

PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
August 01, 2007

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

FORM 10-Q

(mark one)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007
- or
- TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d) OF THE
SECURITIES AND EXCHANGE ACT OF 1934**
For the transition period from ____ to ____
Commission File Number: 000-31225

, Inc.

(Exact name of registrant as specified in its
charter)

Tennessee
(State or other jurisdiction of incorporation or
organization)

62-1812853
(I.R.S. Employer Identification No.)

211 Commerce Street, Suite 300, Nashville, Tennessee
(Address of principal executive offices)

37201
(Zip Code)

(615) 744-3700
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changes since last report)

Indicate by check mark 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 T

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. (Check one):

Large Accelerated Filer £

Accelerated Filer T

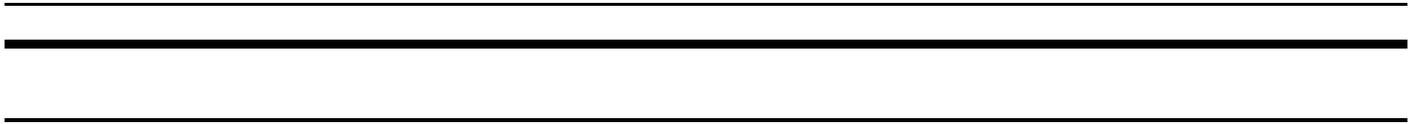
Non-accelerated Filer £

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes £

No T

As of July 30, 2007 there were 15,547,063 shares of common stock, \$1.00 par value per share, issued and outstanding.



Pinnacle Financial Partners, Inc.
Report on Form 10-Q
June 30, 2007

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FORWARD-LOOKING STATEMENTS

Pinnacle Financial Partners, Inc. (“Pinnacle Financial”) may from time to time make written or oral statements, including statements contained in this report which may constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect”, “anticipate”, “intend”, “consider”, “plan”, “believe”, “seek”, “should”, “estimate”, and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management's belief as well as assumptions made by, and information currently available to, management pursuant to "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Pinnacle Financial’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors are described below and in Pinnacle Financial’s Form 10-K, as updated by Item 1A of part II of this Form 10-Q and include, without limitation, (i) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (ii) increased competition with other financial institutions, (iii) lack of sustained growth in the economy in the Nashville, Tennessee or Knoxville, Tennessee areas, (iv) rapid fluctuations or unanticipated changes in interest rates, (v) the inability of our bank subsidiary, Pinnacle

National Bank to satisfy regulatory requirements for its expansion plans, (vi) the inability of Pinnacle Financial to achieve its targeted expansion goals in the Knoxville, Tennessee market, (vii) the ability of Pinnacle Financial to grow its loan portfolio at historic or planned rates and (viii) changes in the legislative and regulatory environment, including compliance with the various provisions of the Sarbanes-Oxley Act of 2002. Many of such factors are beyond Pinnacle Financial's ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Pinnacle Financial does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Pinnacle Financial.

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ITEM 1.

Part I. FINANCIAL INFORMATION

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2007	December 31, 2006
<u>ASSETS</u>		
Cash and noninterest-bearing due from banks	\$ 51,816,558	\$ 43,611,533
Interest-bearing due from banks	10,375,896	1,041,174
Federal funds sold	43,808,801	47,866,143
Cash and cash equivalents	106,001,255	92,518,850
Securities available-for-sale, at fair value	312,712,769	319,237,428
Securities held-to-maturity (fair value of \$26,211,163 and \$26,594,235 at June 30, 2007 and December 31, 2006, respectively)	27,068,467	27,256,876
Mortgage loans held-for-sale	4,972,689	5,654,381
Loans	1,663,029,941	1,497,734,824
Less allowance for loan losses	(17,375,408)	(16,117,978)
Loans, net	1,645,654,533	1,481,616,846
Premises and equipment, net	37,854,546	36,285,796
Investments in unconsolidated subsidiaries and other entities	17,000,500	16,200,684
Accrued interest receivable	11,434,826	11,019,173
Goodwill	114,287,640	114,287,640
Core deposit intangible, net	10,353,498	11,385,006
Other assets	27,986,475	26,724,183
Total assets	\$ 2,315,327,198	\$ 2,142,186,863
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Deposits:		
Noninterest-bearing demand	\$ 294,630,589	\$ 300,977,814
Interest-bearing demand	284,080,394	236,674,425
Savings and money market accounts	530,081,179	485,935,897
Time	688,744,094	598,823,167
Total deposits	1,797,536,256	1,622,411,303
Securities sold under agreements to repurchase	140,442,583	141,015,761
Federal Home Loan Bank advances	26,698,614	53,725,833
Federal funds purchased	20,000,000	-
Subordinated debt	51,548,000	51,548,000
Accrued interest payable	5,960,627	4,952,422
Other liabilities	7,946,624	12,516,523
Total liabilities	2,050,132,704	1,886,169,842
Stockholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, par value \$1.00; 90,000,000 shares authorized;		

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15,545,581 issued and outstanding at June 30, 2007 and 15,446,074 issued and outstanding at December 31, 2006	15,545,581	15,446,074
Additional paid-in capital	212,922,658	211,502,516
Retained earnings	42,137,029	31,109,324
Accumulated other comprehensive loss, net of deferred income taxes	(5,410,774)	(2,040,893)
Total stockholders' equity	265,194,494	256,017,021
Total liabilities and stockholders' equity	\$ 2,315,327,198	\$ 2,142,186,863

See accompanying notes to consolidated financial statements.

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Interest income:				
Loans, including fees	\$ 30,555,889	\$ 24,245,895	\$ 59,533,113	\$ 37,424,725
Securities:				
Taxable	3,394,359	3,148,459	6,740,479	6,009,577
Tax-exempt	693,417	494,849	1,362,936	895,622
Federal funds sold and other	864,198	415,437	1,610,577	785,112
Total interest income	35,507,863	28,304,640	69,247,105	45,115,036
Interest expense:				
Deposits	14,456,629	9,563,035	27,993,892	15,413,344
Securities sold under agreements to repurchase	1,890,743	678,177	3,602,834	1,186,965
Federal funds purchased and other borrowings	1,499,436	1,168,265	2,906,896	2,112,761
Total interest expense	17,846,808	11,409,477	34,503,622	18,713,070
Net interest income	17,661,055	16,895,163	34,743,483	26,401,966
Provision for loan losses	899,998	1,706,865	1,687,964	2,094,049
Net interest income after provision for loan losses	16,761,057	15,188,298	33,055,519	24,307,917
Noninterest income:				
Service charges on deposit accounts	1,920,085	1,356,114	3,717,234	1,794,384
Investment sales commissions	850,207	652,900	1,584,767	1,166,497
Insurance sales commissions	628,953	748,534	1,265,915	1,013,362
Gain on loans and loan participations sold, net	638,895	470,809	1,002,201	795,355
Trust fees	425,205	311,997	845,495	363,997
Other noninterest income	1,088,172	839,771	2,161,488	1,294,781
Total noninterest income	5,551,517	4,380,125	10,577,100	6,428,376
Noninterest expense:				
Compensation and employee benefits	8,794,853	7,289,996	17,061,354	11,738,354
Equipment and occupancy	2,412,528	2,081,194	4,577,230	3,254,547
Marketing and other business development	430,291	357,904	682,026	548,375
Postage and supplies	524,197	445,211	979,114	630,619
Amortization of core deposit intangible	515,755	515,755	1,031,508	647,437
Other noninterest expense	1,806,680	1,493,765	3,276,764	2,250,377
Merger related expense	-	921,237	-	1,364,567
Total noninterest expense	14,484,304	13,105,062	27,607,996	20,434,276
Income before income taxes	7,828,270	6,463,361	16,024,623	10,302,017

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Income tax expense	2,402,405	2,140,887	4,996,918	3,367,647
Net income	\$ 5,425,865	\$ 4,322,474	\$ 11,027,705	\$ 6,934,370

Per share information:

Basic net income per common share	\$ 0.35	\$ 0.28	\$ 0.71	\$ 0.56
Diluted net income per common share	\$ 0.33	\$ 0.26	\$ 0.66	\$ 0.51

Weighted average shares outstanding:

Basic	15,494,522	15,335,754	15,464,151	12,473,187
Diluted	16,664,213	16,503,692	16,640,977	13,640,565

See accompanying notes to consolidated financial statements.

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(Unaudited)

For the six months ended June 30, 2007 and 2006

Common Stock

	Shares	Amount	Additional Paid-in Capital	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balances, December 31, 2005	8,426,551	\$ 8,426,551	\$ 44,890,912	\$ (169,689)	\$ 13,182,291	\$ (2,893,640)	\$ 63,436,425
Transfer of unearned compensation to additional paid-in capital upon adoption of SFAS No. 123(R)	-	-	(169,689)	169,689	-	-	-
Exercise of employee common stock options and related tax benefits	83,667	83,667	813,688	-	-	-	897,355
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan	4,400	4,400	(4,400)	-	-	-	-
Compensation expense for restricted stock	-	-	127,218	-	-	-	127,218
Compensation expense for stock options	-	-	405,394	-	-	-	405,394
Merger with Cavalry Bancorp, Inc.	6,856,298	6,856,298	164,231,274	-	-	-	171,087,572
Dividends paid to minority interest shareholders of PNFP Properties, Inc.	-	-	-	-	(7,813)	-	(7,813)

Costs to register common stock issued in connection with the merger with Cavalry Bancorp, Inc.	-	-	(187,609)	-	-	-	(187,609)
Comprehensive income:							
Net income	-	-	-	-	6,934,370	-	6,934,370
Net unrealized holding losses on available-for-sale securities, net of deferred tax benefit of \$2,316,138	-	-	-	-	-	(3,954,393)	(3,954,393)
Total comprehensive income							2,979,977
Balances, June 30, 2006	15,370,916	\$ 15,370,916	\$ 210,106,788	\$ -	\$ 20,108,848	\$ (6,848,033)	\$ 238,738,519
Balances, December 31, 2006	15,446,074	\$ 15,446,074	\$ 211,502,516	\$ -	\$ 31,109,324	\$ (2,040,893)	\$ 256,017,021
Exercise of employee common stock options and related tax benefits	70,981	70,981	525,216	-	-	-	596,197
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan	28,526	28,526	(28,526)	-	-	-	-
Compensation expense for restricted stock	-	-	121,747	-	-	-	121,747
Compensation expense for stock options	-	-	801,705	-	-	-	801,705
Comprehensive income:							
Net income	-	-	-	-	11,027,705	-	11,027,705
Net unrealized holding losses on available-for-sale securities, net of	-	-	-	-	-	(3,369,881)	(3,369,881)

deferred tax benefit of \$1,285,456							
Total comprehensive income	7,657,824						
Balances, June 30, 2007	15,545,581	\$ 15,545,581	\$ 212,922,658	\$ -	\$ 42,137,029	\$ (5,410,774)	\$ 265,194,494

See accompanying notes to consolidated financial statements.

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six months ended June 30,	
	2007	2006
Operating activities:		
Net income	\$ 11,027,705	\$ 6,934,370
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net amortization of premium on securities	256,167	407,638
Depreciation and net amortization	1,040,380	2,102,657
Provision for loan losses	1,687,964	2,094,049
Gains on loans and loan participations sold, net	(1,002,201)	(795,355)
Stock-based compensation expense	923,452	532,612
Deferred tax benefit from exercise of stock options	(328,621)	(1,155,385)
Excess tax benefit from stock compensation	(94,640)	(74,908)
Mortgage loans held for sale:		
Loans originated	(81,770,437)	(61,896,095)
Loans sold	83,242,466	60,374,707
(Increase) decrease in other assets	1,263,176	(7,284,404)
Decrease in other liabilities	(3,561,695)	(7,225,932)
Net cash provided by (used in) operating activities	12,683,716	(5,986,046)
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(19,457,551)	(10,779,152)
Sales	-	-
Maturities, prepayments and calls	20,479,160	17,014,717
Increase in loans, net	1,021,609	6,235,565
Purchases of premises and equipment and software	(164,558,472)	(159,916,412)
Purchases of premises and equipment and software	(3,425,182)	(2,852,886)
Cash and cash equivalents acquired in merger with Cavalry Bancorp, Inc., net of acquisition costs	-	37,420,210
Investments in unconsolidated subsidiaries and other entities	(823,474)	-
Purchases of other assets	-	(519,689)
Net cash used in investing activities	(167,785,519)	(119,633,212)
Financing activities:		
Net increase in deposits	175,588,408	166,094,406
Net increase (decrease) in securities sold under agreements to repurchase	(573,178)	38,545,678
Net increase in Federal funds purchased	20,000,000	-
Advances from Federal Home Loan Bank:		
Issuances	45,000,000	31,000,000
Payments	(72,027,219)	(56,518,145)
Exercise of common stock options	501,557	822,447
Excess tax benefit from stock compensation	94,640	74,908

Costs incurred in connection with registration of common stock issued in merger	-	(187,609)
Net cash provided by financing activities	168,584,208	179,831,685
Net increase in cash and cash equivalents	13,482,405	54,212,427
Cash and cash equivalents, beginning of period	92,518,850	58,654,270
Cash and cash equivalents, end of period	\$ 106,001,255	\$ 112,866,697

See accompanying notes to consolidated financial statements.

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Nature of Business — Pinnacle Financial Partners, Inc. (Pinnacle Financial) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, Pinnacle National Bank (Pinnacle National). Pinnacle National is a commercial bank headquartered in Nashville, Tennessee with operations in Nashville and Knoxville, Tennessee. Pinnacle National provides a full range of financial services, including banking, investments, mortgages, and insurance.

Basis of Presentation — These consolidated financial statements include the accounts of Pinnacle Financial and its wholly-owned subsidiaries. PNFP Statutory Trust I, PNFP Statutory Trust II, PNFP Statutory Trust III and Collateral Plus, LLC, are affiliates of Pinnacle Financial and are included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary for a fair presentation of such financial statements for all periods presented.

Use of Estimates — The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses.

Impairment— Long-lived assets, including purchased intangible assets subject to amortization, such as Pinnacle Financial's core deposit intangible asset, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the excess of the carrying amount over the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill and intangible assets that have indefinite useful lives are tested annually for impairment and more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. Pinnacle Financial's annual assessment date is as of September 30 such that the assessment will be completed during the fourth quarter of each year. Should Pinnacle Financial determine in a future period that the goodwill recorded in connection with the acquisition of Cavalry Bancorp, Inc. ("Cavalry") has been impaired, then a charge to earnings will be recorded in the period such determination is made.

Cash and Cash Flows — Cash on hand, cash items in process of collection, amounts due from banks, Federal funds sold and securities purchased under agreements to resell, with original maturities within ninety days, are included in cash and cash equivalents. The following supplemental cash flow information addresses certain cash payments and noncash transactions for each of the six months ended June 30, 2007 and 2006 as follows:

For the six months ended June 30,
2007 *2006*

Cash Payments:

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Interest	\$	35,975,282	\$	12,618,997
Income taxes		7,850,000		3,600,000
<i>Noncash Transactions:</i>				
Loans charged-off to the allowance for loan losses		552,180		500,158
Loans foreclosed upon with repossessions transferred to other assets		110,570		-
Common stock and options issued to acquire Cavalry Bancorp, Inc		-		171,087,572

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Income Per Common Share — Basic earnings per share (“EPS”) is computed by dividing net income by the weighted average common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding was attributable to common stock options, warrants and restricted shares. The dilutive effect of outstanding options, warrants and restricted shares is reflected in diluted earnings per share by application of the treasury stock method.

As of June 30, 2007 and 2006, there were options outstanding to purchase 1,902,000 and 1,562,000 common shares, respectively. Most of these options have exercise prices, compensation costs attributable to future services and excess tax benefits, which when considered in relation to the average market price of Pinnacle Financial’s common stock, are considered dilutive and are considered in Pinnacle Financial’s diluted income per share calculation for the three and six months ended June 30, 2007 and 2006. There were common stock options of 221,000, and 380,000 outstanding as of June 30, 2007 and 2006, respectively, which were considered anti-dilutive and thus have not been considered in the diluted earnings per share calculations below. Additionally, as of June 30, 2007 and 2006, Pinnacle Financial had outstanding warrants to purchase 395,000 and 406,000, respectively, of common shares which have been considered in the calculation of Pinnacle Financial’s diluted net income per share for three and six months ended June 30, 2007 and 2006.

The following is a summary of the basic and diluted earnings per share calculation for the three and six months ended June 30, 2007 and 2006:

	<i>For the three months ended June 30,</i>		<i>For the six months ended June 30,</i>	
	<i>2007</i>	<i>2006</i>	<i>2007</i>	<i>2006</i>
Basic earnings per share calculation:				
Numerator - Net income	\$ 5,425,865	\$ 4,322,474	\$ 11,027,705	\$ 6,934,370
Denominator - Average common shares outstanding	15,494,522	15,335,754	15,464,151	12,473,187
Basic net income per share	\$ 0.35	\$ 0.28	\$ 0.71	\$ 0.56
Diluted earnings per share calculation:				
Numerator - Net income	\$ 5,425,865	\$ 4,322,474	\$ 11,027,705	\$ 6,934,370
Denominator - Average common shares outstanding	15,494,522	15,335,754	15,464,151	12,473,187
Dilutive shares contingently issuable	1,169,691	1,167,938	1,176,826	1,167,378
Average diluted common shares outstanding	16,664,213	16,503,692	16,640,977	13,640,565
Diluted net income per share	\$ 0.33	\$ 0.26	\$ 0.66	\$ 0.51

Comprehensive Income — SFAS No. 130, “Reporting Comprehensive Income” describes comprehensive income as the total of all components of comprehensive income including net income. Other comprehensive income refers to revenues, expenses, gains and losses that under U.S. generally accepted accounting principles are included in

comprehensive income but excluded from net income. Currently, Pinnacle Financial's other comprehensive income consists of unrealized gains and losses, net of deferred income taxes, on securities available-for-sale.

Note 2.

Merger with Cavalry Bancorp, Inc.

On March 15, 2006, Pinnacle Financial consummated its merger with Cavalry, a one-bank holding company located in Murfreesboro, Tennessee. Pursuant to the merger agreement, Pinnacle acquired all of the outstanding shares of Cavalry common stock via a tax-free exchange whereby Cavalry shareholders received a fixed exchange ratio of 0.95 shares of Pinnacle Financial common stock for each share of Cavalry common stock, or approximately 6.9 million Pinnacle Financial shares. The accompanying consolidated financial statements include the activities of the former Cavalry since March 15, 2006.

In accordance with SFAS No. 141, "Accounting for Business Combinations" ("SFAS No. 141"), SFAS No. 142, "Goodwill and Intangible Assets" ("SFAS No. 142") and SFAS No. 147, "Acquisition of Certain Financial Institutions" ("SFAS No. 147"), Pinnacle Financial recorded at fair value the following assets and liabilities of Cavalry as of March 15, 2006:

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Cash and cash equivalents	\$ 37,420,210
Investment securities – available-for-sale	39,476,178
Loans, net of an allowance for loan losses of \$5,102,296	545,598,367
Goodwill	114,287,640
Core deposit intangible	13,168,236
Other assets	42,936,956
Total assets acquired	792,887,587
Deposits	583,992,422
Federal Home Loan Bank advances	17,766,661
Other liabilities	18,851,261
Total liabilities assumed	620,610,344
Total consideration paid for Cavalry	\$ 172,277,243

As shown in the table above, total consideration for Cavalry approximates \$172.3 million of which \$171.1 million was in the form of Pinnacle Financial common shares and options to acquire Pinnacle Financial common shares and \$1.2 million in investment banking fees, attorney’s fees and other costs related to the acquisition which have been accounted for as a component of the purchase price. Pinnacle Financial issued 6,856,298 shares of Pinnacle Financial common stock to the former Cavalry shareholders. In accordance with EITF No. 99-12, “Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination,” the consideration shares were valued at \$24.53 per common share which represents the average closing price of Pinnacle Financial common stock from the two days prior to the merger announcement on September 30, 2005 through the two days after the merger announcement. Aggregate consideration for the common stock issued was approximately \$168.2 million. Additionally, Pinnacle Financial also has assumed the Cavalry Bancorp, Inc. 1999 Stock Incentive Plan (the “Cavalry Plan”) pursuant to which Pinnacle is obligated to issue 195,551 shares of Pinnacle Financial common stock upon exercise of stock options awarded to certain former Cavalry employees who held outstanding options as of March 15, 2006. All of these options were fully vested prior to the merger announcement date and expire at various dates between 2011 and 2012. The exercise prices for these stock options range between \$10.26 per share and \$13.68 per share. In accordance with SFAS No. 141, Pinnacle Financial has considered the fair value of these options in determining the acquisition cost of Cavalry. The fair value of these vested options approximated \$2.9 million which has been included as a component of the aggregate purchase price.

In accordance with SFAS Nos. 141 and 142, Pinnacle Financial recognized \$13.2 million as a core deposit intangible in connection with its merger with Cavalry. This identified intangible is being amortized over seven years using an accelerated method which anticipates the life of the underlying deposits to which the intangible is attributable. For the six months ended June 30, 2007 and 2006, \$1,032,000 and \$647,000 of amortization, respectively, was recognized in the accompanying statement of income. Amortization expense associated with this identified intangible will approximate \$1.8 million to \$2.1 million per year for the next four years with lesser amounts for the remaining two years.

Pinnacle Financial also recorded other adjustments to the carrying value of Cavalry’s assets and liabilities in order to reflect the fair value of those net assets in accordance with U.S. generally accepted accounting principles, including a \$4.8 million discount associated with the loan portfolio, a \$2.9 million premium for Cavalry’s certificates of deposit and a \$4.6 million premium for Cavalry’s land and buildings. Pinnacle Financial also recorded the corresponding deferred tax assets or liabilities associated with these adjustments. The discounts and premiums related to financial

assets and liabilities are being amortized into the statements of income using a method that approximates the level yield method over the anticipated lives of the underlying financial assets or liabilities. For the six months ended June 30, 2007 and 2006, the accretion of the fair value discounts related to the acquired loans and certificates of deposit increased net interest income by approximately \$1,520,000 and \$1,639,000, respectively. Based on the estimated useful lives of the acquired loans and deposits, Pinnacle Financial expects to recognize increases in net interest income related to accretion of these purchase accounting adjustments of \$2.5 million for the remainder of 2007 and in subsequent years.

Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer (“SOP 03-03”) addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. The SOP does not apply to loans originated by the entity. At March 15, 2006, Pinnacle Financial identified \$3.9 million in loans to which the application of the provisions of SOP 03-03 was required. The purchase accounting adjustments reflect a reduction in loans and the allowance for loan losses of \$1.0 million related to Cavalry’s impaired loans, thus reducing the carrying value of these loans to \$2.9 million as of March 15, 2006. At June 30, 2007, the carrying value of these loans had been reduced to \$903,000 due to cash payments received from the borrowers.

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The following pro forma income statements assume the merger was consummated on January 1, 2006 and purchase accounting adjustments began to be recorded at that time. The pro forma information does not reflect Pinnacle Financial's results of operations that would have actually occurred had the merger been consummated on such date (dollars in thousands, except per share information).

	Six months ended June 30,	
	2007	2006(1)
<i>Pro Forma Income Statements:</i>		
Net interest income	\$ 34,737	\$ 32,775
Provision for loan losses	1,688	3,075
Noninterest income	10,577	8,825
Noninterest expense:		
Compensation	17,061	14,519
Other noninterest expense	10,547	9,752
Net income before taxes	16,018	14,254
Income tax expense	4,995	6,075
Net income	\$ 11,023	\$ 8,179
<i>Pro Forma Per Share Information:</i>		
Basic net income per common share	\$ 0.71	\$ 0.53
Diluted net income per common share	\$ 0.66	\$ 0.50
Weighted average shares outstanding:		
Basic	15,494,522	15,314,194
Diluted	16,664,213	16,481,573

(1) In preparation and as a result of the merger during 2006, Cavalry and Pinnacle Financial incurred significant merger related charges of approximately \$10.6 million in the aggregate, primarily for severance benefits, accelerated vesting of defined compensation agreements, investment banker fees, etc. Including these charges would have decreased pro forma net income for the six months ended June 30, 2006 by \$6.1 million resulting in net income of \$2,080,000 and a basic and fully diluted net income per share of \$0.14 and \$0.13, respectively.

During the three and six months ended June 30, 2006, Pinnacle Financial incurred merger integration expense related to the merger with Cavalry of \$921,000 and \$1,365,000, respectively. These expenses were directly related to the merger, recognized as incurred and reflected on the accompanying consolidated statement of income as merger related expense.

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Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at June 30, 2007 and December 31, 2006 are summarized as follows:

	June 30, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	\$ -	\$ -	\$ -	\$ -
U.S. government agency securities	37,088,067	-	748,524	36,339,543
Mortgage-backed securities	214,963,742	33,903	6,512,318	208,485,327
State and municipal securities	67,633,103	1,315	1,582,346	66,052,072
Corporate notes and other	1,886,814	-	50,987	1,835,827
	\$ 321,571,726	\$ 35,218	\$ 8,894,175	\$ 312,712,769
Securities held-to-maturity:				
U.S. government agency securities	\$ 17,747,406	\$ -	\$ 491,431	\$ 17,255,975
State and municipal securities	9,321,061	-	365,873	8,955,188
	\$ 27,068,467	\$ -	\$ 857,304	\$ 26,211,163

	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	\$ -	\$ -	\$ -	\$ -
U.S. Government agency securities	38,076,428	9,739	457,321	37,628,846
Mortgage-backed securities	220,397,093	455,203	3,028,241	217,824,055
State and municipal securities	62,215,952	131,412	388,124	61,959,240
Corporate notes and other	1,887,475	-	62,188	1,825,287
	\$ 322,576,948	\$ 596,354	\$ 3,935,874	\$ 319,237,428
Securities held-to-maturity:				
U.S. government agency securities	\$ 17,747,228	\$ -	\$ 378,528	\$ 17,368,700
State and municipal securities	9,509,648	-	284,113	9,225,535
	\$ 27,256,876	\$ -	\$ 662,641	\$ 26,594,235

At June 30, 2007, approximately \$306,514,000 of Pinnacle Financial's investment portfolio was pledged to secure public funds and other deposits and securities sold under agreements to repurchase.

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At June 30, 2007 and 2006, included in securities were the following investments with unrealized losses. The information below classifies these investments according to the term of the unrealized loss of less than twelve months or twelve months or longer:

	Investments with an Unrealized Loss of less than 12 months		Investments with an Unrealized Loss of 12 months or longer		Total Investments with an Unrealized Loss	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>At June 30, 2007:</i>						
U.S. government agency securities	\$ 5,942,800	\$ 56,794	\$ 47,652,718	\$ 1,183,161	\$ 53,595,518	\$ 1,239,955
Mortgage-backed securities	58,120,871	869,050	143,303,914	5,643,267	201,424,785	6,512,317
State and municipal securities	34,888,249	602,524	38,230,860	1,345,696	73,119,109	1,948,220
Corporate notes and other	-	-	1,835,827	50,987	1,835,827	50,987
Total temporarily-impaired securities	\$ 98,951,920	\$ 1,528,368	\$ 231,023,319	\$ 8,223,111	\$ 329,975,239	\$ 9,751,479
<i>At December 31, 2006:</i>						
U.S. government agency securities	\$ -	\$ -	\$ 47,988,246	\$ 835,849	\$ 47,988,246	\$ 835,849
Mortgage-backed securities	13,959,080	68,965	149,496,521	2,959,276	163,455,601	3,028,241
State and municipal securities	13,975,595	47,071	35,660,379	625,166	49,635,974	672,237
Corporate notes and other	-	-	1,825,286	62,188	1,825,286	62,188
Total temporarily-impaired securities	\$ 27,934,675	\$ 116,036	\$ 234,970,432	\$ 4,482,479	\$ 262,905,107	\$ 4,598,515

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of Pinnacle Financial to retain its investment in the issue for a period of time sufficient to allow for any anticipated recovery in fair value. Because the declines in fair value noted above were attributable to increases in interest rates and not attributable to credit quality and because Pinnacle Financial has the ability and intent to hold all of these investments until a market price recovery or maturity, the impairment of these

investments is not deemed to be other-than-temporary.

Note 4. Loans and Allowance for Loan Losses

The composition of loans at June 30, 2007 and December 31, 2006 is summarized as follows:

	<i>At June 30, 2007</i>	<i>At December 31, 2006</i>
Commercial real estate – Mortgage	\$ 307,757,223	\$ 284,301,650
Commercial real estate – Construction	177,425,911	161,903,496
Commercial – Other	738,866,187	608,529,830
Total Commercial	1,224,049,321	1,054,734,976
Consumer real estate – Mortgage	288,325,366	299,626,769
Consumer real estate – Construction	102,998,286	91,193,738
Consumer – Other	47,656,968	52,179,341
Total Consumer	438,980,620	442,999,848
Total Loans	1,663,029,941	1,497,734,824
Allowance for loan losses	(17,375,408)	(16,117,978)
Loans, net	\$ 1,645,654,533	\$ 1,481,616,846

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Changes in the allowance for loan losses for the six months ended June 30, 2007 and for the year ended December 31, 2006 are as follows:

	June 30, 2007	December 31, 2006
Balance at beginning of period	\$ 16,117,978	\$ 7,857,774
Charged-off loans	(552,180)	(818,467)
Recovery of previously charged-off loans	121,646	244,343
Allowance acquired in acquisition of Cavalry (see note 2)	-	5,102,296
Provision for loan losses	1,687,964	3,732,032
Balance at end of period	\$ 17,375,408	\$ 16,117,978

At June 30, 2007 and at December 31, 2006, Pinnacle Financial had certain impaired loans on nonaccruing interest status. The principal balance of these nonaccrual loans amounted to \$2,392,000 and \$7,070,000 at June 30, 2007 and December 31, 2006, respectively. In each case, at the date such loans were placed on nonaccrual, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Had nonaccruing loans been on accruing status, interest income would have been higher by \$230,000 and \$54,000 for the six months ended June 30, 2007 and 2006, respectively.

At June 30, 2007, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$23,598,000 to certain directors, executive officers, and their related entities, of which \$14,137,000 had been drawn upon. During the six months ended June 30, 2007, \$20,000 of new loans to certain directors, executive officers, and their related entities were made and repayments totaled \$3,344,000. At December 31, 2006, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$29,942,000 to certain directors, executive officers, and their related entities, of which approximately \$17,461,000 had been drawn upon. The terms of these loans and extensions are substantially the same terms customary for other persons for the type of loan involved. None of these loans to certain directors, executive officers, and their related entities, were impaired at June 30, 2007.

During the three and six months ended June 30, 2007 and 2006, Pinnacle Financial sold participations in certain loans to correspondent banks at an interest rate that was less than that of the borrower's rate of interest. In accordance with U.S. generally accepted accounting principles, Pinnacle Financial recognized a net gain on the sale of these participated loans for the six months ended June 30, 2007 and 2006 of approximately \$212,000 and \$122,000, respectively, which is attributable to the present value of the future net cash flows of the difference between the interest payments the borrower is projected to pay Pinnacle Financial and the amount of interest that will be owed the correspondent bank based on their participation in the loans. At June 30, 2007, Pinnacle Financial was servicing \$129 million of loans for correspondent banks and other entities, of which \$116 million was commercial loans.

SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes a contractual obligation to service a financial asset in certain circumstances. All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value. Subsequent measurement methods include the amortization method, whereby servicing assets or servicing liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss, or the fair value method, whereby servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value are reported in earnings in the period in which they occur. If the amortization method is used, an entity must assess servicing assets or

servicing liabilities for impairment or increased obligation based on the fair value at each reporting date. SFAS No. 156 is effective for fiscal years beginning after December 15, 2006. Pinnacle Financial's adoption of SFAS No. 156 did not have a material impact on the consolidated financial statements.

Note 5.

Income Taxes

FASB Interpretation 48, "Accounting for Income Tax Uncertainties" ("FIN 48") was issued in June 2006 and defines the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority. FIN 48 also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties and includes guidance concerning accounting for income tax uncertainties in interim periods. Pinnacle Financial adopted the provisions of FIN 48, on January 1, 2007, and determined there was no need to make an adjustment to retained earnings upon adoption of this Interpretation. As of January 1, 2007, Pinnacle Financial had \$700,000 of unrecognized tax benefits related to Federal income tax matters. During the six months ended June 30, 2007, Pinnacle Financial reduced the amount of unrecognized tax benefits by \$86,000, leaving \$614,000 remaining, as the result of the resolution of certain uncertainties related to a prior year tax return. If ultimately recognized, this amount will reduce goodwill associated with the acquisition of Cavalry and therefore would not impact the Company's effective tax rate. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2007 relative to any tax positions taken prior to January 1, 2007.

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As of January 1, 2007, Pinnacle Financial has accrued no interest and no penalties related to uncertain tax positions. It is Pinnacle Financial's policy to recognize interest and/or penalties related to income tax matters in income tax expense.

Pinnacle Financial and its subsidiaries file a consolidated U.S. Federal income tax return. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2003 through 2006. Pinnacle Financial and its subsidiaries' state income tax returns are open to audit under the statute of limitations for the years ended December 31, 2002 through 2006.

Income tax expense attributable to income from continuing operations for the three and six months ended June 30, 2007 and 2006 consists of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<i>Current tax expense (benefit):</i>				
Federal	\$ 2,738,401	\$ 2,738,720	\$ 5,131,999	\$ 4,212,938
State	126,740	200,060	193,541	310,094
Total current tax expense (benefit)	2,865,141	2,938,780	5,325,540	4,523,032
<i>Deferred tax expense (benefit):</i>				
Federal	(386,066)	(667,940)	(274,172)	(979,266)
State	(76,670)	(129,953)	(54,449)	(176,119)
Total deferred tax expense (benefit)	(462,736)	(797,893)	(328,621)	(1,155,385)
	\$ 2,402,405	\$ 2,140,887	\$ 4,996,919	\$ 3,367,647

Pinnacle Financial's income tax expense (benefit) differs from the amounts computed by applying the Federal income tax statutory rates of 35% in 2007 and 34% in 2006 to income before income taxes. A reconciliation of the differences for the three and six months ended June 30, 2007 and 2006 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Income taxes at statutory rate	\$ 2,739,894	\$ 2,262,176	\$ 5,608,618	\$ 3,605,706
State tax expense, net of federal tax effect	32,546	45,568	90,410	87,084
Federal tax credits	(90,000)	(75,000)	(180,000)	(150,000)
Tax-exempt securities	(202,123)	(150,639)	(398,730)	(270,612)
Insurance related items	(161,541)	(41,607)	(324,486)	(54,351)
Other items	83,629	100,389	201,106	149,820
Income tax expense	\$ 2,402,405	\$ 2,140,887	\$ 4,996,918	\$ 3,367,647

The effective tax rate for 2007 and 2006 is impacted by Federal tax credits related to the New Markets Tax Credit program whereby a subsidiary of Pinnacle National has been awarded approximately \$2.3 million in future Federal tax credits which are available thru 2010. Tax benefits related to these credits will be recognized for financial reporting purposes in the same periods that the credits are recognized in the Company's income tax returns. The credit that is

available for the year ended December 31, 2007 is \$360,000 and for the year ended December 31, 2006 is \$300,000. Pinnacle Financial believes that it will comply with the various regulatory provisions of the New Markets Tax Credit program, and therefore has reflected the impact of the credits in its estimated annual effective tax rate for 2007 and 2006.

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The components of deferred income taxes included in other assets in the accompanying consolidated balance sheets at June 30, 2007 and December 31, 2006 are as follows:

	2007	2006
<i>Deferred tax assets:</i>		
Allowance for loan losses	\$ 7,147,562	\$ 6,654,334
Loans	1,068,495	1,337,983
Securities	3,317,047	1,251,636
Accrued liability for supplemental retirement agreements	1,568,234	1,535,688
Deposits	405,848	585,568
Other deferred tax assets	349,517	340,296
	13,856,703	11,705,505
<i>Deferred tax liabilities:</i>		
Depreciation and amortization	1,511,134	1,563,078
Core deposit intangible asset	4,068,467	4,473,076
FHLB dividends	837,744	770,156
Other deferred tax liabilities	586,771	440,642
	7,004,116	7,246,952
<i>Net deferred tax assets</i>	\$ 6,852,587	\$ 4,458,553

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that Pinnacle Financial will realize the benefit of these deductible differences. However, the amount of the deferred tax asset considered realizable could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

Note 6. Commitments and Contingent Liabilities

In the normal course of business, Pinnacle Financial has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions, thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the

beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from Pinnacle Financial under certain prescribed circumstances. Subsequently, Pinnacle Financial would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

Pinnacle Financial follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each customer's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment, and personal property.

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The contractual amounts of these commitments are not reflected in the consolidated financial statements and would only be reflected if drawn upon. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should our customers default on their resulting obligation to us, Pinnacle Financial's maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those instruments.

A summary of Pinnacle Financial's total contractual amount for all off-balance sheet commitments at June 30, 2007 is as follows:

Commitments to extend credit	\$ 542,953,929
Standby letters of credit	62,979,736

At June 30, 2007, the fair value of Pinnacle Financial's standby letters of credit was \$211,000. This amount represents the unamortized fee associated with these standby letters of credit and is included in the consolidated balance sheet of Pinnacle Financial. This fair value will decrease over time as the existing standby letters of credit approach their expiration dates.

Various legal claims also arise from time to time in the normal course of business. As of June 30, 2007, management is not aware of any such proceedings against Pinnacle Financial.

Note 7. Stock Option Plan and Restricted Shares

Pinnacle Financial has two equity incentive plans under which it has granted stock options to its employees to purchase common stock at or above the fair market value on the date of grant and granted restricted share awards to employees and directors. During the first quarter of 2006 and in connection with its merger with Cavalry, Pinnacle Financial assumed a third equity incentive plan, the 1999 Cavalry Bancorp, Inc. Stock Option Plan (the "Cavalry Plan"). All options granted under the Cavalry Plan were fully vested prior to Pinnacle Financial's merger with Cavalry and expire at various dates between January 2011 and June 2012.

As of June 30, 2007, of the approximately 1,902,000 stock options outstanding, 1,225,000 of those options were granted with the intention to be incentive stock options qualifying under Section 422 of the Internal Revenue Code for favorable tax treatment to the option holder while 677,000 options would be deemed non-qualified stock options and thus not subject to favorable tax treatment to the option holder. All stock options under the plans vest in equal increments over five years from the date of grant and are exercisable over a period of ten years from the date of grant.

A summary of the activity within the three equity incentive plans during the six months ended June 30, 2007 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters was as follows:

Number	Weighted-Average Exercise Price	Weighted-Average Contractual Remaining Term	Aggregate Intrinsic Value (1) (000's)
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			(in years)		
Outstanding at December 31, 2006	1,658,459	\$	12.93	6.4	\$ 31,848
Granted	327,843		30.98		
Exercised	(70,981)		7.07		
Forfeited	(13,188)		29.43		
Outstanding at June 30, 2007	1,902,133	\$	17.12	6.6	\$ 24,262
Outstanding and expected to vest as of June 30, 2007	1,859,493	\$	16.90	6.6	\$ 24,095
Options exercisable at June 30, 2007	1,028,479	\$	8.80	4.9	\$ 21,149

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of Pinnacle Financial common stock of \$29.36 and \$33.18 per common share for the approximately 1.3 million and 1.6 million options that were in-the-money at June 30, 2007 and December 31, 2006, respectively.

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During the six months ended June 30, 2007, 175,000 option awards vested at an average exercise price of \$15.35 and an intrinsic value of approximately \$2.4 million.

During the six months ended June 30, 2007, the aggregate intrinsic value of options exercised under the equity incentive plans was \$1.66 million determined as of the date of option exercise. As of June 30, 2007, there was approximately \$6.64 million of total unrecognized compensation cost related to unvested stock options granted under the equity incentive plans. That cost is expected to be recognized over a weighted-average period of 4.0 years.

During the three and six months ended June 30, 2007 and 2006, Pinnacle Financial recorded stock-based compensation expense using the Black-Scholes valuation model for awards granted prior to, but not yet vested, as of January 1, 2006 and for stock-based awards granted after January 1, 2006. For these awards, Pinnacle Financial has recognized compensation expense using a straight-line amortization method. Stock-based compensation expense has been reduced for estimated forfeitures. The impact on the Company's results of operations (compensation and employee benefits expense) and earnings per share of recording stock-based compensation in accordance with SFAS No. 123(R) (related to stock option awards) for the three and six months ended June 30, 2007 and 2006 was as follows:

	Three months ended June 30, 2007			
	Awards granted with the intention to be classified as incentive stock options	Non-qualified stock option awards	Total	Three months ended June 30, 2006
Stock-based compensation expense	\$ 116,000	\$ 341,000	\$ 457,000	\$ 218,000
Deferred income tax benefit	-	134,000	134,000	8,000
Impact of stock-based compensation expense after deferred income tax benefit	\$ 116,000	\$ 207,000	\$ 323,000	\$ 210,000
Impact on earnings per share:				
Basic	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.01
Fully diluted	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.01

	Six months ended June 30, 2007			
	Awards granted with the intention to be classified as incentive stock options	Non-qualified stock option awards	Total	Six months ended June 30, 2006
Stock-based compensation expense	\$ 233,000	\$ 569,000	\$ 801,000	\$ 405,000

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Deferred income tax benefit	-	223,000	223,000	42,000
Impact of stock-based compensation expense after deferred income tax benefit	\$ 233,000	\$ 346,000	\$ 578,000	\$ 363,000
Impact on earnings per share:				
Basic	\$ 0.02	\$ 0.02	\$ 0.04	\$ 0.03
Fully diluted	\$ 0.01	\$ 0.02	\$ 0.03	\$ 0.03

For purposes of these calculations, the fair value of options granted for the six months ended June 30, 2007 and 2006 was estimated using the Black-Scholes option pricing model and the following assumptions:

	<i>2007</i>	<i>2006</i>
Risk free interest rate	4.63%	4.48%
Expected life of options	6.50 years	6.50 years
Expected dividend yield	0.00%	0.00%
Expected volatility	20.8%	23.6%
Weighted average fair value	\$10.13	\$9.61

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Pinnacle Financial's computation of expected volatility is based on weekly historical volatility since September of 2002. Pinnacle Financial used the simplified method in determining the estimated life of stock option issuances. The risk free interest rate of the award is based on the closing market bid for U.S. Treasury securities corresponding to the expected life of the stock option issuances in effect at the time of grant.

Additionally, Pinnacle Financial's 2004 Equity Incentive Plan provides for the granting of restricted share awards and other performance or market-based awards, such as stock appreciation rights. There were no market-based awards or stock appreciation rights outstanding as of June 30, 2007. During the six months ended June 30, 2007, Pinnacle Financial awarded 25,296 shares of restricted common stock to certain executives of Pinnacle Financial. Of these awards, 8,423 are considered granted for financial reporting purposes. The fair value of these awards as of the date of grant was \$31.25 per share. The forfeiture restrictions on the restricted shares lapse in three separate tranches should Pinnacle Financial achieve certain earnings and soundness targets over the subsequent three year period. 16,873 of the shares awarded on June 30, 2007 are not yet deemed to be granted for financial reporting purposes because the key terms required to be achieved in order for the forfeiture restrictions to lapse have not yet been defined. These terms will be defined in the third quarter of 2007 at the conclusion of Pinnacle Financial's usual strategic planning process.

Compensation expense associated with these restricted share awards is recognized over the time period that the restrictions associated with the awards lapse based on a graded vesting schedule such that each year's tranche is amortized separately. For the three and six months ended June 30, 2007, Pinnacle Financial recognized approximately \$16,000 and \$122,000, respectively, in compensation costs attributable to all awards issued prior to June 30, 2007 to certain executives of Pinnacle Financial. During the six months ended June 30, 2007, \$89,000 in previously expensed compensation associated with certain tranches of restricted share awards was reversed when Pinnacle Financial determined that the performance targets required to vest the awards were unlikely to be achieved. Accumulated compensation costs since the date these shares were awarded have amounted to approximately \$872,000 through June 30, 2007.

During 2006, the Board of Directors of Pinnacle Financial awarded 4,400 shares of restricted common stock to the outside members of the board in accordance with their 2006 board compensation package, of which 400 were forfeited. On March 20, 2007, the Board of Directors of Pinnacle Financial awarded 3,230 shares of restricted common stock to the outside members of the board in accordance with their 2007 board compensation package. Each board member received an award of 323 shares. The restrictions on the shares issued in 2007 are expected to lapse on January 18, 2008 if each individual board member meets his or her attendance goals for the various board and board committee meetings to which each member is scheduled to attend during the year ended December 31, 2007. The fair value of these restricted share awards granted to our directors in 2007 as of the date of grant was \$30.99 per share. For the six months ended June 30, 2007, Pinnacle Financial recognized approximately \$35,000, in compensation costs attributable to these awards.

A summary of activity for restricted share awards for the six months ended June 30, 2007 follows:

<i>(number of share awards)</i>	<i>Executive Management Awards</i>			<i>Board of Director Awards</i>		
	<i>Vested</i>	<i>Unvested</i>	<i>Totals</i>	<i>Vested</i>	<i>Unvested</i>	<i>Totals</i>
Balances at December 31, 2006	20,769	17,500	38,269	-	4,000	4,000

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Granted	-	8,431	8,431	-	3,230	3,230
Forfeited	-	-	-	-	-	-
Vested	12,755	(12,755)	-	4,000	(4,000)	-
Balances at June 30, 2007	33,524	13,176	46,700	4,000	3,230	7,230

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A summary of compensation expense, net of the impact of income taxes, related to restricted stock awards for the three and six months ended June 30, 2007 and 2006, follows:

	Three months ended June 30, 2007		Six months ended June 30, 2007		2006	
Stock-based compensation expense	\$ 16,000	\$ 34,000	\$ 122,000	\$ 127,000		
Income tax benefit	6,000	13,000	47,000	50,000		
Impact of stock-based compensation expense, net of income tax benefit	\$ 10,000	\$ 21,000	\$ 75,000	\$ 77,000		
Impact on earnings per share:						
Basic	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.01		
Fully diluted	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.01		

Note 8.**Regulatory Matters**

Pinnacle National is subject to restrictions on the payment of dividends to Pinnacle Financial under Federal banking laws and the regulations of the Office of the Comptroller of the Currency. Pinnacle Financial is also subject to limits on payment of dividends to its shareholders by the rules, regulations and policies of Federal banking authorities. Pinnacle Financial has not paid any cash dividends since inception, and it does not anticipate that it will consider paying dividends until Pinnacle National generates sufficient capital from operations to support both anticipated asset growth and dividend payments.

Pinnacle Financial and Pinnacle National are subject to various regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions, by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Pinnacle Financial and Pinnacle National must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Pinnacle Financial's and Pinnacle National's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require Pinnacle Financial and Pinnacle National to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes, as of June 30, 2007 and December 31, 2006, that Pinnacle Financial and Pinnacle National met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized, Pinnacle National must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. Pinnacle Financial and Pinnacle National's actual capital amounts and ratios are presented in the following table (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>At June 30, 2007</u>						
Total capital to risk weighted assets:						
Pinnacle Financial	\$ 217,400	11.3%	\$ 153,707	8.0%	not applicable	
Pinnacle National	\$ 194,373	10.1%	\$ 153,431	8.0%	\$ 191,754	10.0%
Tier I capital to risk weighted assets:						
Pinnacle Financial	\$ 200,025	10.4%	\$ 76,854	4.0%	not applicable	
Pinnacle National	\$ 176,988	9.2%	\$ 76,715	4.0%	\$ 115,052	6.0%
Tier I capital to average assets (*):						
Pinnacle Financial	\$ 200,025	9.5%	\$ 84,342	4.0%	not applicable	
Pinnacle National	\$ 176,988	8.4%	\$ 84,381	4.0%	\$ 105,477	5.0%

At December 31, 2006

Total capital to risk weighted assets:						
Pinnacle Financial	\$ 202,881	11.8%	\$ 137,638	8.0%	not applicable	
Pinnacle National	\$ 175,159	10.2%	\$ 137,340	8.0%	\$ 171,676	10.0%
Tier I capital to risk weighted assets:						
Pinnacle Financial	\$ 186,763	10.9%	\$ 68,819	4.0%	not applicable	
Pinnacle National	\$ 159,031	9.3%	\$ 68,670	4.0%	\$ 103,005	6.0%
Tier I capital to average assets (*):						
Pinnacle Financial	\$ 186,763	9.5%	\$ 79,021	4.0%	not applicable	
Pinnacle National	\$ 159,031	8.1%	\$ 79,056	4.0%	\$ 98,820	5.0%

(* Average assets for the above calculations were based on the most recent quarter.

Note 9.

Business Segment Information

Pinnacle Financial has four reporting segments comprised of commercial banking, trust and investment services, mortgage origination and insurance services. Pinnacle Financial's primary segment is commercial banking which consists of commercial loan and deposit services as well as the activities of Pinnacle National's branch locations. Pinnacle Financial's segments were changed in 2006 as a result of the acquisition of Cavalry to include Trust within the Investment Services segment and to add a new segment for Insurance Services. Trust and investment services include trust services offered by Pinnacle National and all brokerage and investment activities associated with Pinnacle Asset Management, an operating unit within Pinnacle National. Mortgage origination is also a separate unit within Pinnacle National and focuses on the origination of residential mortgage loans for sale to investors in the secondary residential mortgage market. Insurance Services reflect the activities of Pinnacle National's wholly owned subsidiary, Miller and Loughry Insurance Services, Inc. Miller and Loughry is a general insurance agency located in Murfreesboro, Tennessee and is licensed to sell various commercial and consumer insurance products. The following tables present financial information for each reportable segment as of June 30, 2007 and 2006 and for the three and six months ended June 30, 2007 and 2006 (dollars in thousands):

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	Commercial Banking	Trust and Investment Services	Mortgage Origination	Insurance Services	Total Company
<i>For the three months ended</i>					
<i>June 30, 2007:</i>					
Net interest income	\$ 17,661	\$ -	\$ -	\$ -	\$ 17,661
Provision for loan losses	900	-	-	-	900
Noninterest income	2,851	1,122	949	630	5,552
Noninterest expense	12,558	816	643	467	14,484
Income tax expense	2,099	120	120	64	2,403
Net income	\$ 4,955	\$ 186	\$ 186	\$ 99	\$ 5,426

*For the three months ended**June 30, 2006:*

Net interest income	\$ 16,898	\$ -	\$ -	\$ (3)	\$ 16,895
Provision for loan losses	1,707	-	-	-	1,707
Noninterest income	2,357	941	453	629	4,380
Noninterest expense	11,776	568	317	444	13,105
Income tax expense	1,854	148	55	84	2,141
Net income	\$ 3,918	\$ 225	\$ 81	\$ 98	\$ 4,322

	Commercial Banking	Trust and Investment Services	Mortgage Origination	Insurance Services	Total Company
<i>For the six months ended June</i>					
<i>30, 2007:</i>					
Net interest income	\$ 34,743	\$ -	\$ -	\$ -	\$ 34,743
Provision for loan losses	1,688	-	-	-	1,688
Noninterest income	5,498	2,236	1,570	1,273	10,577
Noninterest expense	23,955	1,617	1,130	906	27,608
Income tax expense	4,433	243	173	147	4,996
Net income	\$ 10,165	\$ 376	\$ 267	\$ 220	\$ 11,028

*For the six months ended June**30, 2006:*

Net interest income	\$ 26,402	\$ -	\$ -	\$ -	\$ 26,402
Provision for loan losses	2,094	-	-	-	2,094
Noninterest income	3,423	1,370	741	894	6,428
Noninterest expense	18,492	940	482	520	20,434
Income tax expense	2,937	169	102	160	3,368
Net income	\$ 6,302	\$ 261	\$ 157	\$ 214	\$ 6,934

As of June 30, 2007:

End of period assets	\$ 2,306,150	\$ -	\$ 4,973	\$ 4,204	\$ 2,315,327
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As of December 31, 2006:

End of period assets	\$	2,132,615	\$	-	\$	5,654	\$	3,918	\$	2,142,187
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Note 10. Investments in Unconsolidated Subsidiaries and Other Entities

On December 29, 2003, the Company established PNFP Statutory Trust I; on September 15, 2005 the Company established PNFP Statutory Trust II; and on September 7, 2006 the Company established PNFP Statutory Trust III (“Trust I”; “Trust II”; “Trust III” or collectively, the “Trusts”). All are wholly-owned statutory business trusts. Pinnacle Financial is the sole sponsor of the Trusts and acquired each Trust’s common securities for \$310,000, \$619,000 and \$619,000, respectively. The Trusts were created for the exclusive purpose of issuing 30-year capital trust preferred securities (“Trust Preferred Securities”) in the aggregate amount of \$10,000,000 for Trust I; \$20,000,000 for Trust II; and \$20,000,000 for Trust III and using the proceeds to acquire junior subordinated debentures (“Subordinated Debentures”) issued by Pinnacle Financial. The sole assets of the Trusts are the Subordinated Debentures. Pinnacle Financial’s aggregate \$1,548,000 investment in the Trusts is included in investments in unconsolidated subsidiaries and other entities in the accompanying consolidated balance sheet at June 30, 2007 and the \$51,548,000 obligation of Pinnacle Financial is reflected as subordinated debt at June 30, 2007.

The Trust I Preferred Securities bear a floating interest rate based on a spread over 3-month LIBOR (8.16% at June 30, 2007) which is set each quarter and mature on December 30, 2033. The Trust II Preferred Securities bear a fixed interest rate of 5.848% per annum thru September 30, 2010 after which time the securities will bear a floating rate set each quarter based on a spread over 3-month LIBOR. The Trust II securities mature on September 30, 2035. The Trust III Preferred Securities bear a floating interest rate based on a spread over 3-month LIBOR (7.00% at June 30, 2007) which is set each quarter and mature on September 30, 2036.

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Distributions are payable quarterly. The Trust Preferred Securities are subject to mandatory redemption upon repayment of the Subordinated Debentures at their stated maturity date or their earlier redemption in an amount equal to their liquidation amount plus accumulated and unpaid distributions to the date of redemption. Pinnacle Financial guarantees the payment of distributions and payments for redemption or liquidation of the Trust Preferred Securities to the extent of funds held by the Trusts. Pinnacle Financial's obligations under the Subordinated Debentures together with the guarantee and other back-up obligations, in the aggregate, constitute a full and unconditional guarantee by Pinnacle Financial of the obligations of the Trusts under the Trust Preferred Securities.

The Subordinated Debentures are unsecured; bear interest at a rate equal to the rates paid by the Trusts on the Trust Preferred Securities and mature on the same dates as those noted above for the Trust Preferred Securities. Interest is payable quarterly. Pinnacle Financial may defer the payment of interest at any time for a period not exceeding 20 consecutive quarters provided that the deferral period does not extend past the stated maturity. During any such deferral period, distributions on the Trust Preferred Securities will also be deferred and Pinnacle Financial's ability to pay dividends on our common shares will be restricted.

Subject to approval by the Federal Reserve Bank of Atlanta, the Trust Preferred Securities may be redeemed prior to maturity at the Company's option on or after September 17, 2008 for Trust I; on or after September 30, 2010 for Trust II and September 30, 2011 for Trust III. The Trust Preferred Securities may also be redeemed at any time in whole (but not in part) in the event of unfavorable changes in laws or regulations that result in (1) the Trust becoming subject to Federal income tax on income received on the Subordinated Debentures, (2) interest payable by the parent company on the Subordinated Debentures becoming non-deductible for Federal tax purposes, (3) the requirement for the Trust to register under the Investment Company Act of 1940, as amended, or (4) loss of the ability to treat the Trust Preferred Securities as "Tier I capital" under the Federal Reserve capital adequacy guidelines.

The Trust Preferred Securities for the Trusts qualify as Tier I capital under current regulatory definitions subject to certain limitations. Debt issuance costs associated with Trust I of \$105,000 consisting primarily of underwriting discounts and professional fees are included in other assets in the accompanying consolidated balance sheet. These debt issuance costs are being amortized over ten years using the straight-line method. There were no debt issuance costs associated with Trust II or Trust III.

Combined summary financial information for the Trusts follows (dollars in thousands) at June 30, 2007 and December 31, 2006 and for the six months ended June 30, 2007 and 2006:

Combined Summary Balance Sheets

	June 30, 2007	December 31, 2006
<i>Asset</i> — Investment in subordinated debentures issued by Pinnacle Financial	\$ 51,548	\$ 51,548
<i>Liabilities</i>	\$ -	\$ -
<i>Stockholder's equity</i> — Trust preferred securities	50,000	50,000
Common securities (100% owned by Pinnacle Financial)	1,548	1,548
Total stockholder's equity	51,548	51,548
<i>Total liabilities and stockholder's equity</i>	\$ 51,548	\$ 51,548

Combined Summary Income Statements

	Six months ended June 30,	
	2007	2006
<i>Income</i> – Interest income from subordinated debentures issued by Pinnacle Financial	\$ 1,754	\$ 1,001
<i>Net Income</i>	\$ 1,754	\$ 1,001

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Combined Summary Statements of Stockholder's Equity

	Trust Preferred Securities	Total Common Stock	Retained Earnings	Stockholder's Equity
<i>Balances, December 31, 2005</i>	\$ 30,000	\$ 929	\$ -	\$ 30,929
Net income	-	-	1,001	1,001
Dividends:				
Trust preferred securities	-	-	(986)	(986)
Common paid to Pinnacle Financial	-	-	(15)	(15)
<i>Balances, June 30, 2006</i>	\$ 30,000	\$ 929	\$ -	\$ 30,929
<i>Balances, December 31, 2006</i>	\$ 50,000	\$ 1,548	\$ -	\$ 51,548
Net income	-	-	1,754	1,754
Issuance of trust preferred securities				
Dividends:				
Trust preferred securities	-	-	(1,721)	(1,721)
Common paid to Pinnacle Financial	-	-	(33)	(33)
<i>Balances, June 30, 2007</i>	\$ 50,000	\$ 1,548	\$ -	\$ 51,548

In addition, the Company has investments in other entities which totaled approximately \$889,000 and \$66,000 at June 30, 2007 and December 31, 2006, respectively. These investments are reported at fair value.

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2. OF OPERATIONS**

The following is a discussion of our financial condition at June 30, 2007 and December 31, 2006 and our results of operations for the three and six months ended June 30, 2007 and 2006. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Overview

General. Our rapid growth from inception through the first half of 2007 has had a material impact on our financial condition and results of operations. This rapid growth resulted in fully diluted net income per share for the three months ended June 30, 2007 and 2006 of \$0.33 and \$0.26, respectively, and for the six months ended June 30, 2007 and 2006 of \$0.66 and \$0.51, respectively. At June 30, 2007, loans totaled \$1.663 billion, as compared to \$1.498 billion at December 31, 2006, while total deposits increased to \$1.798 billion at June 30, 2007 compared to \$1.622 billion at December 31, 2006.

Acquisition. On March 15, 2006, we consummated our merger with Cavalry. Pursuant to the merger agreement, we acquired all Cavalry common stock via a tax-free exchange whereby Cavalry shareholders received a fixed exchange ratio of 0.95 shares of our common stock for each share of Cavalry common stock, or approximately 6.9 million Pinnacle Financial shares. The financial information herein includes the activities of the former Cavalry (the "Rutherford County market") since March 15, 2006.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Accounting for Business Combinations" ("SFAS No. 141"), SFAS No. 142, "Goodwill and Intangible Assets" ("SFAS No. 142") and SFAS No. 147, "Acquisition of Certain Financial Institutions" ("SFAS No. 147"), we recorded at fair value the following assets and liabilities of Cavalry as of March 15, 2006 (dollars in thousands):

Cash and cash equivalents	\$ 37,420
Investment securities – available-for-sale	39,476
Loans, net of an allowance for loan losses of \$5,102	545,598
Goodwill	114,288
Core deposit intangible	13,168
Other assets	42,937
Total assets acquired	792,887
Deposits	583,992
Federal Home Loan Bank advances	17,767
Other liabilities	18,851
Total liabilities assumed	620,610
Total consideration paid for Cavalry	\$ 172,277

As noted above, total consideration for Cavalry approximates \$172.3 million of which \$171.1 million was in the form of our common shares and options to acquire our common shares and \$1.2 million in investment banking fees, attorney's fees and other costs related to the purchase of Cavalry. We issued 6,856,298 shares of our common stock to the former Cavalry shareholders. In accordance with EITF 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination," the shares were valued at \$24.53 per common share which represents the average closing price of our common stock from the two days prior to the merger

announcement on September 30, 2005 through the two days after the merger announcement. Aggregate consideration for the common stock issued was approximately \$168.2 million. Additionally, we also have assumed the Cavalry Bancorp, Inc. 1999 Stock Incentive Plan (the "Cavalry Plan") pursuant to which we were obligated to issue 195,551 shares of our common stock upon exercise of stock options awarded to certain former Cavalry employees who held outstanding options as of March 15, 2006. All of these options were fully vested prior to the merger announcement date and expire at various dates between 2011 and 2012. The exercise prices for these stock options range between \$10.26 per share and \$13.68 per share. In accordance with SFAS No. 141, we considered the fair value of these options in determining the acquisition cost of Cavalry. The fair value of these vested options approximated \$2.9 million which has been included as a component of the aggregate purchase price.

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In accordance with SFAS Nos. 141 and 142, we recognized \$13.2 million as a core deposit intangible in connection with our merger with Cavalry. This identified intangible is being amortized over seven years using an accelerated method which anticipates the life of the underlying deposits to which the intangible is attributable. For the three and six months ended June 30, 2007, approximately \$516,000 and \$1,032,000, respectively, of amortization was recognized in the statement of income compared to \$516,000 and \$647,000 for the three and six months ended June 30, 2006. Amortization expense associated with the core deposit intangible will approximate \$1.8 million to \$2.1 million per year for the next four years with lesser amounts for the remaining two years.

We also recorded other adjustments to the carrying value of Cavalry's assets and liabilities in order to reflect the fair value of those net assets in accordance with U.S. generally accepted accounting principles, including a \$4.8 million discount associated with the loan portfolio, a \$2.9 million premium for Cavalry's certificates of deposit and a \$4.6 million premium for Cavalry's land and buildings. We have also recorded the corresponding deferred tax assets or liabilities associated with these adjustments. The discounts and premiums related to financial assets and liabilities will be amortized into our statements of income in future periods using a method that approximates the level yield method over the anticipated lives of the underlying financial assets or liabilities. For the three and six months ended June 30, 2007, the accretion of the fair value discounts related to the acquired loans and certificates of deposit increased net interest income by approximately \$687,000 and \$1,520,000 respectively, compared to \$1,208,000 and \$1,639,000 for the three and six months ended June 30, 2006, respectively. Based on the estimated useful lives of the acquired loans and deposits, we expect to recognize increases in net interest income related to accretion of these purchase accounting adjustments of \$2.5 million for the remainder of 2007 and in subsequent years.

We also incurred approximately \$921,000 and \$1,365,000 in merger related expenses during the three and six months ended June 30, 2006, respectively, directly related to the Cavalry merger. These charges were for our integration of Cavalry and accelerated depreciation and amortization related to software and other technology assets whose useful lives were shortened as a result of the Cavalry acquisition. We do not anticipate any merger related expenses associated with the Cavalry merger in 2007.

Knoxville, Tennessee Expansion. On April 9, 2007, we announced our plans to expand to the Knoxville, Tennessee, market and the hiring of two prominent veteran bankers to lead our firm in Knoxville. We have estimated that our expansion into Knoxville will result in a reduction in our net income for 2007 as we hire new associates in that market and build out our initial branch network. Our current estimates are that our Knoxville expansion will negatively impact our diluted earnings per share by \$0.08 in 2007.

Results of Operations. Our net interest income increased to \$17.7 million for the second quarter of 2007 compared to \$16.9 million for the second quarter of 2006. The net interest margin (the ratio of net interest income to average earning assets) for the three months ended June 30, 2007 was 3.58% compared to 4.17% for the same period in 2006. Our net interest income increased to \$34.7 million for the six months ended June 30, 2007 compared to \$26.4 million for the six months ended June 30, 2006. The net interest margin for the six months ended June 30, 2007 was 3.61% compared to 3.97% for the same period in 2006.

Our provision for loan losses was \$900,000 for the second quarter of 2007 compared to \$1.7 million for the same period in 2006. The provision for loan losses was \$1.7 million for the six months ended June 30, 2007 compared to \$2.1 million for the same period in 2006. Impacting the provision for loan losses in any accounting period are several matters including the amount of loan growth during the period, the level of charge-offs or recoveries incurred during the period, the results of our quarterly assessment of the inherent risks of our loan portfolio and the impact of the assessment on the level of the allowance for loan losses.

Noninterest income for the second quarter of 2007 compared to the same time period in 2006 increased by \$1.2 million or 26.7%. For the first six months of 2007, noninterest income was \$4.1 million greater than the first six

months of 2006. These increases are largely attributable to the fee businesses associated with the Cavalry acquisition, particularly with regard to service charges on deposit accounts, insurance sales commissions and trust fees.

Our continued growth during 2007 resulted in increased noninterest expense compared to 2006 due to the addition of the Rutherford County market, increases in salaries and employee benefits, equipment and occupancy expenses and other operating expenses. The number of full-time equivalent employees increased from 359.0 at June 30, 2006 to 441.0 at June 30, 2007. We expect to add additional employees throughout 2007 which will cause our compensation and employee benefit expense to increase in 2007. Additionally, our branch expansion efforts and our recently announced expansion into the Knoxville, Tennessee market will result in increased operating expenses in the future.

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Our efficiency ratio (the ratio of noninterest expense to the sum of net interest income and noninterest income) was 62.4% for the second quarter of 2007 compared to 61.60% for the same period in 2006. Our efficiency ratio was 60.9% for the six months ended June 30, 2007 compared to 62.2% for the same period in 2006.

The effective income tax expense rate for the three and six months ended June 30, 2007 was approximately 30.7% and 31.2%, respectively, compared to an effective income tax expense rate for the three and six months ended June 30, 2006 of approximately 33.1% and 32.7%, respectively. The slight decrease in the effective tax rate between the two periods was due to increased bank owned life insurance acquired with the Cavalry acquisition and other tax initiatives.

Net income for the second quarter of 2007 was \$5.4 million compared to \$4.3 million for the same period in 2006, an increase of 25.5%. Net income for the first six months of 2007 was \$11.0 million compared to \$6.9 million for the same period in 2006, an increase of 59.0%.

Financial Condition. Loans increased \$165.3 million during the first six months of 2007. As we seek to increase our loan portfolio, we must also continue to monitor the risks inherent in our lending operations. If our allowance for loan losses is not sufficient to cover the estimated loan losses in our loan portfolio, increases to the allowance for loan losses would be required which would decrease our earnings.

We have successfully grown our total deposits to \$1.798 billion at June 30, 2007 compared to \$1.622 billion at December 31, 2006, an increase of \$176.1 million. This growth in deposits had a higher funding cost due to rising rates and increased deposit pricing competition in 2007 compared to 2006. We typically adjust our loan yields at a faster rate than we adjust our deposit rates in an environment where short term rates are increasing. As such, unless competitive pressures dictate, our deposit funding costs do not usually adjust as quickly as do revenues from interest income on floating rate earning assets when short term rates are increasing.

Capital and Liquidity. At June 30, 2007, our capital ratios, including our bank's capital ratios, met regulatory minimum capital requirements. Additionally, at June 30, 2007, our bank would be considered to be "well-capitalized" pursuant to banking regulations. As our bank grows it will require additional capital from us over that which can be earned through operations. At June 30, 2007, Pinnacle Financial had \$18.8 million in capital that could be transferred to Pinnacle National in order to continue to meet capital requirements. We anticipate that we will continue to use various capital raising techniques in order to support the growth of our bank.

In the past, we have been successful in procuring additional capital from the capital markets (via public and private offerings of trust preferred securities and common stock). This additional capital was required to support our growth. As of June 30, 2007, we believe we have sufficient capital to support our current growth plans, including our expansion into the Knoxville market. However, expansion by acquisition of other banks or by branching into a new geographic market could result in issuance of additional capital, including additional common shares or trust preferred securities.

We continue to believe there is broad acceptance of our business model and in our target markets of small to mid-sized businesses and affluent clients, real estate professionals and consumers that desire a deep relationship with their bank.

Critical Accounting Estimates

The accounting principles we follow and our methods of applying these principles conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, the application of SFAS No. 123 (revised 2004), "Share Based Payments" ("SFAS No. 123(R)")

and the assessment of impairment of the intangibles resulting from the Cavalry merger have been critical to the determination of our financial position and results of operations.

Allowance for Loan Losses (“allowance”). Our management assesses the adequacy of the allowance prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The level of the allowance is based upon management’s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower’s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loan losses are charged off when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a “confirming event” has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management’s judgment, is deemed to be uncollectible.

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Larger balance commercial and commercial real estate loans are impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment loss is recognized if the present value of expected future cash flows from the loan is less than the recorded investment in the loan (recorded investment in the loan is the principal balance plus any accrued interest, net deferred loan fees or costs and unamortized premium or discount, and does not reflect any direct write-down of the investment). The impairment loss is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs. Income is recognized on impaired loans on a cash basis.

The level of allowance maintained is believed by management to be adequate to absorb losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the consolidated allowance, we also consider the results of our ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, the input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process. We incorporate loan review results in the determination of whether or not it is probable that we will be able to collect all amounts due according to the contractual terms of a loan.

As part of management's quarterly assessment of the allowance, management divides the loan portfolio into four segments: commercial, commercial real estate, consumer and consumer real estate. Each segment is then analyzed such that an allocation of the allowance is estimated for each loan segment.

The allowance allocation for commercial and commercial real estate loans begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on our internal system of credit risk ratings and historical loss data for industry and various peer bank groups. The estimated loan loss allocation rate for our internal system of credit risk grades for commercial and commercial real estate is based on management's experience with similarly graded loans, discussions with banking regulators and our internal loan review processes. We then weight the allocation methodologies for the commercial and commercial real estate portfolios and determine a weighted average allocation for these portfolios.

The allowance allocation for consumer and consumer real estate loans which includes installment, home equity, consumer mortgages, automobiles and others is established for each of the categories by estimating losses inherent in that particular category of consumer and consumer real estate loans. The estimated loan loss allocation rate for each category is based on management's experience. Additionally, consumer and consumer real estate loans are analyzed based on our actual loss rates, industry loss rates and loss rates of various peer bank groups. Consumer and consumer real estate loans are evaluated as a group by category (i.e. retail real estate, installment, etc.) rather than on an individual loan basis because these loans are smaller and homogeneous. We weight the allocation methodologies for the consumer and consumer real estate portfolios and determine a weighted average allocation for these portfolios.

The estimated loan loss allocation for all four loan portfolio segments is then adjusted for management's estimate of probable losses for several "environmental" factors. The allocation for environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated inherent credit losses

which may exist, but have not yet been identified, as of the balance sheet date based upon quarterly trend assessments in delinquent and nonaccrual loans, unanticipated charge-offs, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These environmental factors are considered for each of the four loan segments and the allowance allocation as determined by the processes noted above for each segment is increased or decreased based on the incremental assessment of these various “environmental” factors.

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We then test the resulting allowance balance by comparing the balance in the allowance to historical trends and industry and peer information. Our management then evaluates the result of the procedures performed, including the result of our testing, and concludes on the appropriateness of the balance of the allowance in its entirety. The audit committee of our board of directors reviews the assessment prior to the filing of quarterly and annual financial information.

As of June 30, 2006 and March 31, 2006, we assessed the allowance in two separate processes using methodologies for both the Pinnacle portfolios as the portfolios existed prior to the merger with Cavalry (the “Nashville market”) and the Rutherford County portfolio. Our methodology for the first two quarters of 2006 was consistent with the past methodologies of Pinnacle Financial and Cavalry on a stand-alone basis. In view of the acquisition, we evaluated the respective assessment methodologies and made certain changes as noted above and implemented such changes during the third quarter of 2006. The revised assessment methodology did not significantly impact our recorded allowance for loan losses.

Share Based Payments – Our stock compensation is subject to financial accounting standards that required us to assess numerous factors including the historical volatility of our stock price, anticipated option forfeitures and estimates concerning the length of time that our options would remain unexercised. Many of these assessments impact the fair value of the underlying stock option more significantly than others and changes to these assessments in future periods could be significant.

Impairment of Intangible Assets - Long-lived assets, including purchased intangible assets subject to amortization, such as our core deposit intangible asset, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill and intangible assets that have indefinite useful lives are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset’s fair value. Our annual assessment date is September 30. Should we determine in a future period that the goodwill recorded in connection with our acquisition of Cavalry has been impaired, then a charge to our earnings will be recorded in the period such determination is made.

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Our results for the three and six months ended June 30, 2007 and 2006 were highlighted by the continued growth in loans and other earning assets and deposits, which resulted in increased revenues and expenses. The following is a summary of our results of operations (dollars in thousands):

	<i>Three months ended</i>		<i>2007-2006</i>	<i>Six months ended</i>		<i>2007-2006</i>
	<i>June 30,</i>		<i>Percent</i>	<i>June 30,</i>		<i>Percent</i>
	<i>2007</i>	<i>2006</i>	<i>Increase(decrease)</i>	<i>2007</i>	<i>2006</i>	<i>Increase(decrease)</i>
Interest income	\$ 35,508	\$ 28,305	25.4%	\$ 69,247	\$ 45,115	53.5%
Interest expense	17,847	11,410	56.4%	34,504	18,713	84.4%
Net interest income	17,661	16,895	4.5%	34,743	26,402	31.6%
Provision for loan losses	900	1,707	(47.3%)	1,688	2,094	(19.4%)
Net interest income after provision for loan losses	16,761	15,188	10.4%	33,055	24,308	36.0%
Noninterest income	5,551	4,380	26.7%	10,578	6,428	64.6%
Noninterest expense:						
Merger related expense	-	921	(100.0%)	-	1,365	(100.0%)
Other noninterest expense	14,484	12,184	18.9%	27,608	19,069	44.8%
Net income before income taxes	7,828	6,463	21.1%	16,025	10,302	55.6%
Income tax expense	2,402	2,141	12.2%	4,997	3,368	48.4%
Net income	\$ 5,426	\$ 4,322	25.5%	\$ 11,028	\$ 6,934	59.0%

Net Interest Income. Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest bearing liabilities and is the most significant component of our earnings. For the three months ended June 30, 2007 and 2006, we recorded net interest income of \$17,661,000, and \$16,895,000 respectively, which resulted in a net interest margin of 3.58% and 4.17%. For the six months ended June 30, 2007 and 2006, we recorded net interest income of \$34,743,000 and \$26,402,000 which resulted in a net interest margin of 3.61% and 3.97% respectively.

The following table sets forth the amount of our average balances, interest income or interest expense for each category of interest-earning assets and interest-bearing liabilities and the average interest rate for total interest-earning assets and total interest-bearing liabilities, net interest spread and net interest margin for the three and six months ended June 30, 2007 and 2006 (dollars in thousands):

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<i>(dollars in thousands)</i>	<i>Three months ended June 30, 2007</i>			<i>Three months ended June 30, 2006</i>		
	<i>Average Balances</i>	<i>Interest</i>	<i>Rates/ Yields</i>	<i>Average Balances</i>	<i>Interest</i>	<i>Rates/ Yields</i>
<i>Interest-earning assets:</i>						
Loans	\$ 1,598,967	\$ 30,556	7.66%	\$ 1,328,121	\$ 24,246	7.32%
<i>Securities:</i>						
Taxable	272,024	3,394	5.00%	248,682	3,148	5.08%
Tax-exempt (1)	75,057	693	4.89%	50,227	495	5.21%
Federal funds sold and other	58,836	865	6.08%	24,932	416	7.09%
Total interest-earning assets	2,004,884	35,508	7.15%	1,651,962	28,305	6.92%
<i>Nonearning assets</i>	224,343			226,950		
Total assets	\$ 2,229,227			\$ 1,878,912		
<i>Interest-bearing liabilities:</i>						
<i>Interest bearing deposits</i>						
Interest checking	\$ 254,171	\$ 2,147	3.39%	\$ 190,055	\$ 848	1.79%
Savings and money market	501,373	4,239	3.39%	434,094	3,234	2.99%
Certificates of deposit	646,251	8,071	5.01%	546,715	5,481	4.02%
Total interest bearing deposits	1,401,795	14,457	4.14%	1,170,864	9,563	3.28%
Securities sold under agreements to repurchase	172,872	1,891	4.39%	68,079	678	4.00%
Federal Home Loan Bank advances and other borrowings	47,998	621	5.19%	48,113	653	5.44%
Subordinated debt	51,548	878	6.84%	30,929	516	6.69%
Total interest-bearing liabilities	1,674,213	17,847	4.28%	1,317,985	11,410	3.47%
<i>Noninterest-bearing deposits</i>	276,241	-	-	311,286	-	-
Total deposits and interest-bearing liabilities	1,950,454	17,847	3.67%	1,629,271	11,410	2.81%
Other liabilities	14,718			15,241		
<i>Stockholders' equity</i>	264,055			234,400		
	\$ 2,229,227			\$ 1,878,912		
<i>Net interest income</i>		\$ 17,661			\$ 16,895	
Net interest spread (2)			2.88%			3.45%
Net interest margin (3)			3.58%			4.17%

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- (1) *Yields computed on tax-exempt instruments on a tax equivalent basis.*
- (2) *Yields realized on interest-earning assets less the rates paid on interest-bearing liabilities.*
- (3) *Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.*

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<i>(dollars in thousands)</i>	<i>Six months ended June 30, 2007</i>			<i>Six months ended June 30, 2006</i>		
	<i>Average Balances</i>	<i>Interest</i>	<i>Rates/ Yields</i>	<i>Average Balances</i>	<i>Interest</i>	<i>Rates/ Yields</i>
<i>Interest-earning assets:</i>						
Loans	\$ 1,564,869	\$ 59,533	7.67%	\$ 1,044,724	\$ 37,425	7.22%
<i>Securities:</i>						
Taxable	272,346	6,740	4.99%	245,216	6,009	4.94%
Tax-exempt (1)	74,009	1,363	4.90%	47,399	896	5.04%
Federal funds sold and other	57,367	1,611	5.66%	26,085	785	6.45%
Total interest-earning assets	1,968,591	69,247	7.14%	1,363,424	45,115	6.72%
<i>Nonearning assets</i>	220,987			152,944		
Total assets	\$ 2,189,578			\$ 1,516,368		
<i>Interest-bearing liabilities:</i>						
<i>Interest bearing deposits</i>						
Interest checking	\$ 249,425	\$ 4,104	3.32%	\$ 147,089	\$ 1,330	1.82%
Savings and money market	498,625	8,364	3.38%	389,473	5,574	2.89%
Certificates of deposit	635,172	15,526	4.93%	430,854	8,509	3.98%
Total interest bearing deposits	1,383,222	27,994	4.08%	967,416	15,413	3.21%
Securities sold under agreements to repurchase	165,026	3,603	4.40%	63,901	1,187	3.75%
Federal Home Loan Bank advances and other borrowings	44,120	1,152	5.04%	47,412	1,112	4.73%
Subordinated debt	51,548	1,755	6.86%	30,929	1,001	6.53%
Total interest-bearing liabilities	1,643,916	34,504	4.23%	1,109,658	18,713	3.40%
<i>Noninterest-bearing deposits</i>	273,052	-	-	231,767	-	-
Total deposits and interest-bearing liabilities	1,916,968	34,504	3.63%	1,341,425	18,713	2.81%
Other liabilities	10,849			9,976		
<i>Stockholders' equity</i>	261,761			164,967		
	\$ 2,189,578			\$ 1,516,368		
<i>Net interest income</i>		\$ 34,743			\$ 26,402	
Net interest spread (2)			2.91%			3.32%
Net interest margin (3)			3.61%			3.97%

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- (1) *Yields computed on tax-exempt instruments on a tax equivalent basis.*
- (2) *Yields realized on interest-earning assets less the rates paid on interest-bearing liabilities.*
- (3) *Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.*

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As noted above, the net interest margin for the three and six months ended June 30, 2007 was 3.58% and 3.61%, respectively, compared to a net interest margin of 4.17% and 3.97% for the same periods in 2006. In comparing the decreases in the net interest margins between the three months ended June 30, 2007 and 2006 and the six months ended June 30, 2007 and 2006, the primary cause of the decreased margins was due to the higher rate of increase for funding costs over the increased rates for interest earning assets. When comparing the three months ended June 30, 2007 to the same period in 2006, funding costs increased by 86 basis points while interest earning assets increased only 23 basis points. The comparison for the six month periods had similar results with funding costs up 82 basis points while interest earning assets increasing by only 42 basis points. We believe substantially all small cap community banks are experiencing similar trends across the country. However, for Pinnacle, our absolute growth in average earning asset balances, primarily loan balances, has been enough to overcome the negative trends in rates such that we experienced a 4.5% increase in net interest income comparing the three months ended June 30, 2007 to the same period in 2006 and 31.6% increase when comparing the six months ended June 30, 2007 to the same period in 2006.

Other matters related to the changes in net interest income, net interest yields and rates, and net interest margin are presented below:

- Our loan yields increased between 2007 and 2006. The pricing of a large portion of our loan portfolio (approximately 45.4% of total loans at June 30, 2007 compared to 47.0% at June 30, 2006) is tied to our prime rate. Our weighted average prime rate for the first six months of 2007 was 8.25% compared to 7.66% in 2006.
 - We have been able to grow our funding base significantly. For asset/liability management purposes in 2007 and 2006, we elected to allocate a greater proportion of such funds to our loan portfolio versus our securities and shorter-term investment portfolio. For the first six months of 2007, average loan balances were 71.5% of total assets compared to 68.9% in 2006. Loans generally have higher yields than do securities and other shorter-term investments. This change in allocation contributed to the increase in the overall total interest earning asset yields between the two periods.
- During 2007, overall deposit rates were higher than those rates for the comparable period in 2006. Changes in interest rates paid on such products as interest checking, savings and money market accounts, securities sold under agreements to repurchase and Federal funds purchased will generally increase or decrease in a manner that is consistent with changes in the short-term rate environment. During 2007, as was the case with our prime lending rate, short-term rates were higher than in 2006. We also monitor the pricing of similar products by our primary competitors. The changes in the short-term rate environment and the pricing of our primary competitors required us to increase these rates in 2007 compared to the previous periods which resulted in increased rates paid on interest bearing liabilities.
- During 2007, the average balances of noninterest bearing deposit balances, interest bearing transaction accounts, savings and money market accounts and securities sold under agreements to repurchase amounted to 61.9% of our total funding compared to 54.9% in 2006. These funding sources generally have lower rates than do other funding sources, such as certificates of deposit and other borrowings and, as a result, these products served to offset some of the increase in funding costs in 2007.
- Also impacting the net interest margin during 2007 compared to 2006 was pricing of our floating rate subordinated indebtedness which comprises approximately \$31 million of the \$52 million of subordinated indebtedness as of June 30, 2007. The interest rate charged on this indebtedness is generally higher than other funding sources. The rate charged on the floating rate portion of the indebtedness is determined in relation to the three-month LIBOR index and reprices quarterly. During 2007, the short-term interest rate environment was higher than previous years, and, as a result, the pricing for this funding source was higher in 2007.

There continues to be speculation in the marketplace as to the direction of interest rates and whether the Federal Reserve will increase or decrease the Federal funds target rate from the current 5.25%. As to intermediate and long-term rates, many economists are forecasting that these rates should increase over the next several quarters such that the “yield curve” approaches a more traditional position; however, these forecasts are always accompanied by many qualifiers. As a result, we continue to forecast in our modeling that interest rates will remain stable over the next few quarters.

The current shape of the yield curve represents a challenge for most banks, including Pinnacle National. However, we believe we will increase net interest income through growth in earning assets with continued emphasis on floating rate lending. The additional revenues provided by increased floating rate loans may not be sufficient to overcome any immediate increases in funding costs such that we are unable to maintain our current net interest margin. As a result, even though our net interest income will likely increase, our net interest margins could decrease due to new deposits being obtained at current market rates which are higher than our current average cost of funding and the continued competitive deposit pricing in our market area. We believe our net interest margin for the remainder of 2007 should be within a range of 3.45% to 3.65%, compared to 3.58% for the second quarter of 2007.

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Provision for Loan Losses. The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in our management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. The provision for loan losses amounted to \$900,000 and \$1,707,000 for the three months ended June 30, 2007 and 2006, respectively and \$1,688,000 and \$2,094,000 for the six months ended June 30, 2007 and 2006, respectively.

Based upon our management's evaluation of the loan portfolio, we believe the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at June 30, 2007. During the three and six month periods ended June 30, 2007 and 2006, the provision for loan losses decreased by \$807,000 and \$406,000, respectively. These decreases were primarily attributable to the relatively low levels of nonperforming loans, past due loans, risk grades and net charge-off levels which resulted in reduced provisioning through our quarterly allowance for loan loss risk assessment. These decreases were offset by increased provisioning due to increases in charged off loans and loan volumes.

Based upon management's assessment of the loan portfolio, we adjust our allowance for loan losses to an amount deemed appropriate to adequately cover inherent risks in the loan portfolio. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by our management and are reviewed from time to time by our regulators, they are necessarily approximate and imprecise. There exist factors beyond our control, such as general economic conditions both locally and nationally, which may negatively impact, materially, the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

Noninterest Income. Our noninterest income is composed of several components, some of which vary significantly between quarterly periods. Service charges on deposit accounts and other noninterest income generally reflect our growth, while investment services and fees from the origination of mortgage loans will often reflect market conditions and fluctuate from period to period. The opportunities for recognition of gains on loans and loan participations sold and gains on sales of investment securities may also vary widely from quarter to quarter and year to year.

The following is the makeup of our noninterest income for the three and six months ended June 30, 2007 and 2006 (dollars in thousands):

	<i>Three months ended June 30,</i>		<i>2007-2006 Percent Increase (decrease)</i>	<i>Six months ended June 30,</i>		<i>2007-2006 Percent Increase (decrease)</i>
	<i>2007</i>	<i>2006</i>		<i>2007</i>	<i>2006</i>	
<i>Noninterest income:</i>						
Service charges on deposit accounts	\$ 1,920	\$ 1,356	41.6%	\$ 3,717	\$ 1,794	107.2%
Investment sales commissions	850	653	30.2%	1,585	1,166	35.9%
Gains on sales of loans and loan participations, net:						
Fees from the origination and sale of mortgage loans, net of sales commissions	472	422	11.8%	790	673	17.4%

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Gains on loan participations sold, net	167	49	240.8%	212	122	73.8%
Insurance sales commissions	629	749	(16.0%)	1,266	1,013	25.0%
Gain on sale of investment securities, net	-	-	0.0%	-	-	0.0%
Trust fees	425	312	36.2%	845	364	132.1%
Other noninterest income:						