated by the terms of the sale of the portfolio to Universal Settlements International, Inc., described below.

On July 1, 2003, the United States District Court for the Western District of Michigan authorized the receiver to borrow money from Macatawa Bank to pay premiums, if needed. Macatawa Bank agreed to extend a \$4 million line of credit to the receiver, conditioned upon obtaining a security interest in the viaticals. No draws were made against the line, and the line expired during the fourth quarter of 2004.

The receiver received authorization from the Court in July 2005 to sell the entire portfolio, which the receiver said had a face value of approximately \$170 million, to Universal Settlements International, Inc., a Canadian company, for an amount equal to 26.58% of face value, or approximately \$43 million. Under the terms of the sale, payments are to be made by Universal Settlements to the receivership as policy transfers are processed by the issuing insurance companies. The receiver has reported that as of October 15, 2006 payments aggregating approximately \$31.2 million had been received on policies transferred pursuant to the sale agreement, plus another \$903,772.68 on policies that matured after the sale but before transfer.

The receiver on July 21, 2006 filed a proposed amended plan of distribution and related disclosure statement, contemplating a complete liquidation of the assets of Trade Partners. Hearings have been held on the proposed plan, but no ruling has yet been issued approving or disapproving it. The receiver reported as of October 15, 2006 that claims against the receivership estate totaling \$167,403,474.79 have been approved, and reported total active claims of \$169,686,482.15. The receiver further reported that as of October 15, 2006 emergency distributions totaling \$344,844.25 had been made as advances to certain investors.

The proposed disclosure statement that accompanied the July 21, 2006 proposed amended plan of distribution stated that the receiver estimates that he will have approximately \$42.5 million available for distribution when he proposes to commence distributions in late 2006. The receiver proposes to complete distributions in 2007. The disclosure statement estimated that approved claims would total approximately \$162,052,663.83. The disclosure statement indicated that Trade Partners investors should therefore expect to receive initial distributions totaling about 26.39% of their approved claims, and estimates that another 8% of such approved claims will ultimately be distributed.

It is possible that one or more additional legal actions may be initiated involving the custodial and escrow agent services provided by Grand Bank in connection with Trade Partners. If any such legal actions are commenced, the Company intends to defend them vigorously. To the extent any pending or future claims allege errors or omissions on the part of Grand Bank or Macatawa Bank, Management believes that some or all liability, if any is proven or established, will be covered by errors and omissions insurance maintained by Grand Bank and Macatawa Bank. The Company has reported the Trade Partners matter to its two insurance carriers. Federal Insurance Company has assumed the Company's defense and has advanced a portion of its defense costs pursuant to a reservation of rights letter asserting certain coverage defenses, and an Interim Funding Agreement. Federal Insurance Company notified the Company on July 21, 2006 that it has filed an Arbitration Demand with the American Arbitration Association, seeking a declaration that based upon its asserted coverage defenses its policy does not cover this matter. The Company and Federal Insurance Company have agreed to defer any proceedings with respect to this Arbitration Demand. The Company believes that Federal Insurance Company is obligated to provide coverage, and the Company intends to vigorously pursue its rights under the insurance policy. The other carrier has taken the position that the duty of defense rests solely with the first carrier, and reserves its rights with respect to indemnity pursuant to a reservation letter asserting certain coverage defenses.

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As of the date hereof, except as disclosed above, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking to which we or any of our subsidiaries are a party of or which any of our properties are the subject.

Item 1A. Risk Factors.

There have been no material changes in the risk factors applicable to the Company from those disclosed in its Annual Report on Form 10-K for the year ended December 31, 2005.

Item 2. Changes in Securities and Use of Proceeds. None.

Item 3. Defaults Upon Senior Securities. None.

Item 4. Submission of Matters to a Vote of Securities Holders. None.

Item 5. Other Information. None.

Item 6. Exhibits.

- 31.1 Certificate of the Chief Executive Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of the Chief Financial Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Chief Executive Officer and the Chief Financial Officer of Macatawa Bank Corporation pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Quarterly Report on Form 10-Q for the quarter ended September 30, 2006, to be signed on its behalf by the undersigned, thereunto duly authorized.

MACATAWA BANK CORPORATION

/s/ Benj. A. Smith, III

Benj. A. Smith, III
Chairman and Chief Executive Officer

/s/ Jon W. Swets

Jon W. Swets
Chief Financial Officer
(Principal Financial and Accounting Officer)

DATE: November 2, 2006

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EXHIBIT INDEX

| <u>Exhibit</u> | <u>Description</u> |
|----------------|---|
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