

FIRST FINANCIAL BANKSHARES INC

Form 10-K

February 22, 2008

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**Form 10-K**

**▶ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the fiscal year ended December 31, 2007**

**Commission file number 0-7674**  
**First Financial Bankshares, Inc.**  
*(Exact Name of Registrant as Specified in Its Charter)*

|  |  |
|--|--|
| <b>Texas</b><br><i>(State or Other Jurisdiction of<br/>Incorporation or Organization)</i><br><b>400 Pine Street, Abilene, Texas</b><br><i>(Address of Principal Executive Offices)</i><br><i>Registrant's telephone number, including area code:</i> | <b>75-0944023</b><br><i>(I.R.S. Employer<br/>Identification No.)</i><br><b>79601</b><br><i>(Zip Code)</i><br><b>(325) 627-7155</b> |
|--|--|

**Securities registered pursuant to Section 12(b) of the Act:**

| <b>Title of Class</b>                    | <b>Name of Exchange on Which Registered</b> |
|--|---|
| Common Stock, par value \$0.01 per share | Nasdaq Global Select Market                 |

**Securities registered pursuant to Section 12(g) of the Act:**  
**None**

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

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

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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of June 30, 2007, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of voting and non-voting common stock held by non-affiliates was \$750,200,000.

As of February 18, 2008, there were 20,771,124 shares of Common Stock outstanding.

### **Documents Incorporated by Reference**

Certain information called for by Part III is incorporated by reference to the Proxy Statement for the 2008 Annual Meeting of our shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2007.

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**CAUTIONARY STATEMENT REGARDING  
FORWARD-LOOKING STATEMENTS**

This Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. When used in this Form 10-K, words such as anticipate, believe, estimate, expect, intend, predict, project, and similar expressions, as they relate to us or our management, identify forward-looking statements. These forward-looking statements are based on information currently available to our management. Actual results could differ materially from those contemplated by the forward-looking statements as a result of certain factors, including but not limited, to those listed in Item 1A-Risk Factors and the following:

General economic conditions, including our local and national real estate markets;

Legislative and regulatory actions and reforms;

Competition from other financial institutions and financial holding companies;

The effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board;

Changes in the demand for loans;

Fluctuations in value of collateral and loan reserves;

Inflation, interest rate, market and monetary fluctuations;

Changes in consumer spending, borrowing and savings habits;

Our ability to attract deposits;

Consequences of continued bank mergers and acquisitions in our market area, resulting in fewer but much larger and stronger competitors;

Expansion of operations, including branch openings, new product offerings and expansion into new markets; and

Acquisitions and integration of acquired businesses.

Such statements reflect the current views of our management with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this paragraph. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## PART I

### ITEM 1. *BUSINESS*

#### General

First Financial Bankshares, Inc., a Texas corporation, is a financial holding company registered under the Bank Holding Company Act of 1956, or BHCA. As such, we are supervised by the Board of Governors of the Federal Reserve System, or Federal Reserve Board, as well as several other state and federal regulators. We were formed as a bank holding company in 1956 under the original name F & M Operating Company, but our banking operations date back to 1890, when Farmers and Merchants National Bank opened for business in Abilene, Texas. Through our wholly-owned Delaware subsidiary, First Financial Bankshares of Delaware, Inc., we own ten banks, a trust company and a technology operating company, all organized and located in Texas. These subsidiaries are:

First Financial Bank, National Association, Abilene, Texas;

First Technology Services, Inc., Abilene, Texas;

First Financial Trust & Asset Management Company, National Association, Abilene, Texas;

Hereford State Bank, Hereford, Texas;

First Financial Bank, National Association, Sweetwater, Texas;

First Financial Bank, National Association, Eastland, Texas;

First Financial Bank, National Association, Cleburne, Texas;

First Financial Bank, National Association, Stephenville, Texas;

San Angelo National Bank, San Angelo, Texas;

Weatherford National Bank, Weatherford, Texas;

First Financial Bank, National Association, Southlake, Texas; and

First Financial Bank, National Association, Mineral Wells, Texas.

Through our subsidiary banks, we conduct a full-service commercial banking business. Our service centers are located primarily in North Central and West Texas. Considering the branches and locations of all our subsidiaries, as of December 31, 2007, we had 45 financial centers across Texas, with ten locations in Abilene, two locations in Cleburne, three locations in Stephenville, two locations in Granbury, two locations in San Angelo, three locations in Weatherford, and one location each in Mineral Wells, Hereford, Sweetwater, Eastland, Ranger, Rising Star, Southlake, Aledo, Willow Park, Alvarado, Burleson, Keller, Trophy Club, Boyd, Bridgeport, Decatur, Roby, Trent, Clyde, Moran, Albany, Midlothian and Glen Rose.

Even though we operate in a growing number of Texas markets, we continue to believe that decisions are best made at the local level. Accordingly, each of our ten separately chartered banks operates with local boards of directors, local bank presidents and local decision-making. However, we have consolidated many of the backroom operations, such as investment securities, accounting, check processing, technology and employee benefits, which improves the local bank's efficiency and frees the local bank management to concentrate on serving the banking needs of the local community. We call this our "one bank, ten charters" concept.

Although many of our competitors branch across state lines, we have chosen to keep our Company focused on the State of Texas, one of the nation's largest, fastest-growing and most economically diverse states. With nearly 23 million residents, Texas has more people than any other state except California. The population of Texas grew

9.6 percent from 2000-2005, nearly double the national rate, according to the U.S. Census Bureau. Many of the communities in which we operate are growing faster than the statewide average, as shown below:

**Population Growth 2000-2005\***

|   |       |                                    |       |
|---|-------|------------------------------------|-------|
| Bridgeport and Wise County              | 16.2% | Weatherford, Willow Park and Aledo | 16.2% |
| Fort Worth/Tarrant County               | 12.1% | Granbury and Hood County           | 16.6% |
| Cleburne, Midlothian and Johnson County | 15.4% | *Source: U.S. Census Bureau        |       |

These economies include dynamic centers of higher education, agriculture, energy and natural resources, healthcare, tourism, retirement living, manufacturing and distribution. Because there are many growth opportunities in Texas, we do not believe it is necessary to look outside the state. Additionally, we prefer to focus on the areas where we have historically done business: the economies in the Central, West and High Plains regions of Texas.

We have also largely foregone the larger metropolitan areas of Texas. Our community matters way of doing business works best for us in small and mid-size markets, where we can play a prominent role in the economic, civic and cultural life of the community. Our goal is to serve these communities well and to experience growth as these markets continue to expand. In many instances, banking competition is also less fierce in smaller markets, making it easier for us to operate rationally and attract and retain high-caliber employees who prefer not only our community-banker concept but the high quality of life in smaller cities.

Over the years, we have grown three ways: by growing our banks internally, opening new branch locations and by acquisition of other banks. Since the beginning of 1997, we have completed ten bank acquisitions and almost doubled total assets from \$1.57 billion to \$3.07 billion. We have also established a trust and asset management company and a technology services company, both of which operate as subsidiaries of First Financial Bankshares. Looking ahead, we will continue to grow locally by better serving the needs of our customers and putting them first in all of our decisions. We continually look for new branch locations, so we can serve our customers more conveniently, and we are always cultivating relationships with other Texas bankers who may have an interest in being acquired by us at some point in the future.

When targeting a bank for acquisition, the bank generally needs to be in the type of community that fits our profile. We like growing communities with good amenities schools, infrastructure, commerce and lifestyle. We prefer non-metropolitan markets, either within a 50-mile radius of the Dallas/Fort Worth metroplex or along the Interstate 35 and 20 corridors in Texas. Banks in the \$100 million to \$250 million asset size fit our sweet spot for acquisition, but we will consider banks that are larger or smaller, or that are in other areas of Texas if we believe they would be a good fit to our existing Company.

Information on our revenues, profits and losses and total assets appears in the discussion of our Results of Operations contained in Item 7 hereof.

**First Financial Bankshares, Inc.**

We provide management and technical resources and policy direction to our subsidiaries, which enable them to improve or expand their banking services while continuing their local activity and identity. Each of our subsidiaries operates under the day-to-day management of its own board of directors and officers, with substantial authority in making decisions concerning their own loan decisions, interest rates, service charges and marketing. We provide resources and policy direction in, among other things, the following areas:



asset and liability management;

investments, accounting, budgeting, training, marketing, planning, risk management, loan review, compliance, human resources and insurance;

capitalization; and

regulatory compliance.

In particular, we assist our subsidiaries with, among other things, decisions concerning major capital expenditures, employee fringe benefits, including retirement plans and group medical, dividend policies, and appointment of officers and directors and their compensation. We also perform, through corporate staff groups or by outsourcing to third parties, internal audits, compliance oversight and loan reviews of our subsidiaries. We provide advice and specialized services for our banks related to lending, investing, purchasing, advertising, public relations, and computer services.

We evaluate various potential financial institution acquisition opportunities and approve potential locations for new branch offices. We anticipate that funding for any acquisitions or expansions would be provided from our existing cash balances, available dividends from subsidiary banks, utilization of available lines of credit and future debt or equity offerings.

### **Services Offered by Our Subsidiary Banks**

Each of our subsidiary banks is a separate legal entity that operates under the day-to-day management of its own board of directors and officers. Each of our subsidiary banks provides general commercial banking services, which include accepting and holding checking, savings and time deposits, making loans, automated teller machines, drive-in and night deposit services, safe deposit facilities, transmitting funds, and performing other customary commercial banking services. We also conduct full service trust activities through First Financial Trust & Asset Management Company, National Association. Through this trust company, we administer all types of retirement and employee benefit accounts which include 401(k) profit sharing plans and IRAs. We also offer personal trust services which include the administration of estates, testamentary trusts, revocable and irrevocable trusts and agency accounts. In addition, First Financial Bank, National Association, Abilene, and San Angelo National Bank provide securities brokerage services through arrangements with an unrelated third party.

### **Competition**

Commercial banking in Texas is highly competitive, and because we hold less than 1% of the state's deposits, we represent only a minor segment of the industry. To succeed in this industry, we believe that our banks must have the capability to compete in the areas of (1) interest rates paid or charged; (2) scope of services offered; and (3) prices charged for such services. Our subsidiary banks compete in their respective service areas against highly competitive banks, thrifts, savings and loan associations, small loan companies, credit unions, mortgage companies, insurance companies, and brokerage firms, all of which are engaged in providing financial products and services and some of which are larger than our subsidiary banks in terms of capital, resources and personnel.

Our business does not depend on any single customer or any few customers, the loss of any one of which would have a materially adverse effect upon our business. Although we have a broad base of customers that are not related to us, our customers also occasionally include our officers and directors, as well as other entities with which we are affiliated. With our subsidiary banks we may make loans to officers and directors, and entities with which we are affiliated, in the ordinary course of business. We make these loans on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. Loans to directors, officers and their affiliates are also subject to numerous restrictions under federal and state banking laws which we describe in greater detail below.

### **Employees**

With our subsidiary banks we employed approximately 975 full-time equivalent employees at December 31, 2007. Our management believes that our employee relations have been and will continue to be good.

## **Supervision and Regulation**

Both federal and state laws extensively regulate bank holding companies, financial holding companies and banks. These laws (and the regulations promulgated thereunder) are primarily intended to protect depositors and the deposit insurance fund of the Federal Deposit Insurance Corporation, or FDIC, although shareholders may also benefit. The following information describes particular laws and regulatory provisions relating to financial holding companies and banks. This discussion is qualified in its entirety by reference to the particular laws and regulatory

provisions. A change in any of these laws or regulations may have a material effect on our business and the business of our subsidiary banks.

### ***Bank Holding Companies and Financial Holding Companies***

Historically, the activities of bank holding companies were limited to the business of banking and activities closely related or incidental to banking. Bank holding companies were generally prohibited from acquiring control of any company which was not a bank and from engaging in any business other than the business of banking or managing and controlling banks. The Gramm-Leach-Bliley Act, which took effect on March 12, 2000, dismantled many Depression-era restrictions against affiliation between banking, securities and insurance firms by permitting bank holding companies to engage in a broader range of financial activities, so long as certain safeguards are observed. Specifically, bank holding companies may elect to become financial holding companies that may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental to a financial activity. Thus, with the enactment of the Gramm-Leach-Bliley Act, banks, securities firms and insurance companies find it easier to acquire or affiliate with each other and cross-sell financial products. The Act permits a single financial services organization to offer a more complete array of financial products and services than historically was permitted.

A financial holding company is essentially a bank holding company with significantly expanded powers. Under the Gramm-Leach-Bliley Act, in addition to traditional lending activities, the following activities are among those that will be deemed financial in nature for financial holding companies: securities underwriting, dealing in or making a market in securities, sponsoring mutual funds and investment companies, insurance underwriting and agency activities, activities which the Federal Reserve Board determines to be closely related to banking, and certain merchant banking activities.

We elected to become a financial holding company in September 2001. As a financial holding company, we have very broad discretion to affiliate with securities firms and insurance companies, make merchant banking investments, and engage in other activities that the Federal Reserve Board has deemed financial in nature. In order to continue as a financial holding company, we must continue to be well-capitalized, well-managed and maintain compliance with the Community Reinvestment Act. Depending on the types of financial activities that we may elect to engage in, under Gramm-Leach-Bliley's fractional regulation principles, we may become subject to supervision by additional government agencies. The election to be treated as a financial holding company increases our ability to offer financial products and services that historically we were either unable to provide or were only able to provide on a limited basis. As a result, we will face increased competition in the markets for any new financial products and services that we may offer. Likewise, an increased amount of consolidation among banks and securities firms or banks and insurance firms could result in a growing number of large financial institutions that could compete aggressively with us.

### ***Mergers and Acquisitions***

We generally must obtain approval from the banking regulators before we can acquire other financial institutions. We may not engage in certain acquisitions if we are undercapitalized. Furthermore, the BHCA provides that the Federal Reserve Board cannot approve any acquisition, merger or consolidation that may substantially lessen competition in the banking industry, create a monopoly in any section of the country, or be a restraint of trade. However, the Federal Reserve Board may approve such a transaction if the convenience and needs of the community clearly outweigh any anti-competitive effects. Specifically, the Federal Reserve Board would consider, among other factors, the expected benefits to the public (greater convenience, increased competition, greater efficiency, etc.) against the risks of possible adverse effects (undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, etc.).

***Banks***

Federal and state laws and regulations that govern banks have the effect of, among other things, regulating the scope of business, investments, cash reserves, the purpose and nature of loans, the maximum interest rate chargeable on loans, the amount of dividends declared, and required capitalization ratios.

*National Banking Associations.* Banks organized as national banking associations under the National Bank Act are subject to regulation and examination by the Office of the Comptroller of the Currency, or OCC. The OCC supervises, regulates and regularly examines:

First Financial Bank, National Association, Abilene;  
First Financial Bank, National Association, Sweetwater;  
First Financial Bank, National Association, Cleburne;  
First Financial Bank, National Association, Eastland;  
San Angelo National Bank;  
Weatherford National Bank;  
First Financial Bank, National Association, Southlake;  
First Financial Bank, National Association, Stephenville;  
First Financial Bank, National Association, Mineral Wells;  
First Financial Trust & Asset Management Company, National Association; and  
First Technology Services, Inc.

The OCC's supervision and regulation of banks is primarily intended to protect the interests of depositors. The National Bank Act:

requires each national banking association to maintain reserves against deposits,  
restricts the nature and amount of loans that may be made and the interest that may be charged, and  
restricts investments and other activities.

*State Banks.* Banks that are organized as state banks under Texas law are subject to regulation and examination by the Banking Commissioner of the State of Texas. The Commissioner regulates and supervises, and the Texas Banking Department regularly examines our one subsidiary state bank, Hereford State Bank. The Commissioner's supervision and regulation of banks is primarily designed to protect the interests of depositors. Texas law

restricts the nature and amount of loans that may be made and the interest that may be charged, and  
restricts investments and other activities.

Because Hereford State Bank is a member of the FDIC and Federal Reserve, it is also subject to regulation at the federal level by the FDIC, and is subject to most of the federal laws described below.

***Deposit Insurance***

Each of our subsidiary banks is a member of the FDIC. The FDIC provides deposit insurance protection that covers all deposit accounts in FDIC-insured depository institutions and generally does not exceed \$100,000 per depositor. Our subsidiary banks must pay assessments to the FDIC under a risk-based assessment system for federal deposit insurance protection. FDIC-insured depository institutions that are members of the Bank Insurance Fund pay insurance premiums at rates based on their risk classification. Institutions assigned to higher risk classifications (i.e., institutions that pose a greater risk of loss to their respective deposit insurance fund) pay assessments at higher rates than institutions assigned to lower risk classifications. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to bank regulators. In addition, the FDIC can impose special assessments to cover the costs of borrowings from the U.S. Treasury, the Federal Financing Bank and the Bank Insurance Fund member banks. As of December 31, 2007, the assessment rate for each of our subsidiary banks is at the lowest level risk-based premium available.

Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or FIRREA, an FDIC-insured depository institution can be held liable for any losses incurred by the FDIC in connection with (1) the default of one of its FDIC-insured subsidiaries or (2) any assistance provided by the FDIC to one of its FDIC-insured subsidiaries in danger of default. Default is defined generally as the appointment of a conservator or receiver, and in danger of default is defined generally as the existence of certain conditions indicating that a default is likely to occur in the absence of regulatory assistance.

The Federal Deposit Insurance Act, or FDIA, requires that the FDIC review (1) any merger or consolidation by or with an insured bank, or (2) any establishment of branches by an insured bank. The FDIC is also empowered to regulate interest rates paid by insured banks. Approval of the FDIC is also required before an insured bank retires any part of its common or preferred stock, or any capital notes or debentures. Insured banks that are also members of the Federal Reserve System, however, are regulated with respect to the foregoing matters by the Federal Reserve System.

### *Payment of Dividends*

We are a legal entity separate and distinct from our banking and other subsidiaries. We receive most of our revenue from dividends paid to us by our Delaware holding company subsidiary. Similarly, the Delaware holding company subsidiary receives dividends from our bank subsidiaries. Described below are some of the laws and regulations that apply when either we or our subsidiary banks pay dividends.

Each state bank that is a member of the Federal Reserve System and each national banking association is required by federal law to obtain the prior approval of the Federal Reserve Board and the OCC, respectively, to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank's net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus. In addition, these banks may only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

Our subsidiary banks paid aggregate dividends of approximately \$42.3 million in 2007 and approximately \$40.0 million in 2006. Under the dividend restrictions discussed above, as of December 31, 2007, our subsidiary banks, without obtaining regulatory approvals, could have declared in the aggregate additional dividends of approximately \$31.9 million from retained net profits.

To pay dividends, we and our subsidiary banks must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in, or is about to engage in, an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve Board and the OCC have each indicated paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve Board, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends to the extent net income is sufficient to cover both cash dividends and a rate of earnings retention consistent with capital needs, asset quality and overall financial condition. No undercapitalized institution may pay a dividend.

### *Affiliate Transactions*

The Federal Reserve Act, the FDIA and the rules adopted under these statutes restrict the extent to which we can borrow or otherwise obtain credit from, or engage in certain other transactions with, our depository subsidiaries. These laws regulate covered transactions between insured depository institutions and their subsidiaries, on the one hand, and



their nondepository affiliates, on the other hand. Covered transactions include a loan or extension of credit to a nondepository affiliate, a purchase of securities issued by such an affiliate, a purchase of assets from such an affiliate (unless otherwise exempted by the Federal Reserve Board), an acceptance of securities issued by such an affiliate as collateral for a loan, and an issuance of a guarantee, acceptance, or letter of credit for the benefit of such an affiliate. The covered transactions that an insured depository institution and its subsidiaries are permitted to engage in with their nondepository affiliates are limited to the following amounts: (1) in the case of any

one such affiliate, the aggregate amount of covered transactions cannot exceed ten percent of the capital stock and the surplus of the insured depository institution; and (2) in the case of all affiliates, the aggregate amount of covered transactions cannot exceed twenty percent of the capital stock and surplus of the insured depository institution. In addition, extensions of credit that constitute covered transactions must be collateralized in prescribed amounts. Further, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. Finally, when we and our subsidiary banks conduct transactions internally among us, we are required to do so at arm's length.

### ***Loans to Directors, Executive Officers and Principal Shareholders***

The authority of our subsidiary banks to extend credit to our directors, executive officers and principal shareholders, including their immediate family members and corporations and other entities that they control, is subject to substantial restrictions and requirements under Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder, as well as the Sarbanes-Oxley Act of 2002. These statutes and regulations impose specific limits on the amount of loans our subsidiary banks may make to directors and other insiders, and specified approval procedures must be followed in making loans that exceed certain amounts. In addition, all loans our subsidiary banks make to directors and other insiders must satisfy the following requirements:

The loans must be made on substantially the same terms, including interest rates and collateral, as prevailing at the time for comparable transactions with persons not affiliated with us or the subsidiary banks;

The subsidiary banks must follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with us or the subsidiary banks; and

The loans must not involve a greater than normal risk of non-payment or include other features not favorable to the bank.

Furthermore, each subsidiary bank must periodically report all loans made to directors and other insiders to the bank regulators, and these loans are closely scrutinized by the regulators for compliance with Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O. Each loan to directors or other insiders must be pre-approved by the bank's board of directors with the applicable director abstaining from voting.

### ***Capital***

***Bank Holding Companies and Financial Holding Companies.*** The Federal Reserve Board has adopted risk-based capital guidelines for bank holding companies and financial holding companies. The ratio of total capital to risk weighted assets (including certain off-balance-sheet activities, such as standby letters of credit) must be a minimum of eight percent. At least half of the total capital is to be composed of common shareholders' equity, minority interests in the equity accounts of consolidated subsidiaries and a limited amount of perpetual preferred stock, less goodwill, which is collectively referred to as Tier 1 Capital. The remainder of total capital may consist of subordinated debt, other preferred stock and a limited amount of loan loss reserves.

In addition, the Federal Reserve Board has established minimum leverage ratio guidelines for bank holding companies and financial holding companies. Bank holding companies and financial holding companies that meet certain specified criteria, including having the highest regulatory rating, must maintain a minimum Tier 1 Capital leverage ratio (Tier 1 Capital to average assets for the current quarter, less goodwill) of three percent. Bank holding companies and financial holding companies that do not have the highest regulatory rating will generally be required to maintain a higher Tier 1 Capital leverage ratio of three percent plus an additional cushion of 100 to 200 basis points. The Federal Reserve Board has not advised us of any specific minimum leverage ratio applicable to us except for Hereford State Bank (see

below). The guidelines also provide that bank holding companies and financial holding companies experiencing internal growth or making acquisitions will be expected to maintain strong capital positions. Such strong capital positions must be kept substantially above the minimum supervisory levels without significant reliance on intangible assets (e.g., goodwill and core deposit intangibles). As of December 31, 2007, our capital ratios were as follows: (1) Tier 1 Capital to Risk-Weighted Assets Ratio, 14.65%; (2) Total Capital to Risk-Weighted Assets Ratio, 15.62%; and (3) Tier 1 Capital Leverage Ratio, 9.23%.

*Banks.* The Federal Deposit Insurance Corporation Improvement Act of 1991, or FDICIA, established five capital tiers with respect to depository institutions: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. A depository institution's capital tier will depend upon where its capital levels are in relation to various relevant capital measures, including (1) risk-based capital measures, (2) a leverage ratio capital measure and (3) certain other factors. Regulations establishing the specific capital tiers provide that a well-capitalized institution will have a total risk-based capital ratio of ten percent or greater, a Tier 1 risk-based capital ratio of six percent or greater, and a Tier 1 leverage ratio of five percent or greater, and not be subject to any written regulatory enforcement agreement, order, capital directive or prompt corrective action derivative. For an institution to be adequately capitalized, it will have a total risk-based capital ratio of eight percent or greater, a Tier 1 risk-based capital ratio of four percent or greater, and a Tier 1 leverage ratio of four percent or greater (in some cases three percent). For an institution to be undercapitalized, it will have a total risk-based capital ratio that is less than eight percent, a Tier 1 risk-based capital ratio less than four percent or a Tier 1 leverage ratio less than four percent (or a leverage ratio less than three percent if the institution's composite rating is 1 in its most recent report of examination, subject to appropriate federal banking agency guidelines). For an institution to be significantly undercapitalized, it will have a total risk-based capital ratio less than six percent, a Tier 1 risk-based capital ratio less than three percent, or a Tier 1 leverage ratio less than three percent. For an institution to be critically undercapitalized, it will have a ratio of tangible equity to total assets equal to or less than two percent. FDICIA requires federal banking agencies to take prompt corrective action against depository institutions that do not meet minimum capital requirements. Under current regulations, we were well capitalized as of December 31, 2007 at all of our subsidiary banks, except our Hereford State Bank's total risk-based capital ratio was 9.92% versus the well capitalized minimum of 10%, which was corrected effective January 31, 2008.

FDICIA generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. An undercapitalized institution must develop a capital restoration plan and its parent holding company must guarantee that institution's compliance with such plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the institution's assets at the time it became undercapitalized or the amount needed to bring the institution into compliance with all capital standards. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent's general unsecured creditors. If a depository institution fails to submit an acceptable capital restoration plan, it shall be treated as if it is significantly undercapitalized. Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks.

Critically undercapitalized institutions are subject to the appointment of a receiver or conservator. Finally, FDICIA requires the various regulatory agencies to set forth certain standards that do not relate to capital. Such standards relate to the safety and soundness of operations and management and to asset quality and executive compensation, and permit regulatory action against a financial institution that does not meet such standards.

If an insured bank fails to meet its capital guidelines, it may be subject to a variety of other enforcement remedies, including a prohibition on the taking of brokered deposits and the termination of deposit insurance by the FDIC. Bank regulators continue to indicate their desire to raise capital requirements beyond their current levels.

In addition to FDICIA capital standards, Texas-chartered banks must also comply with the capital requirements imposed by the Texas Banking Department. Neither the Texas Finance Code nor its regulations specify any minimum capital-to-assets ratio that must be maintained by a Texas-chartered bank. Instead, the Texas Banking Department determines the appropriate ratio on a bank by bank basis, considering factors such as the nature of a bank's business, its total revenue, and the bank's total assets. As of December 31, 2007, our Texas-chartered bank exceeded the minimum ratios applied to it.

***Our Support of Our Subsidiary Banks***

Under Federal Reserve Board policy, we are expected to commit resources to act as a source of strength to support each of our subsidiary banks. This support may be required at times when, absent such Federal Reserve Board policy, we would not otherwise be required to provide it. In addition, any loans we make to our subsidiary

banks would be subordinate in right of payment to deposits and to other indebtedness of our banks. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and be subject to a priority of payment.

Under the National Bank Act, if the capital stock of a national bank is impaired by losses or otherwise, the OCC is authorized to require the bank's shareholders to pay the deficiency on a pro-rata basis. If any shareholder refuses to pay the pro-rata assessment after three months notice, then the bank's board of directors must sell an appropriate amount of the shareholder's stock at a public auction to make up the deficiency. To the extent necessary, if a deficiency in capital still exists and the bank refuses to go into liquidation, then a receiver may be appointed to wind up the bank's affairs. Additionally, under the Federal Deposit Insurance Act, in the event of a loss suffered or anticipated by the FDIC (either as a result of the default of a banking subsidiary or related to FDIC assistance provided to a subsidiary in danger of default) our other banking subsidiaries may be assessed for the FDIC's loss.

### ***Interstate Banking and Branching Act***

Pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, or Riegle-Neal Act, a bank holding company or financial holding company is able to acquire banks in states other than its home state. The Riegle-Neal Act also authorized banks to merge across state lines, thereby creating interstate branches. Furthermore, under this act, a bank is also able to open new branches in a state in which it does not already have banking operations, if the laws of such state permit it to do so. Accordingly, both the OCC and the Texas Banking Department accept applications for interstate merger and branching transactions, subject to certain limitations on ages of the banks to be acquired and the total amount of deposits within the state a bank or financial holding company may control. Since our primary service area is Texas, we do not expect that the ability to operate in other states will have any material impact on our growth strategy. We may, however, face increased competition from out-of-state banks that branch or make acquisitions in our primary markets in Texas.

### ***Community Reinvestment Act of 1977***

The Community Reinvestment Act of 1977, or CRA, subjects a bank to regulatory assessment to determine if the institution meets the credit needs of its entire community, including low- and moderate-income neighborhoods served by the bank, and to take that determination into account in its evaluation of any application made by such bank for, among other things, approval of the acquisition or establishment of a branch or other deposit facility, an office relocation, a merger, or the acquisition of shares of capital stock of another financial institution. The regulatory authority prepares a written evaluation of an institution's record of meeting the credit needs of its entire community and assigns a rating. These ratings are Outstanding, Satisfactory, Needs Improvement and Substantial Non-Compliance. Institutions with ratings lower than Satisfactory may be restricted from engaging in the aforementioned activities. We believe our subsidiary banks have taken significant actions to comply with the CRA, and each has received at least a satisfactory rating in its most recent review by federal regulators with respect to its compliance with the CRA.

### ***Monitoring and Reporting Suspicious Activity***

Under the Bank Secrecy Act, IRS rules and other regulations, we are required to monitor and report unusual or suspicious account activity as well as transactions involving the transfer or withdrawal of amounts in excess of prescribed limits. Under the USA PATRIOT Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and know your customer standards in their dealings with financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures and controls generally require financial institutions to take reasonable steps:

to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction;

to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

Under the USA PATRIOT Act, financial institutions are also required to establish anti-money laundering programs. The USA PATRIOT Act sets forth minimum standards for these programs, including:

the development of internal policies, procedures, and controls;

the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

In addition, under the USA PATRIOT Act, the Secretary of the Treasury has adopted rules addressing a number of related issues, including increasing the cooperation and information sharing between financial institutions, regulators, and law enforcement authorities regarding individuals, entities and organizations engaged in, or reasonably suspected based on credible evidence of engaging in, terrorist acts or money laundering activities. Any financial institution complying with these rules will not be deemed to violate the privacy provisions of the Gramm-Leach-Bliley Act that are discussed below. Finally, under the regulations of the Office of Foreign Asset Control, we are required to monitor and block transactions with certain specially designated nationals who OFAC has determined pose a risk to U.S. national security.

### ***Consumer Laws and Regulations***

We are also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the following list is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, The Fair and Accurate Credit Transactions Act and the Fair Housing Act, among others. These laws and regulations, among other things, prohibit discrimination on the basis of race, gender or other designated characteristics and mandate various disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. These and other laws also limit finance charges or other fees or charges earned in our activities. We must comply with the applicable provisions of these consumer protection laws and regulations as part of our ongoing customer relations.

### ***Technology Risk Management and Consumer Privacy***

State and federal banking regulators have issued various policy statements emphasizing the importance of technology risk management and supervision in evaluating the safety and soundness of depository institutions with respect to banks that contract with outside vendors to provide data processing and core banking functions. The use of technology-related products, services, delivery channels and processes exposes a bank to various risks, particularly operational, privacy, security, strategic, reputation and compliance risk. Banks are generally expected to prudently manage technology-related risks as part of their comprehensive risk management policies by identifying, measuring, monitoring and controlling risks associated with the use of technology.



Under Section 501 of the Gramm-Leach-Bliley Act, the federal banking agencies have established appropriate standards for financial institutions regarding the implementation of safeguards to ensure the security and confidentiality of customer records and information, protection against any anticipated threats or hazards to the security or integrity of such records and protection against unauthorized access to or use of such records or information in a way that could result in substantial harm or inconvenience to a customer. Among other matters, the rules require each bank to implement a comprehensive written information security program that includes administrative, technical and physical safeguards relating to customer information.

Under the Gramm-Leach-Bliley Act, a financial institution must also provide its customers with a notice of privacy policies and practices. Section 502 prohibits a financial institution from disclosing nonpublic personal

information about a customer to nonaffiliated third parties unless the institution satisfies various notice and opt-out requirements and the customer has not elected to opt out of the disclosure. Under Section 504, the agencies are authorized to issue regulations as necessary to implement notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about customers to nonaffiliated third parties. Under the final rule the regulators adopted, all banks must develop initial and annual privacy notices which describe in general terms the bank's information sharing practices. Banks that share nonpublic personal information about customers with nonaffiliated third parties must also provide customers with an opt-out notice and a reasonable period of time for the customer to opt out of any such disclosure (with certain exceptions). Limitations are placed on the extent to which a bank can disclose an account number or access code for credit card, deposit or transaction accounts to any nonaffiliated third party for use in marketing.

### ***Monetary Policy***

Banks are affected by the credit policies of monetary authorities, including the Federal Reserve Board, that affect the national supply of credit. The Federal Reserve Board regulates the supply of credit in order to influence general economic conditions, primarily through open market operations in United States government obligations, varying the discount rate on financial institution borrowings, varying reserve requirements against financial institution deposits, and restricting certain borrowings by financial institutions and their subsidiaries. The monetary policies of the Federal Reserve Board have had a significant effect on the operating results of banks in the past and are expected to continue to do so in the future.

### ***Pending and Proposed Legislation***

New regulations and statutes are regularly proposed containing wide-ranging proposals for altering the structures, regulations and competitive relationships of financial institutions operating in the United States. We cannot predict whether, or in what form, any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

### ***Enforcement Powers of Federal Banking Agencies***

The Federal Reserve and other state and federal banking agencies and regulators have broad enforcement powers, including the power to terminate deposit insurance, issue cease-and-desist orders, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Our failure to comply with applicable laws, regulations and other regulatory pronouncements could subject us, as well as our officers and directors, to administrative sanctions and potentially substantial civil penalties.

### ***Available Information***

We file annual, quarterly and special reports, proxy statements and other information with the Securities and Exchange Commission. You may read and copy any document we file at the Securities and Exchange Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public at the Securities and Exchange Commission's web site at <http://www.sec.gov>. Our web site is <http://www.ffin.com>. You may also obtain copies of our annual, quarterly and special reports, proxy statements and certain other information filed with the SEC, as well as amendments thereto, free of charge from our web site. These documents are posted to our web site as soon as reasonably practicable after we have filed them with the SEC. Our corporate governance guidelines, including our code of conduct applicable to all our employees, officers and directors, as well as the charters of our audit and nominating committees, are available at [www.ffin.com](http://www.ffin.com). The foregoing information is also available in print to any shareholder who requests it. Except as explicitly provided, information on

any web site is not incorporated into this Form 10-K or our other securities filings and is not a part of them.

## **ITEM 1A. RISK FACTORS**

Our business, financial condition, operating results and cash flows can be impacted by a number of factors, including but not limited to those set forth below, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results and other forward looking statements that we make from time to time in our news releases, annual reports and other written communications, as well as oral forward looking statements, and other statements made from time to time by our representatives.

### ***Our Business Faces Unpredictable Economic Conditions***

General economic conditions impact the banking industry. The credit quality of our loan portfolio necessarily reflects, among other things, the general economic conditions in the areas in which we conduct our business. Our continued financial success depends somewhat on factors beyond our control, including:

general economic conditions, including national and local real estate markets;

the supply of and demand for investable funds;

demand for loans and access to credit;

interest rates; and

federal, state and local laws affecting these matters.

Any substantial deterioration in any of the foregoing conditions could have a material adverse effect on our financial condition and results of operations, which would likely adversely affect the market price of our common stock.

### ***Our Business Is Concentrated In Texas And A Downturn In The Economy Of Texas May Adversely Affect Our Business***

Our network of subsidiary banks is concentrated in Texas, primarily in the Western and North Central regions of the state. Most of our customers and revenue are derived from this area. The economy of this region is focused on agriculture (including farming and ranching), commercial and industrial, medical, education, oil and gas production, and real estate. Historically, these industries have fluctuated widely between boom and bust. Because we generally do not derive revenue or customers from other parts of the state or nation, our business and operations are dependent on economic conditions in this part of Texas. Any decline in one or more segments of the local economy could adversely affect our business, revenue, operations and properties.

### ***Recent Developments In The Mortgage Market May Affect Our Ability To Originate Loans And The Profitability Of Loans In Our Pipeline.***

During 2007, a combination of rising interest rates and softening real estate prices throughout the United States culminated in an industry-wide increase in borrowers unable to make their mortgage payments and increased foreclosure rates. Lenders in certain sections of the housing and mortgage markets were forced to close or limit their operations or seek additional capital. In response, financial institutions have tightened their underwriting standards, limiting the availability of sources of credit and liquidity. While we have never been a subprime lender, recent reports of credit quality, financial solvency and other problems among subprime lenders have increased volatility in the price of the securities of a broader class of financial institutions. If the subprime segment continues to have problems in the future or credit quality problems spread to other industry segments, including lenders who make loans to prime credit

quality borrowers, there could be a prolonged decrease in the demand for our loans in the secondary market, adversely affecting our earnings and negatively impacting the price of our common stock.

***Changes in Economic Conditions Could Cause An Increase In Delinquencies And Non-Performing Assets, Including Loan Charge-Offs, And Depress Our Income And Growth.***

Our loan portfolios include many real estate secured loans, demand for which may decrease during economic downturns as a result of, among other things, an increase in unemployment, a decrease in real estate values, a

slowdown in housing price appreciation or increases in interest rates. If a recession occurs that negatively impacts economic conditions in the United States as a whole or in the portions of Texas that we serve, we could experience higher delinquencies and loan charge-offs, which would reduce our income and adversely affect our financial condition. Furthermore, to the extent that real estate collateral is obtained through foreclosure, the costs of holding and marketing the real estate collateral, as well as the ultimate values obtained from disposition could reduce our earnings and adversely affect our financial condition.

***The Value Of Real Estate Collateral May Fluctuate Significantly***

The market value of real estate, particularly real estate held for investment, can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. If the value of the real estate serving as collateral for our loan portfolio were to decline materially, a significant part of our loan portfolio could become under-collateralized. If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, then, in the event of foreclosure, we may not be able to realize the amount of collateral that we anticipated at the time of originating the loan, which could have a material adverse effect on our provision for loan losses and our operating results and financial condition.

***Recent Trends In The Student Loan Market May Reduce The Income We Derive From Originating And Selling Student Loans.***

Recent federal legislation will reduce federal subsidies to us for making student loans and require us to pay higher origination fees. These factors may reduce the net income we earn from making these loans. Additionally, recent trends in the capital markets may make it more difficult for third parties to whom we sell students loans in the secondary market to raise funds to purchase our loans. If our ability to sell these loans to third parties is reduced, then we may realize less premiums from the sale of student loans or hold them for longer periods of time, or both.

***Our Business Is Subject To Significant Government Regulation***

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Texas Department of Banking, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels and other aspects of our operations. The bank regulatory agencies possess broad authority to prevent or remedy unsafe or unsound practices or violations of law.

In addition, future legislation and government policy could adversely affect the banking industry as a whole, including our results of operations. For example, new legislation or regulation may limit the manner in which we may conduct our business, including our ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads.

***We Compete With Many Larger Financial Institutions Which Have Substantially Greater Financial Resources Than We Have***

Competition among financial institutions in Texas is intense. We compete with other bank holding companies, state and national commercial banks, savings and loan associations, consumer financial companies, credit unions, securities brokers, insurance companies, mortgage banking companies, money market mutual funds, asset-based non-bank lenders and other financial institutions. Many of these competitors have substantially greater financial resources,

larger lending limits, larger branch networks and less regulatory oversight than we do, and are able to offer a broader range of products and services than we can. Failure to compete effectively for deposit, loan and other banking customers in our markets could cause us to lose market share, slow our growth rate and may have an adverse effect on our financial condition and results of operations.

***In Our Business, We Must Effectively Manage Our Credit Risk***

As a lender, we are exposed to the risk that our loan customers may not repay their loans according to the terms of these loans and the collateral securing the payment of these loans may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs to dispose of the collateral. We may experience significant loan losses which could have a material adverse effect on our operating results and financial condition. Management makes various assumptions and judgments about the collectibility of our loan portfolio, including the diversification by industry of our commercial loan portfolio, the amount of nonperforming loans and related collateral, the volume, growth and composition of our loan portfolio, the effects on the loan portfolio of current economic indicators and their probable impact on borrowers and the evaluation of our loan portfolio through our internal loan review process and other relevant factors.

We maintain an allowance for credit losses in an attempt to cover credit losses inherent in our loan portfolio. Additional credit losses will likely occur in the future and may occur at a rate greater than we have experienced to date. In determining the amount of the allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions. If our assumptions prove to be incorrect, our current allowance may not be sufficient and adjustments may be necessary to allow for different economic conditions or adverse developments in our loan portfolio. Material additions to the allowance could materially decrease net income.

In addition, federal and state regulators periodically review our allowance for credit losses and may require us to increase our provision for credit losses or recognize further charge-offs, based on judgments different than those of our management. Any increase in our allowance for credit losses or charge-offs as required by these regulatory agencies could have a material negative effect on our operating results and financial condition.

***Our Operations Are Significantly Affected By Interest Rate Levels***

Our profitability is dependent to a large extent on our net interest income, which is the difference between interest income we earn as a result of interest paid to us on loans and investments and interest we pay to third parties such as our depositors and those from whom we borrow funds. Like most financial institutions, we are affected by changes in general interest rate levels and by other economic factors beyond our control. Interest rate risk can result from mismatches between the dollar amount of repricing or maturing assets and liabilities and from mismatches in the timing and rate at which our assets and liabilities reprice. Although we have implemented strategies which we believe reduce the potential effects of changes in interest rates on our results of operations, these strategies may not always be successful. In addition, any substantial and prolonged increase in market interest rates could reduce our customers desire to borrow money from us or adversely affect their ability to repay their outstanding loans by increasing their credit costs since most of our loans have adjustable interest rates that reset periodically. Any of these events could adversely affect our results of operations or financial condition.

***First Financial Bankshares, Inc. Relies On Dividends From Its Subsidiaries For Most Of Its Revenue***

First Financial Bankshares, Inc. is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the Company's common stock and interest and principal on First Financial Bankshares, Inc. debt (if we had balances outstanding). Various federal and/or state laws and regulations limit the amount of dividends that our bank subsidiaries may pay to First Financial Bankshares, Inc. In the event our bank subsidiaries are unable to pay dividends to First Financial Bankshares, Inc., First Financial Bankshares, Inc. may not be able to service debt or pay dividends on the Company's common stock. The inability to receive dividends from our bank subsidiaries could have a material adverse effect on the Company's business, financial condition and results of operations.



***To Continue Our Growth, We Are Affected By Our Ability To Identify And Acquire Other Financial Institutions***

*We intend to continue our current growth strategy.* This strategy includes opening new branches and acquiring other banks that serve customers or markets we find desirable. The market for acquisitions remains highly competitive, and we may be unable to find satisfactory acquisition candidates in the future that fit our acquisition

and growth strategy. To the extent that we are unable to find suitable acquisition candidates, an important component of our growth strategy may be lost. Additionally, our completed acquisitions, or any future acquisitions, may not produce the revenue, earnings or synergies that we anticipated.

***Our Operational And Financial Results Are Affected By Our Ability To Successfully Integrate Our Acquisitions***

Acquisitions of financial institutions involve operational risks and uncertainties and acquired companies may have unforeseen liabilities, exposure to asset quality problems, key employee and customer retention problems and other problems that could negatively affect our organization. We may not be able to successfully integrate the operations, management, products and services of the entities that we acquire and eliminate redundancies. The integration process may also require significant time and attention from our management that they would otherwise direct at servicing existing business and developing new business. Our failure to successfully integrate the entities we acquire into our existing operations may increase our operating costs significantly and adversely affect our business and earnings.

***We Rely Heavily On Our Management Team, And The Unexpected Loss of Key Management May Adversely Affect Our Operations***

Our success to date has been strongly influenced by our ability to attract and to retain senior management experienced in banking in the markets we serve. Our ability to retain executive officers and the current management teams will continue to be important to successful implementation of our strategies. We do not have employment agreements with these key employees other than executive agreements in the event of a change of control and a confidential information, non-solicitation and non-competition agreement related to our stock options. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business and financial results.

***Although Publicly Traded, Our Common Stock Does Not Have A Significant Amount Of Trading Liquidity.***

Although our trading activity continues to increase, a relatively small percentage of our outstanding common stock is actively traded on the Nasdaq Global Select Market. The risks of low liquidity include increased volatility of the price of our common stock. Low liquidity may also limit holders of our common stock in their ability to sell or transfer our shares at the price, time and quantity desired.

***Breakdowns In Our Internal Controls And Procedures Could Have An Adverse Effect On Us***

We believe our internal control system as currently documented and functioning is adequate to provide reasonable assurance over our internal controls. Nevertheless, because of the inherent limitation in administering a cost effective control system, misstatements due to error or fraud may occur and not be detected. Breakdowns in our internal controls and procedures could occur in the future, and any such breakdowns could have an adverse effect on us. See Item 9A Controls and Procedures for additional information.

***We Compete In An Industry That Continually Experiences Technological Change, And We May Have Fewer Resources Than Many Of Our Competitors To Continue To Invest In Technological Improvements***

The financial services industry is undergoing rapid technological changes, with frequent introductions of new technology-driven products and services. In addition to improving the ability to serve customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for conveniences, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to

effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

***System Failure Or Breaches Of Our Network Security Could Subject Us To Increased Operating Costs As Well As Litigation And Other Liabilities***

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. Any damage or failure that causes an interruption in our operations could have an adverse effect on our financial condition and results of operations. In addition, our operations are dependent upon our ability to protect the computer systems and network infrastructure utilized by us against damage from physical break-ins, security breaches and other disruptive problems caused by the Internet or other users. Such computer break-ins and other disruptions would jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and inhibit potential customers. Although we, with the help of third-party service providers, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

Our principal office is located in the First Financial Bank Building at 400 Pine Street in downtown Abilene, Texas. We lease two spaces in a building owned by First Financial Bank, National Association, Abilene. The lease of approximately 3,300 square feet of space expires December 31, 2010. The lease of approximately 1,135 square feet of space is on a month-to-month basis. Our subsidiary banks collectively own 37 banking facilities, some of which are detached drive-ins, and also lease nine banking facilities and 13 ATM locations. Our management considers all our existing locations to be well-suited for conducting the business of banking. We believe our existing facilities are adequate to meet our requirements and our subsidiary banks' requirements for the foreseeable future.

**ITEM 3. LEGAL PROCEEDINGS**

From time to time we and our subsidiary banks are parties to lawsuits arising in the ordinary course of our banking business. However, there are no material pending legal proceedings to which we, our subsidiary banks or our other direct and indirect subsidiaries, or any of their properties, are currently subject. Other than regular, routine examinations by state and federal banking authorities, there are no proceedings pending or known to be contemplated by any governmental authorities.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our security holders during the fourth quarter of our fiscal year ended December 31, 2007.

## PART II

### ITEM 5. *MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES*

#### **Market Information**

Our common stock, par value \$0.01 per share, is traded on the Nasdaq Global Select Market under the trading symbol FFIN. See Item 8 Financial Statements and Supplementary Data Quarterly Financial Data for the high, low and closing sales prices as reported by the Nasdaq National Market for our common stock for the periods indicated.

#### **Record Holders**

As of February 1, 2008, we had approximately 1,500 shareholders of record.

#### **Dividends**

See Item 8 Financial Statements and Supplementary Data Quarterly Results of Operations for the frequency and amount of cash dividends paid by us. Also, see Item 1 Business Supervision and Regulation Payment of Dividends and Item 7 Management's Discussion and Analysis of the Financial Condition and Results of Operations Liquidity Dividends for restrictions on our present or future ability to pay dividends, particularly those restrictions arising under federal and state banking laws.

**PERFORMANCE GRAPH**

The following performance graph compares cumulative total shareholder return for our common stock, the Russell 3000 Index, and the SNB Banks Index, which is a banking index prepared by SNL Financial LC and is comprised of banks with \$1 billion to \$5 billion in total assets, for a five-year period (December 31, 2002 to December 31, 2007). The performance graph assumes \$100 invested in our common stock at its closing price on December 31, 2001, and in each of the Russell 3000 Index and the SNL Bank Index on the same date. The performance graph also assumes the reinvestment of all dividends. The dates on the performance graph represents the last trading day of each year indicated. The amounts noted on the performance graph have been adjusted to give effect to all stock splits and stock dividends.

**Total Return Performance**

| <b>Index</b>                     | <b>Period Ending</b> |                 |                 |                 |                 |                 |
|----------------------------------|----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                                  | <b>12/31/02</b>      | <b>12/31/03</b> | <b>12/31/04</b> | <b>12/31/05</b> | <b>12/31/06</b> | <b>12/31/07</b> |
| First Financial Bankshares, Inc. | 100.00               | 139.93          | 157.55          | 169.62          | 208.92          | 194.03          |
| Russell 3000                     | 100.00               | 131.06          | 146.71          | 155.69          | 180.16          | 189.42          |
| SNL Bank \$1B-\$5B Index         | 100.00               | 135.99          | 167.83          | 164.97          | 190.90          | 139.06          |

Source: SNL Financial LC, Charlottesville, VA

**ITEM 6. SELECTED FINANCIAL DATA**

The selected financial data presented below as of and for the years ended December 31, 2007, 2006, 2005, 2004, and 2003, have been derived from our audited consolidated financial statements. The selected financial data should be read in conjunction with Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements. The results of operations presented below are not necessarily indicative of the results of operations that may be achieved in the future. The amounts related to shares of our common stock have been adjusted to give effect to all stock dividends and stock splits. Management's Discussion and Analysis of Financial Condition and Results of Operations incorporated information required to be disclosed by the Securities and Exchange Commission's Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

|   | <b>Year Ended December 31,</b>                       |              |              |             |             |
|---|--|--------------|--------------|-------------|-------------|
|   | <b>2007</b>  | <b>2006</b>  | <b>2005</b>  | <b>2004</b> | <b>2003</b> |
|   | <b>(Dollars in thousands, except per share data)</b> |              |              |             |             |
| <b>Summary Income Statement Information:</b>    |  |              |              |             |             |
| Interest income                                 | \$ 169,369   | \$ 154,494   | \$ 123,944   | \$ 99,973   | \$ 95,285   |
| Interest expense                                | 58,557   | 48,628       | 28,757       | 16,077      | 17,131      |
| Net interest income                             | 110,812  | 105,866      | 95,187       | 83,896      | 78,154      |
| Provision for loan losses                       | 2,331  | 2,061        | 1,320        | 1,633       | 1,178       |
| Noninterest income                              | 48,273   | 44,668       | 44,180       | 38,823      | 34,109      |
| Noninterest expense                             | 86,827   | 83,017       | 75,487       | 65,885      | 61,089      |
| Earnings before income taxes                    | 69,927   | 65,456       | 62,560       | 55,201      | 49,996      |
| Income tax expense                              | 20,437   | 19,427       | 18,537       | 16,030      | 14,691      |
| Net earnings                                    | \$ 49,490  | \$ 46,029    | \$ 44,023    | \$ 39,171   | \$ 35,305   |
| <b>Per Share Data:</b>                          |  |              |              |             |             |
| Net earnings per share, basic                   | \$ 2.38  | \$ 2.22      | \$ 2.13      | \$ 1.90     | \$ 1.71     |
| Net earnings per share, assuming dilution       | 2.38   | 2.21         | 2.12         | 1.89        | 1.70        |
| Cash dividends declared                         | 1.26   | 1.18         | 1.10         | 1.00        | 0.91        |
| Book value at period-end                        | 16.16  | 14.51        | 13.34        | 12.84       | 12.19       |
| <b>Earnings performance ratios:</b>             |  |              |              |             |             |
| Return on average assets                        | 1.72%  | 1.68%        | 1.80%        | 1.82%       | 1.75%       |
| Return on average equity                        | 15.87  | 16.20        | 16.17        | 15.09       | 14.40       |
| <b>Summary Balance Sheet Data (Period-end):</b> |  |              |              |             |             |
| Investment securities                           | \$ 1,128,493   | \$ 1,129,313 | \$ 1,046,121 | \$ 854,334  | \$ 910,302  |
| Loans   | 1,528,020  | 1,373,735    | 1,288,604    | 1,164,223   | 987,523     |
| Total assets                                    | 3,070,309  | 2,850,165    | 2,733,827    | 2,315,224   | 2,092,571   |
| Deposits  | 2,546,083  | 2,384,024    | 2,366,277    | 1,994,312   | 1,796,271   |
| Total liabilities                               | 2,734,814  | 2,549,263    | 2,457,551    | 2,049,679   | 1,841,085   |
| Total shareholders' equity                      | 335,495  | 300,901      | 276,276      | 265,545     | 251,487     |
| <b>Asset quality ratios:</b>                    |  |              |              |             |             |

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|  |        |        |        |        |        |
|--|--------|--------|--------|--------|--------|
| Allowance for loan losses/period-end loans                   | 1.14%  | 1.18%  | 1.14%  | 1.19%  | 1.17%  |
| Nonperforming assets/period-end loans plus foreclosed assets | 0.31   | 0.30   | 0.33   | 0.43   | 0.32   |
| Net charge offs/average loans                                | 0.07   | 0.04   | 0.10   | 0.12   | 0.09   |
| <b>Capital ratios:</b>                                       |        |        |        |        |        |
| Average shareholders equity/average assets                   | 10.84% | 10.38% | 11.11% | 12.08% | 12.13% |
| Leverage ratio(1)  | 9.23   | 8.87   | 8.56   | 9.80   | 10.60  |
| Tier 1 risk-based capital(2)                                 | 14.65  | 14.35  | 14.17  | 16.46  | 18.83  |
| Total risk-based capital(3)                                  | 15.62  | 15.32  | 15.13  | 17.49  | 19.83  |
| Dividend payout ratio  | 52.86  | 53.14  | 51.55  | 52.62  | 53.10  |

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- (1) Calculated by dividing at period-end, shareholders' equity (before accumulated other comprehensive earnings/loss) less intangible assets by fourth quarter average assets less intangible assets.
- (2) Calculated by dividing at period-end, shareholders' equity (before accumulated other comprehensive earnings/loss) less intangible assets by risk-adjusted assets.
- (3) Calculated by dividing at period-end, shareholders' equity (before accumulated other comprehensive earnings/loss) less intangible assets plus allowance for loan losses to the extent allowed under regulatory guidelines by risk-adjusted assets.

## **ITEM 7. *MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

### **Introduction**

As a multi-bank financial holding company, we generate most of our revenue from interest on loans and investments, trust fees, and service charges. Our primary source of funding for our loans and investments are deposits held by our subsidiary banks. Our largest expenses are interest on these deposits and salaries and related employee benefits. We usually measure our performance by calculating our return on average assets, return on average equity, our regulatory leverage and risk based capital ratios, and our efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax equivalent basis and noninterest income.

You should read the following discussion and analysis of the major elements of our consolidated balance sheets as of December 31, 2007 and 2006, and consolidated statements of earnings for the years 2005 through 2007 in conjunction with our consolidated financial statements, accompanying notes, and selected financial data presented elsewhere in this Form 10-K. Average share information and earnings per share data related to our common stock have been adjusted to give effect to all stock splits and stock dividends, including the four-for-three stock split in the form of a 33% stock dividend effective June 1, 2005.

### **Critical Accounting Policies**

We prepare consolidated financial statements based on the selection of certain accounting policies, generally accepted accounting principles and customary practices in the banking industry. These policies, in certain areas, require us to make significant estimates and assumptions.

We deem a policy critical if (1) the accounting estimate required us to make assumptions about matters that are highly uncertain at the time we make the accounting estimate; and (2) different estimates that reasonably could have been used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the financial statements.

The following discussion addresses our allowance for loan losses and its provision for loan losses, which we deem to be our most critical accounting policy. We have other significant accounting policies and continue to evaluate the materiality of their impact on our consolidated financial statements, but we believe these other policies either do not generally require us to make estimates and judgments that are difficult or subjective, or it is less likely they would have a material impact on our reported results for a given period.

The allowance for loan losses is an amount we believe will be adequate to absorb inherent estimated losses on existing loans in which full collectibility is unlikely based upon our review and evaluation of the loan portfolio. The allowance

for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries).

Our methodology is based on guidance provide in SEC Staff Accounting Bulletin No. 102, Selected Loan Loss Allowance Methodology and Documentation Issues and includes allowance allocations calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118, and allowance allocations determined in accordance with SFAS No. 5, Accounting for Contingencies. We also follow the guidance of the Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued jointly by the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of Thrift Supervision. We have developed a consistent, well-documented loan review

methodology that includes allowances assigned to certain classified loans, allowances assigned based upon estimated loss factors and qualitative reserves. The level of the allowance reflects our periodic evaluation of general economic conditions, the financial condition of our borrowers, the value and liquidity of collateral, delinquencies, prior loan loss experience, and the results of periodic reviews of the portfolio by our independent loan review department and regulatory examiners.

Our allowance for loan losses is comprised of three elements: (i) specific reserves determined in accordance with SFAS 114 and SFAS 5 based on probable losses on specific classified loans; (ii) general reserves determined in accordance with SFAS 5 that consider historical loss rates; and (iii) a qualitative reserve determined in accordance with SFAS 5 based upon general economic conditions and other qualitative risk factors both internal and external to the Company. We regularly evaluate our allowance for loan losses to maintain an adequate level to absorb estimated loan losses inherent in the loan portfolio. Factors contributing to the determination of specific reserves include the credit-worthiness of the borrower, changes in the value of pledged collateral, and general economic conditions. All classified loans are specifically reviewed and a specific allocation is assigned based on the losses expected to be realized from those loans. For purposes of determining the general reserve, the loan portfolio less cash secured loans, government guaranteed loans and classified loans is multiplied by the Company's historical loss rates. The qualitative reserves are determined by evaluating such things as current economic conditions and trends, changes in lending staff, policies or procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans.

Although we believe we use the best information available to make loan loss allowance determinations, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making our initial determinations. A downturn in the economy and employment could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review our allowance for loan losses. The bank regulatory agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, the borrower's financial condition is such that collection of interest is doubtful.

Our policy requires measurement of the allowance for an impaired collateral dependent loan based on the fair value of the collateral. Other loan impairments are measured based on the present value of expected future cash flows or the loan's observable market price.

### **Acquisitions**

On October 25, 2004, we entered into a stock purchase agreement with the shareholders of Clyde Financial Corporation, the parent company of The Peoples State Bank in Clyde, Texas. On February 1, 2005, the transaction was completed. Pursuant to the purchase agreement, we paid approximately \$25.4 million for all outstanding shares of Clyde Financial Corporation. At closing, Clyde Financial Corporation and The Peoples State Bank were merged into our wholly owned bank subsidiary, First Financial Bank, National Association, Abilene. The total purchase price exceeded the estimated fair value of tangible net assets acquired by approximately \$13.2 million, of which approximately \$1.9 million was assigned to an identifiable intangible asset with the balance recorded as goodwill. The primary purpose of the acquisition was to expand the Company's market share near Abilene and along Interstate Highway 20 in West Texas. Factors that contributed to a purchase price resulting in goodwill include Peoples' historic record of earnings and its geographic location which complements the Company's existing service locations.

The main office of the former The Peoples State Bank was located in the City of Clyde, Callahan County, Texas, approximately 12 miles east of Abilene, Texas. The bank also operated offices in Moran, Ranger and Rising Star, Texas, for a total of 4 banking offices. Effective April 1, 2005, First Financial Bank, National Association, Abilene sold the Ranger and Rising Star banking offices acquired from The Peoples State Bank to another of our wholly owned banking subsidiaries, First Financial Bank, National Association, Eastland, Texas. The Ranger, Rising Star and Eastland offices are located in Eastland County. This transaction had no impact on our consolidated financial statements.

On August 10, 2005, we entered into an agreement and plan of merger with Bridgeport Financial Corporation, the parent company of The First National Bank of Bridgeport, Bridgeport, Texas. On December 1, 2005, the transaction was completed. Pursuant to the agreement, we paid \$20.1 million, plus the assumption of \$5.5 million in

debt and trust preferred securities, for all of the outstanding shares of Bridgeport Financial Corporation. At closing, Bridgeport Financial Corporation was merged into First Financial Bankshares of Delaware, Inc. and the First National Bank of Bridgeport was merged with our wholly owned bank subsidiary, First Financial Bank, National Association, Southlake. The total purchase price exceeded the estimated fair value of tangible net assets acquired by approximately \$14.7 million, of which approximately \$2.3 million was assigned to an identifiable intangible asset with the balance recorded as goodwill. The primary purpose of the acquisition was to expand the Company's market share near Dallas/Ft. Worth, Texas and along Interstate Highway 35 in North Central Texas. Factors that contributed to a purchase price resulting in goodwill include Bridgeport's historic record of earnings and its geographic location which complements the Company's existing service locations.

## Results of Operations

*Performance Summary.* Net earnings for 2007 were \$49.5 million, an increase of \$3.5 million, or 7.5%, over net earnings for 2006 of \$46.0 million. Net earnings for 2005 were \$44.0 million. The increase in net earnings for 2007 over 2006 was primarily attributable to growth in net interest income and noninterest income. The increase in net earnings for 2006 over 2005 was primarily attributable to growth in net interest income.

On a basic net earnings per share basis, net earnings were \$2.38 for 2007 as compared to \$2.22 for 2006 and \$2.13 for 2005. Return on average assets was 1.72% for 2007 as compared to 1.68% for 2006 and 1.80% for 2005. Return on average equity was 15.87% for 2007 as compared to 16.20% for 2006 and 16.17% for 2005.

*Net Interest Income.* Net interest income is the difference between interest income on earning assets and interest expense on liabilities incurred to fund those assets. Our earning assets consist primarily of loans and investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits. Tax-equivalent net interest income was \$116.1 million in 2007 as compared to \$110.5 million in 2006 and \$100.0 million in 2005. The increase in 2007 compared to 2006 was largely attributable to an increase in the volume of earning assets which was partially reduced by increases in the rates paid on interest-bearing liabilities. Average earning assets increased \$141.3 million in 2007 with loans contributing \$119.6 million of the increase. The yield on earning assets increased 25 basis points in 2007, whereas the rate paid on interest-bearing liabilities increased 42 basis points. The increase in 2006 compared to 2005 resulted primarily from the increase in the volume and interest rates of our earning assets, although most of the benefit to our net interest income from rates on our earning assets was offset by similar increases in our rates paid on our deposits and short-term borrowings. Average earning assets were \$2.624 billion in 2007, as compared to \$2.483 billion in 2006 and \$2.229 billion in 2005. The 2007 increase in average earning assets was attributable primarily to internally generated loan growth. The 2006 increase in average earning assets is primarily attributable to loan growth and our acquisitions. Table 1 allocates the change in tax-equivalent net interest income between the amount of change attributable to volume and to rate.

**Table 1 Changes in Interest Income and Interest Expense (in thousands):**

|                                     | 2007 Compared to 2006 |         |              | 2006 Compared to 2005 |         |              |
|-------------------------------------|-----------------------|---------|--------------|-----------------------|---------|--------------|
|                                     | Change Attributable   |         | Total Change | Change Attributable   |         | Total Change |
|                                     | to Volume             | to Rate |              | to Volume             | to Rate |              |
| Short-term investments              | \$ 568                | \$ 213  | \$ 781       | \$ 96                 | \$ 925  | \$ 1,021     |
| Taxable investment securities       | (1,904)               | 1,487   | (417)        | 5,536                 | 2,913   | 8,449        |
| Tax-exempt investment securities(1) | 3,228                 | (603)   | 2,625        | 1,220                 | (646)   | 574          |

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|                           |          |            |          |          |          |           |
|---------------------------|----------|------------|----------|----------|----------|-----------|
| Loans(1)                  | 9,345    | 3,152      | 12,497   | 6,717    | 13,652   | 20,369    |
| Interest income           | 11,237   | 4,249      | 15,486   | 13,569   | 16,844   | 30,413    |
| Interest-bearing deposits | 863      | 8,145      | 9,008    | 2,379    | 13,701   | 16,080    |
| Short-term borrowings     | 2,181    | (1,260)    | 921      | 2,001    | 1,790    | 3,791     |
| Interest expense          | 3,044    | 6,885      | 9,929    | 4,380    | 15,491   | 19,871    |
| Net interest income       | \$ 8,193 | \$ (2,636) | \$ 5,557 | \$ 9,189 | \$ 1,353 | \$ 10,542 |

(1) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.

The net interest margin, which measures tax-equivalent net interest income as a percentage of average earning assets, is illustrated in Table 2 for the years 2005 through 2007. The net interest margin in 2007 was 4.43% a decrease of 3 basis points from 2006 and 6 basis points from 2005. The prime rate increased from 5.25% at January 1, 2005 to 8.25% at December 31, 2006 and decreased to 7.25% at December 31, 2007 and stood at 6.00% at February 18, 2008. Should interest rates continue to decline in 2008, we anticipate that the impact of lower yields on investment securities and competition for deposits will continue to put pressure on our net interest margin.

**Table 2 Average Balances and Average Yields and Rates (in thousands, except percentages):**

|  | 2007            |                |            | 2006            |                |            | 2005            |                |
|--|-----------------|----------------|------------|-----------------|----------------|------------|-----------------|----------------|
|  | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense |
| Investment securities                      | \$ 76,284       | \$ 3,762       | 4.93%      | \$ 64,056       | \$ 2,981       | 4.65%      | \$ 61,059       | \$ 1,960       |
| Investment securities                      | 832,807         | 38,881         | 4.67       | 875,247         | 39,298         | 4.49       | 742,092         | 30,849         |
| Investment securities                      | 287,468         | 17,279         | 6.01       | 235,569         | 14,653         | 6.22       | 216,787         | 14,079         |
| Investment securities                      | 1,427,922       | 114,714        | 8.03       | 1,308,309       | 102,218        | 7.81       | 1,209,095       | 81,849         |
| Earning assets                             | 2,624,481       | 174,636        | 6.66       | 2,483,181       | 159,150        | 6.41       | 2,229,033       | 128,737        |
| Due from banks                             | 107,280         |                |            | 107,134         |                |            | 100,718         |                |
| Loans                                      | 61,036          |                |            | 60,827          |                |            | 55,228          |                |
| Investment securities                      | 34,075          |                |            | 35,283          |                |            | 26,155          |                |
| Loans, net                                 | 65,942          |                |            | 67,555          |                |            | 53,148          |                |
| Provision for loan losses                  | (16,621)        |                |            | (15,666)        |                |            | (14,437)        |                |
| Earning assets                             | \$ 2,876,193    |                |            | \$ 2,738,314    |                |            | \$ 2,449,845    |                |
| <b>Liabilities and Shareholders Equity</b> |                 |                |            |                 |                |            |                 |                |
| Interest-bearing deposits                  | \$ 1,736,227    | \$ 51,980      | 2.99%      | \$ 1,702,051    | \$ 42,972      | 2.52%      | \$ 1,563,709    | \$ 26,892      |
| Interest-bearing borrowings                | 161,648         | 6,577          | 4.07       | 120,566         | 5,656          | 4.69       | 58,162          | 1,865          |
| Interest-bearing                           | 1,897,875       | 58,557         | 3.09       | 1,822,617       | 48,628         | 2.67       | 1,621,871       | 28,757         |
| Interest-bearing deposits                  | 649,642         |                |            | 611,023         |                |            | 537,228         |                |
| Liabilities                                | 16,878          |                |            | 20,557          |                |            | 18,448          |                |
| Liabilities                                | 2,564,395       |                |            | 2,454,197       |                |            | 2,177,547       |                |
| Shareholders equity                        | 311,798         |                |            | 284,117         |                |            | 272,298         |                |
| Liabilities and Shareholders equity        | \$ 2,876,193    |                |            | \$ 2,738,314    |                |            | \$ 2,449,845    |                |

|                   |            |            |           |
|-------------------|------------|------------|-----------|
| est income        | \$ 116,079 | \$ 110,522 | \$ 99,980 |
| lysis:            |            |            |           |
| ncome/earning     | 6.66%      | 6.41%      |           |
| xpense/earning    | 2.23       | 1.95       |           |
| on earning assets | 4.43%      | 4.46%      |           |

(1) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.

(2) Nonaccrual loans are included in loans.



*Noninterest Income.* Noninterest income for 2007 was \$48.3 million, an increase of \$3.6 million, or 8.1%, as compared to 2006. The increase is primarily attributable to (1) an increase of \$1.3 million in ATM and credit card fees primarily as a result of increased use of debit cards, (2) an increase of \$1.1 million in trust fees, (3) an increase in mortgage loan fees of \$808 thousand, and (4) an increase in service charges on deposit accounts of \$470 thousand. The fair value of our trust assets totaled \$1.803 billion at December 31, 2007 compared to \$1.693 billion at December 31, 2006. These increases were partially offset by a decrease of \$228 thousand in the gain on the sale of student loans. In 2007, we sold student loans totaling \$64 million compared to \$72 million in 2006.

Noninterest income for 2006 was \$44.7 million, an increase of \$488 thousand, or 1.10%, as compared to 2005. The increase is primarily attributable to (1) an increase in service charges on deposits of \$1.1 million as a result of an increase in net new accounts and from our acquisitions, (2) an increase of \$1.3 million in ATM and credit card fees primarily as a result of increased use of debit cards, (3) an increase of \$597 thousand in trust fees, (4) an increase in mortgage loan fees of \$458 thousand and (5) an increase in the gain on sale of student loans of \$339 thousand. The fair value of our trust assets totaled \$1.693 billion at December 31, 2006 compared to \$1.438 billion at December 31, 2005. In 2006, we sold student loans totaling \$72 million compared to \$61 million in 2005. These increases were partially offset by (1) the effect of the prior year \$3.9 million gain on the sale of PULSE ownership rights and (2) a decrease of \$173 thousand in net gains on securities transactions. Excluding the PULSE gain, our 2006 noninterest income would have increased 10.9% over 2005.

Table 3 provides comparisons for other categories of noninterest income.

**Table 3 Noninterest Income (in thousands):**

|  | 2007      | Increase<br>(Decrease) | 2006      | Increase<br>(Decrease) | 2005      |
|--|-----------|------------------------|-----------|------------------------|-----------|
| Trust fees                                   | \$ 8,747  | \$ 1,082               | \$ 7,665  | \$ 597                 | \$ 7,068  |
| Service charges on deposit accounts          | 22,920    | 470                    | 22,450    | 1,069                  | 21,381    |
| Real estate mortgage fees                    | 3,347     | 808                    | 2,539     | 458                    | 2,081     |
| Gain on sale of student loans                | 1,913     | (228)                  | 2,141     | 339                    | 1,802     |
| ATM and credit card fees                     | 7,521     | 1,307                  | 6,214     | 1,253                  | 4,961     |
| Net gain on securities transactions          | 150       | 88                     | 62        | (173)                  | 235       |
| Gain on sale of PULSE ownership rights       |           |                        |           | (3,895)                | 3,895     |
| Other:                                       |           |                        |           |                        |           |
| Net gain (loss) on sale of other real estate | 108       | 118                    | (10)      | (70)                   | 60        |
| Check printing fees                          | 595       | (74)                   | 669       | 15                     | 654       |
| Safe deposit rental fees                     | 449       | 5                      | 444       | 25                     | 419       |
| Exchange fees                                | 165       | (24)                   | 189       | (25)                   | 214       |
| Credit life and debt protection fees         | 263       | 44                     | 219       | 135                    | 84        |
| Data processing fees                         | 109       | (30)                   | 139       | (53)                   | 192       |
| Brokerage commissions                        | 192       | (2)                    | 194       | (33)                   | 227       |
| Interest on loan recoveries                  | 284       | (18)                   | 302       | 67                     | 235       |
| Miscellaneous income                         | 1,510     | 59                     | 1,451     | 779                    | 672       |
| Total other                                  | 3,675     | 78                     | 3,597     | 840                    | 2,757     |
| Total Noninterest Income                     | \$ 48,273 | \$ 3,605               | \$ 44,668 | \$ 488                 | \$ 44,180 |

*Noninterest Expense.* Total noninterest expense for 2007 was \$86.8 million, an increase of \$3.8 million, or 4.6%, as compared to 2006. Noninterest expense for 2006 amounted to \$83.0 million, an increase of \$7.5 million or 10.0% as compared to 2005. An important measure in determining whether a banking company effectively manages noninterest expenses is the efficiency ratio, which is calculated by dividing noninterest expense by the sum of net interest income on a tax-equivalent basis and noninterest income. Lower ratios indicate better efficiency since more income is generated with a lower noninterest expense total. Our efficiency ratio for 2007 was 52.83% compared to 53.49% for 2006, and 52.48% for 2005.

Salaries and employee benefits for 2007 totaled \$46.9 million, an increase of \$2.8 million, or 6.3%, as compared to 2006. The primary causes of this increase were higher levels of contributions to the Company's profit sharing plan and overall pay increases effective during the first quarter of 2007. Also included in salaries and benefits for 2007 and 2006 was stock option expense of \$220 thousand and \$157 thousand, respectively, as result of applying the provisions of SFAS No. 123R.

All other categories of non-interest expense for 2007 totaled \$39.9 million, an increase of \$1.0 million, or 2.7%, as compared to 2006. ATM expenses increased \$465 thousand reflecting increased debit card use by our customers, as seen in the increase in the related income above. Legal fees increased \$232 thousand. Operational and other losses were \$220 thousand more in 2007 than in 2006. These losses come from increased charge-offs relating to demand accounts and other losses attributable to fraud. Partially offsetting the increase in noninterest expense were decreases in correspondent bank service charges as a result of maintaining higher compensating balances and in courier expense from the increased use of imaged check clearing and remote deposit capture.

Salaries and employee benefits for 2006 totaled \$44.2 million, an increase of \$3.9 million, or 9.6%, as compared to 2005. The primary causes of this increase were a higher number of full time equivalents from our Bridgeport acquisition and our new branches and overall pay increases effective during the first quarter of 2006. Also included in salaries and benefits for 2006 was stock option expense of \$157 thousand as result applying the new provisions of SFAS No. 123R.

Net occupancy expense for 2006 was up \$943 thousand from the prior year, largely as a result of facilities obtained through our acquisition, the opening of new branches and increased utility costs. Equipment expense was up \$848 thousand in 2006 over 2005 due to increased equipment depreciation expense as a result of our continued investment in our technology infrastructure, our acquisition and new branches. Intangible asset amortization resulting from the core deposit intangibles related to our acquisitions increased \$811 thousand. Our ATM expenses were \$559 thousand more in 2006 than in 2005, primarily due to increased debit card usage by our customers, as seen in the increase in related income above. Operational and other losses were \$314 thousand more in 2006 than in 2005. These losses come from increased charged-offs relating to demand accounts and other losses attributable to fraud. Offsetting the increase in noninterest expense were declines in advertising, audit and accounting and professional and service fees.

**Table 4 Noninterest Expense (in thousands):**

|   | 2007      | Increase<br>(Decrease) | 2006      | Increase<br>(Decrease) | 2005      |
|---|-----------|------------------------|-----------|------------------------|-----------|
| Salaries                                  | \$ 36,644 | \$ 1,427               | \$ 35,217 | \$ 2,829               | \$ 32,388 |
| Medical                                   | 2,730     | 85                     | 2,645     | 161                    | 2,484     |
| Profit sharing                            | 3,220     | 1,104                  | 2,116     | 44                     | 2,072     |
| Pension                                   | 310       | (27)                   | 337       | 325                    | 12        |
| 401(k) match expense                      | 1,127     | 86                     | 1,041     | 173                    | 868       |
| Payroll taxes                             | 2,693     | 26                     | 2,667     | 174                    | 2,493     |
| Stock option expense                      | 220       | 63                     | 157       | 157                    |           |
| Total salaries and employee benefits      | 46,944    | 2,764                  | 44,180    | 3,863                  | 40,317    |
| Net occupancy expense                     | 5,893     | (93)                   | 5,986     | 943                    | 5,043     |
| Equipment expense                         | 7,220     | 181                    | 7,039     | 848                    | 6,191     |
| Intangible amortization                   | 1,495     | 4                      | 1,491     | 811                    | 680       |
| Other:                                    |           |                        |           |                        |           |
| Data processing fees                      | 391       | 41                     | 350       | 12                     | 338       |
| Postage                                   | 1,415     | (4)                    | 1,419     | 176                    | 1,243     |
| Printing, stationery and supplies         | 2,004     | (63)                   | 2,067     | 79                     | 1,988     |
| Advertising                               | 1,179     | (45)                   | 1,224     | (229)                  | 1,453     |
| Correspondent bank service charges        | 1,153     | (200)                  | 1,353     | (85)                   | 1,438     |
| ATM expense                               | 3,335     | 465                    | 2,870     | 559                    | 2,311     |
| Credit card fees                          | 536       | 8                      | 528       | (69)                   | 597       |
| Telephone                                 | 1,257     | (45)                   | 1,302     | 79                     | 1,223     |
| Public relations and business development | 1,309     | 61                     | 1,248     | 143                    | 1,105     |
| Directors fees                            | 650       | 18                     | 632       | (13)                   | 645       |
| Audit and accounting fees                 | 1,175     | 72                     | 1,103     | (231)                  | 1,334     |
| Legal fees                                | 559       | 232                    | 327       | (84)                   | 411       |
| Professional and service fees             | 1,980     | 164                    | 1,816     | (240)                  | 2,056     |
| Regulatory exam fees                      | 785       | 38                     | 747       | 75                     | 672       |
| Travel                                    | 588       | 64                     | 524       | 46                     | 478       |
| Courier expense                           | 760       | (203)                  | 963       | 164                    | 799       |
| Operational and other losses              | 1,861     | 220                    | 1,641     | 314                    | 1,327     |
| Other miscellaneous expense               | 4,338     | 131                    | 4,207     | 369                    | 3,838     |
| Total other                               | 25,275    | 954                    | 24,321    | 1,065                  | 23,256    |
| Total Noninterest Expense                 | \$ 86,827 | \$ 3,810               | \$ 83,017 | \$ 7,530               | \$ 75,487 |

*Income Taxes.* Income tax expense was \$20.4 million for 2007 as compared to \$19.4 million for 2006 and \$18.5 million for 2005. Our effective tax rates on pretax income were 29.2%, 29.7% and 29.6%, respectively, for the years 2007, 2006 and 2005. The effective tax rates differ from the statutory federal tax rate of 35% largely due to tax exempt interest income earned on certain investment securities and loans, the deductibility of dividends paid to our employee stock ownership plan and Texas state taxes.

**Balance Sheet Review**

*Loans.* Our portfolio is comprised of loans made to businesses, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary banks. Real estate loans represent loans primarily for new home construction and owner-occupied real estate. The structure of loans in the real estate mortgage

classification generally provides repricing intervals to minimize the interest rate risk inherent in long-term fixed rate mortgage loans. As of December 31, 2007, total loans were \$1,528.0 million, an increase of \$154.3 million, as compared to December 31, 2006. As compared to year-end 2006, real estate loans increased \$75.2 million, commercial, financial and agricultural loans increased \$63.2 million, and consumer loans increased \$15.9 million. Loans averaged \$1,427.9 million during 2007, an increase of \$119.6 million over the prior year average balances.

**Table 5 Composition of Loans (in thousands):**

|  | 2007         | 2006         | December 31,<br>2005 | 2004         | 2003       |
|--|--------------|--------------|----------------------|--------------|------------|
| Commercial, financial and agricultural | \$ 493,478   | \$ 430,286   | \$ 410,191           | \$ 385,193   | \$ 333,840 |
| Real estate construction               | 196,250      | 155,285      | 112,892              | 107,148      | 77,834     |
| Real estate mortgage                   | 626,146      | 591,893      | 568,793              | 494,524      | 385,770    |
| Consumer, net of unearned income       | 212,146      | 196,271      | 196,728              | 177,358      | 190,079    |
|  | \$ 1,528,020 | \$ 1,373,735 | \$ 1,288,604         | \$ 1,164,223 | \$ 987,523 |

**Table 6 Maturity Distribution and Interest Sensitivity of Loans at December 31, 2007 (in thousands):**

The following tables summarize maturity and yield information for the commercial, financial, and agricultural and the real estate-construction portion of our loan portfolio as of December 31, 2007:

|   | One Year<br>or Less | After One<br>Year<br>Through<br>Five Years | After Five<br>Years | Total      |
|---|---------------------|--|---------------------|------------|
| Commercial, financial, and agricultural | \$ 277,768          | \$ 160,106                                 | \$ 55,604           | \$ 493,478 |
| Real estate construction                | 121,102             | 47,574                                     | 27,574              | 196,250    |
|   | \$ 398,870          | \$ 207,680                                 | \$ 83,178           | \$ 689,728 |

|  | Maturities<br>After One Year |
|--|------------------------------|
| Loans with fixed interest rates                  | \$ 176,507                   |
| Loans with floating or adjustable interest rates | 114,351                      |
|  | \$ 290,858                   |

*Asset Quality.* Loan portfolios of each of our subsidiary banks are subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by state and federal bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectibility of principal or interest under the original terms becomes doubtful. Nonperforming assets, which consist of nonperforming loans and foreclosed assets, were \$4.7 million at December 31, 2007, as compared to \$4.1 million at December 31, 2006 and \$4.2 million at December 31, 2005. As a percent of loans and foreclosed assets, nonperforming assets were 0.31% at December 31, 2007, as compared to 0.30% at December 31, 2006 and 0.33% at December 31, 2005. We consider the level of nonperforming assets to be manageable and are not aware of any material classified credit not properly disclosed as nonperforming at December 31, 2007.

**Table 7 Nonperforming Assets (in thousands, except percentages):**

|   | At December 31, |          |          |          |          |
|---|-----------------|----------|----------|----------|----------|
|   | 2007            | 2006     | 2005     | 2004     | 2003     |
| Nonaccrual loans                                  | \$ 3,189        | \$ 3,529 | \$ 3,524 | \$ 4,142 | \$ 1,690 |
| Loans still accruing and past due 90 days or more | 36              | 129      | 15       | 120      | 61       |
| Restructured loans                                |                 |          |          |          |          |
| Nonperforming loans                               | 3,225           | 3,658    | 3,539    | 4,262    | 1,751    |
| Foreclosed assets                                 | 1,506           | 453      | 705      | 779      | 1,420    |
| Total nonperforming assets                        | \$ 4,731        | \$ 4,111 | \$ 4,244 | \$ 5,041 | \$ 3,171 |
| As a% of loans and foreclosed assets              | 0.31%           | 0.30%    | 0.33%    | 0.43%    | 0.32%    |

We record interest payments received on impaired loans as interest income unless collections of the remaining recorded investment are placed on nonaccrual, at which time we record payments received as reductions of principal. We recognized interest income on impaired loans of approximately \$100,000, \$91,000 and \$62,000 during the years ended December 31, 2007, 2006, and 2005, respectively. If interest on impaired loans had been recognized on a full accrual basis during the years ended December 31, 2007, 2006, and 2005, respectively, such income would have approximated \$358,000, \$396,000 and \$163,000.

*Provision and Allowance for Loan Losses.* The allowance for loan losses is the amount we determine as of a specific date to be adequate to provide for losses on loans that we deem are uncollectible. We determine the allowance and the required provision expense by reviewing general loss experience and the performance of specific credits. The provision for loan losses was \$2.3 million for 2007 as compared to \$2.1 million for 2006 and \$1.3 million for 2005. The provision in 2007 was due to growth in the loan portfolio and a slowing national economy. The increase in 2006 compared with 2005 was due to several factors, including overall loan growth, an increase in internally classified loans and concerns about the slowing national real estate market. As a percent of average loans, net loan charge-offs were 0.07% during 2007, 0.04% during 2006 and 0.10% during 2005. The allowance for loan losses as a percent of loans was 1.14% as of December 31, 2007, as compared to 1.18% as of December 31, 2006. A key indicator of the adequacy of the allowance for loan losses is the ratio of the allowance to nonperforming loans, which consist of nonaccrual loans, loans past due 90 days, and restructured loans. This ratio for the past five years is disclosed in Table 8. Table 9 provides an allocation of the allowance for loan losses based on loan type and the percent of total loans that each major loan type represents.

Although we believe we use the best information available to make loan loss allowance determinations, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making our initial determinations. A downturn in the economy and employment could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review our allowance for loan losses. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.



**Table 8 Loan Loss Experience and Allowance for Loan Losses (in thousands, except percentages):**

|  | 2007         | 2006         | 2005         | 2004         | 2003       |
|--|--------------|--------------|--------------|--------------|------------|
| Balance at January 1,                            | \$ 16,201    | \$ 14,719    | \$ 13,837    | \$ 11,576    | \$ 11,219  |
| Allowance established from purchase acquisitions |              |              | 793          | 1,858        |            |
|  | 16,201       | 14,719       | 14,630       | 13,434       | 11,219     |
| Charge-offs:                                     |              |              |              |              |            |
| Commercial, financial and agricultural           | 1,056        | 956          | 867          | 873          | 990        |
| Consumer   | 742          | 865          | 1,088        | 1,075        | 1,186      |
| All other  |              |              | 2            | 41           | 1          |
| Total charge-offs                                | 1,798        | 1,821        | 1,957        | 1,989        | 2,177      |
| Recoveries:                                      |              |              |              |              |            |
| Commercial, financial and agricultural           | 346          | 747          | 213          | 342          | 867        |
| Consumer   | 376          | 487          | 507          | 402          | 482        |
| All other  | 6            | 8            | 6            | 15           | 7          |
| Total recoveries                                 | 728          | 1,242        | 726          | 759          | 1,356      |
| Net charge-offs                                  | 1,070        | 579          | 1,231        | 1,230        | 821        |
| Provision for loan losses                        | 2,331        | 2,061        | 1,320        | 1,633        | 1,178      |
| Balance at December 31,                          | \$ 17,462    | \$ 16,201    | \$ 14,719    | \$ 13,837    | \$ 11,576  |
| Loans at year-end                                | \$ 1,528,020 | \$ 1,373,735 | \$ 1,288,604 | \$ 1,164,223 | \$ 987,523 |
| Average loans                                    | 1,427,922    | 1,308,309    | 1,209,095    | 1,044,010    | 946,173    |
| Net charge-offs/average loans                    | 0.07%        | 0.04%        | 0.10%        | 0.12%        | 0.09%      |
| Allowance for loan losses/year-end loans         | 1.14         | 1.18         | 1.14         | 1.19         | 1.17       |
| Allowance for loan losses/nonperforming loans    | 541.49       | 442.94       | 415.91       | 324.67       | 661.10     |

**Table 9 Allocation of Allowance for Loan Losses (in thousands):**

|  | 2007<br>Allocation<br>Amount | 2006<br>Allocation<br>Amount | 2005<br>Allocation<br>Amount | 2004<br>Allocation<br>Amount | 2003<br>Allocation<br>Amount |
|--|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| Commercial, financial and agricultural | \$ 7,786                     | \$ 7,808                     | \$ 5,962                     | \$ 6,293                     | \$ 5,293                     |
| Real estate construction               | 1,887                        | 1,357                        | 855                          | 922                          | 669                          |
| Real estate mortgage                   | 6,117                        | 5,483                        | 6,572                        | 4,636                        | 3,754                        |
| Consumer                               | 1,672                        | 1,553                        | 1,330                        | 1,986                        | 1,860                        |

|       |           |           |           |           |           |
|-------|-----------|-----------|-----------|-----------|-----------|
| Total | \$ 17,462 | \$ 16,201 | \$ 14,719 | \$ 13,837 | \$ 11,576 |
|-------|-----------|-----------|-----------|-----------|-----------|

**Percent of Total Loans:**

|  | 2007   | 2006   | 2005   | 2004   | 2003   |
|--|--------|--------|--------|--------|--------|
| Commercial, financial and agricultural | 32.30% | 31.32% | 31.83% | 33.09% | 33.81% |
| Real estate construction               | 12.84  | 11.30  | 8.76   | 9.20   | 7.88   |
| Real estate mortgage                   | 40.98  | 43.09  | 44.14  | 42.48  | 39.06  |
| Consumer, net of unearned income       | 13.88  | 14.29  | 15.27  | 15.23  | 19.25  |

Certain loans classified for regulatory purposes as doubtful and substandard are included in the nonperforming asset table. Also included in classified loans are certain other loans that are deemed to be potential problems. Potential problem loans are those loans that are currently performing but for which known information about trends

or uncertainties or possible credit problems of the borrowers causes management to have serious doubts as to the ability of such borrowers to comply with present repayment terms, possibly resulting in the transfer of such loans to nonperforming status. These potential problem loans totaled \$13.8 million as of December 31, 2007.

*Investment Securities.* Investment securities totaled \$1.128 billion as of December 31, 2007, as compared to \$1.129 billion at December 31, 2006 and \$1.046 billion at December 31, 2005. At December 31, 2007, securities with an amortized cost of \$26.4 million were classified as securities held-to-maturity and securities with a market value of \$1.102 billion were classified as securities available-for-sale. As compared to December 31, 2006, the overall portfolio at December 31, 2007, reflected (1) a decrease of \$85.5 million in U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies; (2) an increase of \$43.8 million in obligations of states and political subdivisions; (3) an \$18.1 million decrease in corporate bonds and other securities; and (4) a \$59.0 million increase in mortgage-backed securities. As compared to December 31, 2005, the portfolio at December 31, 2006 reflected (1) an increase of \$8.6 million in U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies; (2) an increase of \$40.0 million in obligations of states and political subdivisions; (3) an increase of \$20.6 million in corporate bonds and other securities; and (4) an increase of \$14.0 million in mortgage-backed securities. The overall portfolio yield of 5.13% at the end of 2007 was 22 basis points higher than the prior year-end yield of 4.91% largely as a result of reinvesting the proceeds from securities that matured in 2007 in higher yielding investments. We did not hold any high risk collateralized mortgage obligations or structured notes as of December 31, 2007. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

See Note 2 to the Consolidated Financial Statements for additional disclosures relating to the maturities and fair values of the investment portfolio at December 31, 2007 and 2006.

**Table 10 Composition of Investment Securities (dollars in thousands):**

|  | 2007              |            | At December 31,<br>2006 |            | 2005              |            |
|--|-------------------|------------|-------------------------|------------|-------------------|------------|
|  | Amortized<br>Cost | Fair Value | Amortized<br>Cost       | Fair Value | Amortized<br>Cost | Fair Value |
| <b>Held-to-Maturity:</b>   |                   |            |                         |            |                   |            |
| U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$                | \$         | \$                      | \$         | \$ 21,749         | \$ 21,814  |
| Obligations of states and political subdivisions   | 25,042            | 25,860     | 25,007                  | 25,881     | 27,991            | 29,175     |
| Corporate bonds  |                   |            |                         |            | 503               | 507        |
| Mortgage-backed securities   | 1,373             | 1,389      | 1,975                   | 1,992      | 2,919             | 2,981      |
| Other securities   | 4                 | 4          | 4                       | 4          |                   |            |
|  | \$ 26,419         | \$ 27,253  | \$ 26,986               | \$ 27,877  | \$ 53,162         | \$ 54,477  |
| <b>Available-for-Sale:</b>   |                   |            |                         |            |                   |            |
| U.S. Treasury securities and obligations of U.S.   | \$ 314,894        | \$ 318,381 | \$ 407,795              | \$ 403,855 | \$ 379,440        | \$ 373,529 |

|   |              |              |              |              |              |              |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| government<br>sponsored-enterprises and<br>agencies |              |              |              |              |              |              |
| Obligations of states and<br>political subdivisions | 286,293      | 290,714      | 242,748      | 246,958      | 200,997      | 203,997      |
| Corporate bonds                                     | 45,345       | 45,683       | 69,341       | 69,363       | 53,774       | 53,521       |
| Mortgage-backed securities                          | 427,504      | 429,596      | 375,794      | 370,013      | 361,269      | 355,072      |
| Other securities                                    | 17,588       | 17,700       | 12,092       | 12,138       | 6,840        | 6,840        |
|   | \$ 1,091,624 | \$ 1,102,074 | \$ 1,107,770 | \$ 1,102,327 | \$ 1,002,320 | \$ 992,959   |
|   | \$ 1,118,043 | \$ 1,129,327 | \$ 1,134,756 | \$ 1,130,204 | \$ 1,055,482 | \$ 1,047,436 |

**Table 11 Maturities and Yields of Investment Securities Held at December 31, 2007 (in thousands, except percentages):**

| Maturity:  | One Year or Less |       | After One Year Through Five Years |       | Maturing After Five Years Through Ten Years |       | After Ten Years |       | Total     |       |
|--|------------------|-------|-----------------------------------|-------|---|-------|-----------------|-------|-----------|-------|
|  | Amount           | Yield | Amount                            | Yield | Amount                                      | Yield | Amount          | Yield | Amount    | Yield |
| Obligations of states and political subdivisions | \$ 1,966         | 6.04% | \$ 22,131                         | 7.38% | \$ 615                                      | 7.54% | \$ 330          | 6.51% | \$ 25,042 | 7.27% |
| Other securities                                 |                  |       |                                   |       |   |       | 4               | 0.00% | 4         | 0.00% |
| Mortgage-backed securities                       | 338              | 6.74% | 839                               | 6.17% | 196   | 5.63% |                 |       | 1,373     | 6.23% |
| Total  | \$ 2,304         | 6.14% | \$ 22,970                         | 7.34% | \$ 811                                      | 7.08% | \$ 334          | 6.43% | \$ 26,419 | 7.21% |

| Maturity:  | One Year or Less |       | After One Year Through Five Years |       | Maturing After Five Years Through Ten Years |       | After Ten Years |       | Total        |       |
|--|------------------|-------|-----------------------------------|-------|---|-------|-----------------|-------|--------------|-------|
|  | Amount           | Yield | Amount                            | Yield | Amount                                      | Yield | Amount          | Yield | Amount       | Yield |
| Treasury obligations of U.S. government          | \$ 1,015         | 3.29% | \$                                |       | \$  |       | \$              |       | \$ 1,015     |       |
| Corporate bonds and other securities             | 144,844          | 3.88% | 169,462                           | 4.73% | 3,060                                       | 4.13% |                 |       | 317,366      |       |
| Obligations of states and political subdivisions | 15,303           | 6.22% | 72,052                            | 6.83% | 135,281                                     | 5.86% | 68,078          | 5.74% | 290,714      |       |
| Mortgage-backed securities                       | 12,225           | 4.47% | 43,581                            | 5.10% |   |       | 7,577           | 5.93% | 63,383       |       |
| Other securities                                 | 14,722           | 4.59% | 363,033                           | 4.92% | 51,833                                      | 5.28% | 8               | 6.27% | 429,596      |       |
| Total  | \$ 188,109       | 4.16% | \$ 648,128                        | 5.07% | \$ 190,174                                  | 5.67% | \$ 75,663       | 5.76% | \$ 1,102,074 |       |

| Investment Securities:               | One Year or Less |       | After One Year Through Five Years |       | Maturing After Five Years Through Ten Years |       | After Ten Years |       | Total    |       |
|--------------------------------------|------------------|-------|-----------------------------------|-------|---|-------|-----------------|-------|----------|-------|
|                                      | Amount           | Yield | Amount                            | Yield | Amount                                      | Yield | Amount          | Yield | Amount   | Yield |
| Treasury obligations                 | \$ 1,015         | 3.29% | \$                                |       | \$  |       | \$              |       | \$ 1,015 |       |
| Corporate bonds and other securities | 144,844          | 3.88% | 169,462                           | 4.73% | 3,060                                       | 4.13% |                 |       | 317,366  |       |

|                            |            |       |            |       |            |       |           |       |              |
|----------------------------|------------|-------|------------|-------|------------|-------|-----------|-------|--------------|
| of U.S.                    |            |       |            |       |            |       |           |       |              |
| t                          |            |       |            |       |            |       |           |       |              |
| enterprises and            |            |       |            |       |            |       |           |       |              |
| of states and              |            |       |            |       |            |       |           |       |              |
| divisions                  | 17,269     | 6.20% | 94,183     | 6.96% | 135,896    | 5.87% | 68,408    | 5.74% | 315,756      |
| bonds and other            | 12,225     | 4.47% | 43,581     | 5.10% |            |       | 7,581     | 5.93% | 63,387       |
| mortgage-backed securities | 15,060     | 4.64% | 363,872    | 4.93% | 52,029     | 5.28% | 8         | 6.27% | 430,969      |
|                            | \$ 190,413 | 4.19% | \$ 671,098 | 5.15% | \$ 190,985 | 5.68% | \$ 75,997 | 5.76% | \$ 1,128,493 |

All yields are computed on a tax-equivalent basis assuming a marginal tax rate of 35%. Yields on available-for-sale securities are based on amortized cost. Maturities of mortgage-backed securities are based on contractual maturities and could differ due to prepayments of underlying mortgages.

**Table 12 Disclosure of Investment Securities with Continuous Unrealized Loss**

The following table discloses, as of December 31, 2007 and 2006, our investment securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

|   | Less than 12 Months<br>Unrealized |               | 12 Months or Longer<br>Unrealized |                 | Total<br>Unrealized |                 |
|---|-----------------------------------|---------------|-----------------------------------|-----------------|---------------------|-----------------|
|   | Fair<br>Value                     | Loss          | Fair<br>Value                     | Loss            | Fair<br>Value       | Loss            |
| <b>December 31, 2007</b>  |                                   |               |                                   |                 |                     |                 |
| U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 8,978                          | \$ 28         | \$ 93,466                         | \$ 290          | \$ 102,444          | \$ 318          |
| Obligations of state and political subdivisions   | 40,622                            | 353           | 26,521                            | 412             | 67,143              | 765             |
| Mortgage-backed securities  | 55,676                            | 80            | 115,141                           | 1,600           | 170,817             | 1,680           |
| Corporate and other securities  | 7,021                             | 60            | 5,231                             | 19              | 12,252              | 79              |
| <b>Total</b>  | <b>\$ 112,297</b>                 | <b>\$ 521</b> | <b>\$ 240,359</b>                 | <b>\$ 2,321</b> | <b>\$ 352,656</b>   | <b>\$ 2,842</b> |

|   | Less than 12 Months<br>Unrealized |               | 12 Months or Longer<br>Unrealized |                  | Total<br>Unrealized |                  |
|---|-----------------------------------|---------------|-----------------------------------|------------------|---------------------|------------------|
|   | Fair<br>Value                     | Loss          | Fair<br>Value                     | Loss             | Fair<br>Value       | Loss             |
| <b>December 31, 2006</b>  |                                   |               |                                   |                  |                     |                  |
| U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 115,335                        | \$ 163        | \$ 250,271                        | \$ 3,880         | \$ 365,606          | \$ 4,043         |
| Obligations of state and political subdivisions   | 24,557                            | 78            | 30,860                            | 581              | 55,417              | 659              |
| Mortgage-backed securities  | 57,382                            | 302           | 255,592                           | 6,032            | 312,974             | 6,334            |
| Corporate and other securities  | 13,845                            | 32            | 23,585                            | 200              | 37,430              | 232              |
| <b>Total</b>  | <b>\$ 211,119</b>                 | <b>\$ 575</b> | <b>\$ 560,308</b>                 | <b>\$ 10,693</b> | <b>\$ 771,427</b>   | <b>\$ 11,268</b> |

The number of investment positions in this unrealized loss position totaled 425 at December 31, 2007. We do not believe these unrealized losses are other than temporary as (1) we have the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value and, (2) it is not probable that we will be unable to collect the amounts contractually due. The unrealized losses noted are interest rate related due to the level of short-term and intermediate interest rates at December 31, 2007. We have reviewed the financial condition and near term prospects of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities.

*Deposits.* Deposits held by subsidiary banks represent our primary source of funding. Total deposits were \$2.546 billion as of December 31, 2007, as compared to \$2.384 billion as of December 31, 2006 and \$2.366 billion as of December 31, 2005. Table 13 provides a breakdown of average deposits and rates paid over the past three years and the remaining maturity of time deposits of \$100,000 or more.



**Table 13 Composition of Average Deposits and Remaining Maturity of Time Deposits of \$100,000 or More (in thousands, except percentages):**

|                                       | 2007               |                 | 2006               |                 | 2005               |                 |
|---------------------------------------|--------------------|-----------------|--------------------|-----------------|--------------------|-----------------|
|                                       | Average<br>Balance | Average<br>Rate | Average<br>Balance | Average<br>Rate | Average<br>Balance | Average<br>Rate |
| Noninterest-bearing deposits          | \$ 649,642         |                 | \$ 611,023         |                 | \$ 537,228         |                 |
| Interest-bearing deposits             |                    |                 |                    |                 |                    |                 |
| Interest-bearing checking             | 571,523            | 1.84%           | 563,573            | 1.62%           | 497,743            | 1.10%           |
| Savings and money market<br>accounts  | 361,778            | 1.48            | 384,102            | 1.29            | 414,307            | 1.03            |
| Time deposits under \$100,000         | 431,955            | 4.34            | 414,511            | 3.67            | 363,384            | 2.75            |
| Time deposits of \$100,000 or<br>more | 370,971            | 4.68            | 339,865            | 4.01            | 288,275            | 2.53            |
| Total interest-bearing deposits       | 1,736,227          | 2.99%           | 1,702,051          | 2.52%           | 1,563,709          | 1.72%           |
| Total average deposits                | \$ 2,385,869       |                 | \$ 2,313,074       |                 | \$ 2,100,937       |                 |

**December 31, 2007**

|  |            |
|--|------------|
| Three months or less                     | \$ 150,683 |
| Over three through six months            | 77,332     |
| Over six through twelve months           | 90,041     |
| Over twelve months                       | 34,160     |
| Total time deposits of \$100,000 or more | \$ 352,216 |

*Short-Term Borrowings.* Included in short-term borrowings were federal funds purchased and securities sold under repurchase agreements of \$166 million, \$143 million and \$74 million at December 31, 2007, 2006, and 2005, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds. The average balance of federal funds purchased and securities sold under repurchase agreements was \$162 million, \$121 million and \$58 million in 2007, 2006 and 2005 respectively. The average rate paid on federal funds purchased and securities sold under repurchase agreements was 4.07%, 4.69% and 3.21% in 2007, 2006 and 2005, respectively. The weighted average rate on federal funds purchased and securities sold under repurchase agreements was 2.87%, 4.77% and 3.59% at December 31, 2007, 2006 and 2005, respectively. The highest amount of federal funds purchased and securities sold under repurchase agreements at any month end during 2007, 2006 and 2005 was \$196 million, \$143 million and \$85 million, respectively.

**Capital Resources**

We evaluate capital resources by our ability to maintain adequate regulatory capital ratios to do business in the banking industry. Issues related to capital resources arise primarily when we are growing at an accelerated rate but not retaining a significant amount of our profits or when we experience significant asset quality deterioration.

Total shareholders' equity was \$335.5 million, or 10.9% of total assets, at December 31, 2007, as compared to \$300.9 million, or 10.6% of total assets, at December 31, 2006. During 2007, total shareholders' equity averaged \$311.8 million, or 10.8% of average assets, as compared to \$284.1 million, or 10.4% of average assets, during 2006.

Banking regulators measure capital adequacy by means of the risk-based capital ratio and leverage ratio. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories ranging from 0% to 100%. Regulatory capital is then divided by risk-weighted assets to determine the risk-adjusted capital ratios. The leverage ratio is computed by dividing shareholders' equity less intangible assets by quarter-to-date average assets less intangible assets. Regulatory minimums for total risk-based and leverage ratios are 8.00% and 3.00%, respectively. As of December 31, 2007, our total risk-based and leverage capital ratios were 15.62% and 9.23%, respectively, as compared to total risk-based and leverage

capital ratios of 15.32% and 8.87% as of December 31, 2006. We believe by all measurements our capital ratios remain well above regulatory minimums.

*Interest Rate Risk.* Interest rate risk results when the maturity or repricing intervals of interest-earning assets and interest-bearing liabilities are different. Our exposure to interest rate risk is managed primarily through our strategy of selecting the types and terms of interest-earning assets and interest-bearing liabilities that generate favorable earnings while limiting the potential negative effects of changes in market interest rates. We use no off-balance-sheet financial instruments to manage interest rate risk.

Each of our subsidiary banks has an asset liability committee that monitors interest rate risk and compliance with investment policies; there is also a holding company-wide committee that monitors the aggregate company's interest rate risk and compliance with investment policies. The Company and each subsidiary bank utilize an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet.

As of December 31, 2007, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 2.7% and 5.3%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 100 and 200 basis points would result in negative variances in net interest income of 1.6% and 4.2%, respectively, relative to the base case over the next 12 months. These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics of specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities reprice in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

Should we be unable to maintain a reasonable balance of maturities and repricing of our interest-earning assets and our interest-bearing liabilities, we could be required to dispose of our assets in an unfavorable manner or pay a higher than market rate to fund our activities. Our asset liability committees oversee and monitor this risk.

## **Liquidity**

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument, as detailed in Tables 14 and 15. Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which

include core depositors and correspondent banks that maintain accounts with and sell federal funds to our subsidiary banks. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondents and sales of securities under agreements to repurchase, which amounted to \$166.3 million at December 31, 2007, and an unfunded \$50.0 million line of credit established with a nonaffiliated bank which matures on December 31, 2008. First Financial Bank, N. A., Abilene also has federal funds purchased lines of credit with two non-affiliated banks totaling \$50 million.

On December 31, 2007, we renewed our loan agreement with The Frost National Bank, pursuant to which the Company is permitted to draw up to \$50.0 million on a revolving line of credit. Interest is paid quarterly at LIBOR plus 100 basis points. If a balance exists at December 31, 2008, the principal balance converts to a term facility payable quarterly over five years. The line of credit is unsecured for an outstanding balance up to \$25.0 million and secured by the stock of a subsidiary bank should the balance exceed \$25.0 million. Among other provisions in the credit agreement, we must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require us to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratios. In addition, the credit agreement contains certain operational covenants, which among others, restrict the payment of dividends above 55% of consolidated net income, limit the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibit the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. There was no outstanding balance under the line of credit as of December 31, 2007 or 2006.

Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary banks, we consider our current liquidity position to be adequate to meet our short- and long-term liquidity needs.

In addition, we anticipate that any future acquisition of financial institutions, expansion of branch locations or offering of new products could also place a demand on our cash resources. Available cash at our parent company, which totaled \$36.6 million at December 31, 2007, available dividends from subsidiary banks which totaled \$31.9 million at December 31, 2007, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions. Existing cash resources at our subsidiary banks may also be used as a source of funding for these potential acquisitions or expansions.

**Table 14 Contractual Obligations As of December 31, 2007 (in thousands):**

|                                     | Total<br>Amounts | Payment Due by Period |             |             | Over<br>5<br>Years |
|-------------------------------------|------------------|-----------------------|-------------|-------------|--------------------|
|                                     |                  | Less Than 1<br>Year   | 2 - 3 Years | 4 - 5 Years |                    |
| Deposits with stated maturity dates | \$ 774,034       | \$ 688,025            | \$ 71,700   | \$ 14,309   | \$                 |
| Operating Leases                    | 2,074            | 630                   | 943         | 489         | 12                 |
| Outsourcing Service Contracts       | 1,330            | 939                   | 391         |             |                    |
| Total Contractual Obligations       | \$ 777,438       | \$ 689,594            | \$ 73,034   | \$ 14,798   | \$ 12              |

Amounts above for deposits do not include related accrued interest.

*Off-Balance Sheet Arrangements.* We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include unfunded lines of credit, commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in our consolidated balance sheets.

Our exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for unfunded lines of credit, commitments to extend credit and standby letters of credit is represented by the contractual

notional amount of these instruments. We generally use the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments.

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as we deem necessary upon extension of credit, is based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

Standby letters of credit are conditional commitments we issue to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The average collateral value held on letters of credit usually exceeds the contract amount.

**Table 15 Commitments As of December 31, 2007 (in thousands):**

|  | <b>Total Notional<br/>Amounts<br/>Committed</b> | <b>Less than<br/>1 Year</b> | <b>2 - 3 Years</b> | <b>4 -<br/>5 Years</b> | <b>Over<br/>5 Years</b> |
|--|---|-----------------------------|--------------------|------------------------|-------------------------|
| Unfunded lines of credit                 | \$ 238,313                                      | \$ 227,408                  | \$ 5,728           | \$ 1,818               | \$ 3,359                |
| Unfunded commitments to<br>extend credit | 80,596  | 52,852                      | 10,273             | 4,809                  | 12,662                  |
| Standby letters of credit                | 10,896  | 9,831                       | 1,060              | 5                      |                         |
| <b>Total Commercial<br/>Commitments</b>  | <b>\$ 329,805</b>                               | <b>\$ 290,091</b>           | <b>\$ 17,061</b>   | <b>\$ 6,632</b>        | <b>\$ 16,021</b>        |

We believe we have no other off-balance sheet arrangements or transactions with unconsolidated, special purpose entities that would expose us to liability that is not reflected on the face of the financial statements.

*Parent Company Funding.* Our ability to fund various operating expenses, dividends, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiary banks. These funds historically have been produced by intercompany dividends and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiary banks. At December 31, 2007, approximately \$31.9 million was available for the payment of intercompany dividends by the subsidiary banks without the prior approval of regulatory agencies. Our subsidiary banks paid aggregate dividends of \$42.3 million in 2007 and \$40.0 million in 2006.

*Dividends.* Our long-term dividend policy is to pay cash dividends to our shareholders of between 40% and 55% of net earnings while maintaining adequate capital to support growth. The cash dividend payout ratios have amounted to 52.9%, 53.1% and 51.6% of net earnings, respectively, in 2007, 2006 and 2005. Given our current strong capital position and projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy. Also see *Payments of Dividends* on page 6.

Each state bank that is a member of the Federal Reserve System and each national banking association is required by federal law to obtain the prior approval of the Federal Reserve Board and the OCC, respectively, to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank's net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus. In addition, these banks may only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

To pay dividends, we and our subsidiary banks must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the

payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve Board and the OCC have each indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve Board, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

**ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

Our management considers interest rate risk to be a significant market risk for us. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations Balance Sheet Review Interest Rate Risk for disclosure regarding this market risk.



**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our consolidated financial statements begin on page F-1.

**Quarterly Results of Operations (in thousands, except per share and common stock data):**

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in fiscal 2007 and 2006. This information is derived from unaudited consolidated financial statements that include, in our opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

|   | 4 <sup>th</sup> | 3 <sup>rd</sup> | 2 <sup>nd</sup> | 1 <sup>st</sup> |
|---|-----------------|-----------------|-----------------|-----------------|
|   | 2007            |                 |                 |                 |
| <b>Summary Income Statement Information:</b>        |                 |                 |                 |                 |
| Interest income                                     | \$ 43,482       | \$ 42,556       | \$ 42,259       | \$ 41,072       |
| Interest expense                                    | 14,229          | 14,816          | 15,013          | 14,499          |
| Net interest income                                 | 29,253          | 27,740          | 27,246          | 26,573          |
| Provision for loan losses                           | 1,377           | 475             | 237             | 242             |
| Net interest income after provision for loan losses | 27,876          | 27,265          | 27,009          | 26,331          |
| Noninterest income                                  | 12,320          | 11,996          | 12,972          | 10,836          |
| Net gain (loss) on securities transactions          | 70              | (5)             |                 | 84              |
| Noninterest expense                                 | 22,730          | 21,983          | 21,248          | 20,867          |
| Earnings before income taxes                        | 17,536          | 17,273          | 18,733          | 16,384          |
| Income tax expense                                  | 5,030           | 5,022           | 5,463           | 4,922           |
| Net earnings  | \$ 12,506       | \$ 12,251       | \$ 13,270       | \$ 11,462       |
| <b>Per Share Data:</b>                              |                 |                 |                 |                 |
| Net earnings per share, basic                       | \$ 0.60         | \$ 0.59         | \$ 0.64         | \$ 0.55         |
| Net earnings per share, assuming dilution           | 0.60            | 0.59            | 0.64            | 0.55            |
| Cash dividends declared                             | 0.32            | 0.32            | 0.32            | 0.30            |
| Book value at period-end                            | 16.16           | 15.51           | 14.76           | 14.85           |
| <b>Common stock sales price:(1)</b>                 |                 |                 |                 |                 |
| High  | \$ 42.62        | \$ 44.00        | \$ 42.71        | \$ 43.69        |
| Low   | 35.53           | 35.19           | 37.33           | 39.79           |
| Close   | 37.65           | 40.18           | 38.81           | 41.82           |

|   | 2006            |                 |                 |                 |
|---|-----------------|-----------------|-----------------|-----------------|
|   | 4 <sup>th</sup> | 3 <sup>rd</sup> | 2 <sup>nd</sup> | 1 <sup>st</sup> |
| <b>Summary Income Statement Information:</b>        |                 |                 |                 |                 |
| Interest income                                     | \$ 40,564       | \$ 39,388       | \$ 38,140       | \$ 36,401       |
| Interest expense                                    | 13,594          | 12,685          | 11,598          | 10,750          |
| Net interest income                                 | 26,970          | 26,703          | 26,542          | 25,651          |
| Provision for loan losses                           | 247             | 1,091           | 389             | 333             |
| Net interest income after provision for loan losses | 26,723          | 25,612          | 26,153          | 25,318          |
| Noninterest income                                  | 11,045          | 11,128          | 10,954          | 11,478          |
| Net gain on securities transactions                 | 2               | 60              |                 |                 |
| Noninterest expense                                 | 21,119          | 20,617          | 20,805          | 20,477          |
| Earnings before income taxes                        | 16,651          | 16,183          | 16,302          | 16,319          |
| Income tax expense                                  | 4,942           | 4,778           | 4,854           | 4,852           |
| Net earnings  | \$ 11,709       | \$ 11,405       | \$ 11,448       | \$ 11,467       |
| <b>Per Share Data:</b>                              |                 |                 |                 |                 |
| Net earnings per share, basic                       | \$ 0.56         | \$ 0.55         | \$ 0.55         | \$ 0.55         |
| Net earnings per share, assuming dilution           | 0.56            | 0.55            | 0.55            | 0.55            |
| Cash dividends declared                             | 0.30            | 0.30            | 0.30            | 0.28            |
| Book value at period-end                            | 14.51           | 14.14           | 13.50           | 13.55           |
| <b>Common stock sales price:(1)</b>                 |                 |                 |                 |                 |
| High  | \$ 43.47        | \$ 39.98        | \$ 39.48        | \$ 38.75        |
| Low   | 37.83           | 35.62           | 34.05           | 34.56           |
| Close   | 41.86           | 38.15           | 36.54           | 38.30           |

(1) These quotations reflect inter-dealer prices without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

**ITEM 9A. CONTROLS AND PROCEDURES**

As of December 31, 2007, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act Rule 15d-15. Our management, including the principal executive officer and principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures under Rule 13a-14 (c) and Rule 15d-14 (c) of the Securities Exchange Act of 1934 are effective at the reasonable assurance level as of December 31, 2007.

During the last fiscal quarter and subsequent to our evaluation, there were no significant changes in internal controls over financial reporting or other factors that have materially affected, or is reasonably likely to materially affect, these internal controls.

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of First Financial Bankshares, Inc. and subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting. First Financial Bankshares, Inc. and subsidiaries' internal control system was designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

First Financial Bankshares, Inc. and subsidiaries' management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on our assessment we believe that, as of December 31, 2007, the Company's internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f), is effective based on those criteria.

First Financial Bankshares, Inc. and subsidiaries' independent auditors have issued an audit report, dated February 18, 2008, on the effectiveness of the Company's internal control over financial reporting.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

To the Board of Directors and Shareholders of  
First Financial Bankshares, Inc.

We have audited First Financial Bankshares, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). First Financial Bankshares, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, First Financial Bankshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2007 consolidated financial statements of First Financial Bankshares, Inc. and our report dated February 18, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, Texas  
February 18, 2008



**ITEM 9B. OTHER INFORMATION**

None

**PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by Item 10 is hereby incorporated by reference from our proxy statement for our 2008 annual meeting of shareholders.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 is hereby incorporated by reference from our 2008 proxy statement.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 12 related to security ownership of certain beneficial owners and management is hereby incorporated by reference from our 2008 proxy statement. The following chart gives aggregate information under our equity compensation plans as of December 31, 2007.

|  | Number of<br>Securities<br>to be Issued Upon                     | Weighted Average   | Number of<br>Securities<br>Remaining<br>Available<br>for Future<br>Issuance                           |
|--|--|--|---|
|  | Exercise of<br>Outstanding<br>Options,<br>Warrants and<br>Rights | Exercise Price of<br>Outstanding<br>Options,<br>Warrants and<br>Rights | Under Equity<br>Compensation<br>Plans<br>(Excluding<br>Securities<br>Reflected in<br>Far Left Column) |
| Equity compensation plans approved by security holders     | 266,174  | \$ 30.99   | 580,855   |
| Equity compensation plans not approved by security holders |  |  |   |
| Total  | 266,174  | \$ 30.99   | 580,855   |

The remainder of the information required by Item 12 is incorporated by reference from our 2008 proxy statement.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by Item 13 is hereby incorporated by reference from our 2008 proxy statement.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Item 14 is hereby incorporated by reference from our 2008 proxy statement.



**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

(a) The following documents are filed as part of this report:

(1) *Financial Statements*

|   |     |
|---|-----|
| <u>Report of Independent Registered Public Accounting Firm</u>  | F-1 |
| <u>Consolidated Balance Sheets as of December 31, 2007 and 2006</u>   | F-2 |
| <u>Consolidated Statements of Earnings for the years ended December 31, 2007, 2006 and 2005</u>               | F-3 |
| <u>Consolidated Statements of Comprehensive Earnings for the years ended December 31, 2007, 2006 and 2005</u> | F-4 |
| <u>Consolidated Statements of Shareholders' Equity for the years ended December 31, 2007, 2006 and 2005</u>   | F-5 |
| <u>Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005</u>             | F-6 |
| <u>Notes to the Consolidated Financial Statements</u>   | F-7 |

(2) *Financial Statement Schedules*

These schedules have been omitted because they are not required, are not applicable or have been included in our consolidated financial statements.

(3) *Exhibits*

The information required by this Item 15(a)(3) is set forth in the Exhibit Index immediately following our signature pages. The exhibits listed herein will be furnished upon written request to J. Bruce Hildebrand, Executive Vice President, First Financial Bankshares, Inc., 400 Pine Street, Abilene, Texas 79601, and payment of a reasonable fee that will be limited to our reasonable expense in furnishing such exhibits.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FINANCIAL BANKSHARES, INC.

By: /s/ F. SCOTT DUESER

F. SCOTT DUESER  
 Chairman of the Board, Director, President and  
 Chief Executive Officer

Date: February 18, 2008

The undersigned directors and officers of First Financial Bankshares, Inc. hereby constitute and appoint J. Bruce Hildebrand, with full power to act and with full power of substitution and resubstitution, our true and lawful attorney-in-fact with full power to execute in our name and behalf in the capacities indicated below any and all amendments to this report and to file the same, with all exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission and hereby ratify and confirm all that such attorney-in-fact or his substitute shall lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <b>Name</b>                                    | <b>Title</b>  | <b>Date</b>       |
|--|---|-------------------|
| /s/ F. SCOTT DUESER<br>F. Scott Dueser         | Chairman of the Board, Director, President,<br>and Chief Executive Officer (Principal<br>Executive Officer)               | February 18, 2008 |
| /s/ J. BRUCE HILDEBRAND<br>J. Bruce Hildebrand | Executive Vice President and Chief<br>Financial Officer (Principal Financial<br>Officer and Principal Accounting Officer) | February 18, 2008 |
| /s/ TUCKER S. BRIDWELL<br>Tucker S. Bridwell   | Director  | February 18, 2008 |
| /s/ JOSEPH E. CANON<br>Joseph E. Canon         | Director  | February 18, 2008 |
| /s/ MAC A. COALSON<br>Mac A. Coalson           | Director  | February 18, 2008 |

|                        |          |                   |
|------------------------|----------|-------------------|
| /s/ DAVID COPELAND     | Director | February 18, 2008 |
| David Copeland         |          |                   |
| /s/ MURRAY EDWARDS     | Director | February 18, 2008 |
| Murray Edwards         |          |                   |
| /s/ DERRELL E. JOHNSON | Director | February 18, 2008 |
| Derrell E. Johnson     |          |                   |

| Name                                       | Title    | Date              |
|--|----------|-------------------|
| /s/ KADE L. MATTHEWS<br>Kade L. Matthews   | Director | February 18, 2008 |
| /s/ BYNUM MIERS<br>Bynum Miers             | Director | February 18, 2008 |
| /s/ KENNETH T. MURPHY<br>Kenneth T. Murphy | Director | February 18, 2008 |
| /s/ DIAN GRAVES STAI<br>Dian Graves Stai   | Director | February 18, 2008 |
| /s/ F. L. STEPHENS<br>F. L. Stephens       | Director | February 18, 2008 |
| /s/ JOHNNY TROTTER<br>Johnny Trotter       | Director | February 18, 2008 |

**Item 6. Exhibits**

(a) The following exhibits are filed as part of this report:

- 3.1 Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2006).
- 3.2 Amended and Restated Bylaws, and all amendments thereto, of the Registrant (incorporated by reference from Exhibit 2 of the Registrant's Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
- 3.3 Amendment to Amended and Restated Bylaws of the Registrant, dated April 27, 1994 (incorporated by reference from Exhibit 3.4 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2004).
- 3.4 Amendment to Amended and Restated Bylaws of the Registrant, dated October 23, 2001 (incorporated by reference from Exhibit 3.5 of the Registrant's Form 10-Q Quarterly Report for the quarter ended March 31, 2004).
- 3.5 Amendment to Amended and Restated Bylaws of the Registrant, dated October 23, 2007 (incorporated by reference from Exhibit 3.1 of the Registrant's Form 8-K filed October 24, 2007).
- 4.1 Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant's Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
- 10.1 Deferred Compensation Agreement, dated October 28, 1992, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.1 of the Registrant's Form 10-K Annual Report for the year ended December 31, 2002).
- 10.2 Revised Deferred Compensation Agreement, dated December 28, 1995, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.2 of the Registrant's Form 10-K Annual Report for the year ended December 31, 2002).
- 10.3 Executive Recognition Plan (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K Report filed July 3, 2006).
- 10.4 1992 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.5 of the Registrant's Form 10-K Annual Report for the fiscal year ended December 31, 1998).
- 10.5 2002 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant's Schedule 14a Definitive Proxy Statement for the 2002 Annual Meeting of Shareholders).
- 10.6 Loan agreement dated December 31, 2004, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed December 31, 2004).
- 10.7 First Amendment to Loan Agreement, dated December 28, 2005, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.2 of the Registrant's Form 8-K filed December 28, 2005).
- 10.8 Second Amendment to Loan Agreement, dated December 31, 2006, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K filed December 31, 2006).
- 10.9 Third Amendment to Loan Agreement, dated December 31, 2007, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.4 of the Registrant's Form 8-K filed December 31, 2007).
- \*21.1 Subsidiaries of the Registrant.
- \*23.1 Consent of Ernst & Young LLP.
- 24.1 Power of Attorney (included on signature page of this Form 10-K).
- \*31.1 Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.

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- \*31.2 Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.
- \*32.1 Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.
- \*32.2 Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.

\* Filed herewith

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of  
First Financial Bankshares, Inc.

We have audited the accompanying consolidated balance sheets of First Financial Bankshares, Inc. (a Texas corporation) and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of earnings, comprehensive earnings, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Financial Bankshares, Inc. and subsidiaries at December 31, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R "Share-Based Payment", to account for stock-based compensation. As discussed in Note 7 to the financial statements, effective January 1, 2007, the Company changed its method of accounting for income taxes.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), First Financial Bankshares, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 18, 2008, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, Texas  
February 18, 2008

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets  
December 31, 2007 and 2006**

|   | <b>2007</b>      | <b>2006</b>      |
|---|------------------|------------------|
| <b>ASSETS</b>   |                  |                  |
| CASH AND DUE FROM BANKS   | \$ 163,559,942   | \$ 127,419,210   |
| FEDERAL FUNDS SOLD  | 99,450,000       | 64,485,000       |
| INTEREST-BEARING DEPOSITS IN BANKS  | 1,878,434        | 1,072,443        |
| Total cash and cash equivalents   | 264,888,376      | 192,976,653      |
| INVESTMENT SECURITIES:  |                  |                  |
| Securities held-to-maturity (fair value of \$27,253,367 in 2007 and \$27,876,959 in 2006) | 26,419,040       | 26,985,570       |
| Securities available-for-sale, at fair value  | 1,102,073,636    | 1,102,327,223    |
| Total investment securities   | 1,128,492,676    | 1,129,312,793    |
| LOANS:  |                  |                  |
| Held for investment   | 1,492,223,308    | 1,336,818,747    |
| Held for sale   | 35,796,281       | 36,915,873       |
|   | 1,528,019,589    | 1,373,734,620    |
| Less- allowance for loan losses   | (17,461,514)     | (16,200,804)     |
| Net loans   | 1,510,558,075    | 1,357,533,816    |
| BANK PREMISES AND EQUIPMENT, net  | 61,670,159       | 59,467,923       |
| INTANGIBLE ASSETS   | 65,207,169       | 66,702,100       |
| OTHER ASSETS  | 39,492,957       | 44,171,229       |
| Total assets  | \$ 3,070,309,412 | \$ 2,850,164,514 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                  |                  |
| NONINTEREST-BEARING DEPOSITS  | \$ 739,180,980   | \$ 685,335,743   |
| INTEREST-BEARING DEPOSITS   | 1,806,902,038    | 1,698,688,304    |
| Total deposits  | 2,546,083,018    | 2,384,024,047    |
| DIVIDENDS PAYABLE   | 6,645,590        | 5,413,848        |
| SHORT-TERM BORROWINGS   | 166,266,426      | 143,244,347      |
| OTHER LIABILITIES   | 15,818,916       | 16,581,234       |
| Total liabilities   | 2,734,813,950    | 2,549,263,476    |
| COMMITMENTS AND CONTINGENCIES   |                  |                  |
| SHAREHOLDERS EQUITY:  | 207,669          | 207,392          |



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|  |                  |                  |
|--|------------------|------------------|
| Common stock, \$0.01 par value; authorized 40,000,000 shares; 20,766,848 and 20,739,127 issued and outstanding at December 31, 2007 and 2006, respectively |                  |                  |
| Capital surplus  | 267,136,338      | 266,271,930      |
| Retained earnings  | 64,333,921       | 41,003,600       |
| Treasury stock (shares at cost: 155,415 and 153,187 at December 31, 2007 and 2006, respectively)   | (3,170,304)      | (2,911,506)      |
| Deferred Compensation  | 3,170,304        | 2,911,506        |
| Accumulated other comprehensive earnings (loss)  | 3,817,534        | (6,581,884)      |
| Total shareholders' equity   | 335,495,462      | 300,901,038      |
| Total liabilities and shareholders' equity   | \$ 3,070,309,412 | \$ 2,850,164,514 |

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Earnings  
Years Ended December 31, 2007, 2006 and 2005**

|  | 2007             | 2006             | 2005             |
|--|------------------|------------------|------------------|
| <b>INTEREST INCOME:</b>  |                  |                  |                  |
| Interest and fees on loans   | \$ 114,333,665   | \$ 101,864,998   | \$ 81,486,600    |
| Interest on investment securities:                                       |                  |                  |                  |
| Taxable  | 38,880,569       | 39,297,823       | 30,849,490       |
| Exempt from federal income tax   | 12,393,019       | 10,350,154       | 9,648,054        |
| Interest on federal funds sold and interest-bearing deposits<br>in banks | 3,761,708        | 2,980,973        | 1,959,906        |
| Total interest income  | 169,368,961      | 154,493,948      | 123,944,050      |
| <b>INTEREST EXPENSE:</b>   |                  |                  |                  |
| Interest on deposits   | 51,979,999       | 42,972,105       | 26,892,197       |
| Other  | 6,577,340        | 5,655,579        | 1,864,969        |
| Total interest expense   | 58,557,339       | 48,627,684       | 28,757,166       |
| Net interest income  | 110,811,622      | 105,866,264      | 95,186,884       |
| <b>PROVISION FOR LOAN LOSSES</b>   | <b>2,331,172</b> | <b>2,061,088</b> | <b>1,319,816</b> |
| Net interest income after provision for loan losses                      | 108,480,450      | 103,805,176      | 93,867,068       |
| <b>NONINTEREST INCOME:</b>   |                  |                  |                  |
| Trust fees   | 8,746,756        | 7,664,810        | 7,068,138        |
| Service charges on deposit accounts                                      | 22,919,519       | 22,449,963       | 21,380,623       |
| ATM and credit card fees   | 7,520,988        | 6,213,964        | 4,960,988        |
| Real estate mortgage operations  | 3,346,547        | 2,538,913        | 2,081,003        |
| Net gain on securities transactions                                      | 149,891          | 62,091           | 235,367          |
| Net gain on sale of student loans  | 1,913,407        | 2,141,477        | 1,801,899        |
| Net gain on sale of PULSE ownership rights                               |                  |                  | 3,894,684        |
| Net gain (loss) on sale of other real estate                             | 107,875          | (9,947)          | 60,517           |
| Other  | 3,567,888        | 3,606,731        | 2,696,806        |
| Total noninterest income   | 48,272,871       | 44,668,002       | 44,180,025       |
| <b>NONINTEREST EXPENSE:</b>  |                  |                  |                  |
| Salaries and employee benefits   | 46,943,935       | 44,179,620       | 40,317,256       |
| Net occupancy expense  | 5,893,468        | 5,985,527        | 5,043,187        |
| Equipment expense  | 7,220,339        | 7,039,009        | 6,190,906        |
| Printing, stationery and supplies  | 2,003,814        | 2,067,251        | 1,988,454        |
| Correspondent bank service charges                                       | 1,153,015        | 1,352,793        | 1,438,010        |
| Amortization of intangible assets  | 1,494,931        | 1,491,393        | 680,259          |

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|   |               |               |               |
|---|---------------|---------------|---------------|
| Other expenses                            | 22,117,373    | 20,901,600    | 19,829,336    |
| Total noninterest expense                 | 86,826,875    | 83,017,193    | 75,487,408    |
| EARNINGS BEFORE INCOME TAXES              | 69,926,446    | 65,455,985    | 62,559,685    |
| INCOME TAX EXPENSE                        | 20,436,841    | 19,426,769    | 18,536,705    |
| NET EARNINGS                              | \$ 49,489,605 | \$ 46,029,216 | \$ 44,022,980 |
| NET EARNINGS PER SHARE, BASIC             | \$ 2.38       | \$ 2.22       | \$ 2.13       |
| NET EARNINGS PER SHARE, ASSUMING DILUTION | \$ 2.38       | \$ 2.21       | \$ 2.12       |

The accompanying notes are an integral part of these consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Earnings  
Years Ended December 31, 2007, 2006 and 2005**

|   | <b>2007</b>   | <b>2006</b>   | <b>2005</b>   |
|---|---------------|---------------|---------------|
| NET EARNINGS  | \$ 49,489,605 | \$ 46,029,216 | \$ 44,022,980 |
| OTHER ITEMS OF COMPREHENSIVE EARNINGS:  |               |               |               |
| Change in unrealized gain (loss) on investment securities available-for-sale, before income tax                     | 16,042,662    | 3,979,897     | (15,449,135)  |
| Reclassification adjustment for realized gains on investment securities included in net earnings, before income tax | (149,891)     | (62,091)      | (235,367)     |
| Minimum liability pension adjustment, before income tax   | 124,572       | (174,063)     | (1,363,640)   |
| Total other items of comprehensive earnings   | 16,017,343    | 3,743,743     | (17,048,142)  |
| Income tax benefit (expense) related to other items of comprehensive earnings                                       | (5,606,070)   | (1,310,310)   | 5,966,850     |
| COMPREHENSIVE EARNINGS  | \$ 59,900,878 | \$ 48,462,649 | \$ 32,941,688 |

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Shareholders' Equity  
Years Ended December 31, 2007, 2006 and 2005**

| <b>Common Stock<br/>Shares</b> | <b>Common Stock<br/>Amount</b> | <b>Capital<br/>Surplus</b> | <b>Retained<br/>Earnings</b> | <b>Treasury Stock<br/>Shares</b> | <b>Treasury Stock<br/>Amounts</b> | <b>Deferred<br/>Compensation</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Earnings<br/>(Losses)</b> |
|--------------------------------|--------------------------------|----------------------------|------------------------------|----------------------------------|-----------------------------------|----------------------------------|--|
| 15,511,576                     | \$ 155,115,760                 | \$ 58,529,113              | \$ 49,834,536                | (100,189)                        | \$ (2,289,729)                    | \$ 2,289,729                     | \$ 2,065,975   |
| 5,172,871                      | 51,728,710                     |                            | (51,728,710)                 | (35,298)                         |                                   |                                  |  |
| 29,954                         | 299,540                        | 128,636                    | 44,022,980                   |                                  |                                   |                                  |  |
|                                |                                |                            | (22,694,200)                 |                                  |                                   |                                  |  |
|                                |                                |                            |                              |                                  |                                   |                                  | (886,366)  |
|                                |                                |                            |                              |                                  |                                   |                                  | (10,194,926)   |
|                                |                                | 54,759                     |                              |                                  |                                   |                                  |  |
|                                |                                |                            |                              | (9,835)                          | (302,684)                         | 302,684                          |  |
| 20,714,401                     | \$ 207,144,010                 | \$ 58,712,508              | \$ 19,434,606                | (145,322)                        | \$ (2,592,413)                    | \$ 2,592,413                     | \$ (9,015,317)   |

|            |    |               |                |    |              |           |                |              |                |
|------------|----|---------------|----------------|----|--------------|-----------|----------------|--------------|----------------|
|            |    | (206,971,541) | 206,971,541    |    |              |           |                |              |                |
| 24,726     |    | 34,923        | 405,793        |    | 46,029,216   |           |                |              |                |
|            |    |               |                |    | (24,460,222) |           |                |              |                |
|            |    |               |                |    |              |           |                |              | (113,141)      |
|            |    |               |                |    |              |           |                |              | 2,546,574      |
|            |    |               | 24,996         |    |              |           |                |              |                |
|            |    |               |                |    |              | (7,865)   | (319,093)      | 319,093      |                |
|            |    |               | 157,092        |    |              |           |                |              |                |
| 20,739,127 | \$ | 207,392       | \$ 266,271,930 | \$ | 41,003,600   | (153,187) | \$ (2,911,506) | \$ 2,911,506 | \$ (6,581,884) |
|            |    |               |                |    | 49,489,605   |           |                |              |                |
| 27,721     |    | 277           | 526,359        |    |              |           |                |              |                |
|            |    |               |                |    | (26,159,284) |           |                |              |                |
|            |    |               |                |    |              |           |                |              | 80,972         |
|            |    |               |                |    |              |           |                |              | 10,318,446     |

117,844

(2,228) (258,798) 258,798

220,205

20,766,848 \$ 207,669 \$ 267,136,338 \$ 64,333,921 (155,415) \$ (3,170,304) \$ 3,170,304 \$ 3,817,534

The accompanying notes are an integral part of these consolidated financial statements.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows  
Years Ended December 31, 2007, 2006 and 2005**

|   | 2007          | 2006            | 2005            |
|---|---------------|-----------------|-----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |               |                 |                 |
| Net earnings  | \$ 49,489,605 | \$ 46,029,216   | \$ 44,022,980   |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |               |                 |                 |
| Depreciation and amortization   | 7,817,931     | 7,954,560       | 6,273,204       |
| Provision for loan losses   | 2,331,172     | 2,061,088       | 1,319,816       |
| Securities premium amortization (discount accretion), net                           | (636,173)     | 215,998         | 3,087,581       |
| Gain on sale of assets, net   | (2,102,712)   | (2,234,154)     | (5,992,469)     |
| Deferred federal income tax expense (benefit)                                       | 464,397       | (26,625)        | 277,545         |
| Loans originated for resale   | (190,037,588) | (170,602,938)   | (158,121,586)   |
| Proceeds from sale of loans held for resale   | 193,554,563   | 174,179,850     | 156,683,818     |
| Change in other assets  | (1,629,455)   | (9,951,982)     | 1,095,506       |
| Change in other liabilities   | (4,461,115)   | 233,852         | (7,709,073)     |
| Total adjustments   | 5,301,020     | 1,829,649       | (3,085,658)     |
| Net cash provided by operating activities   | 54,790,625    | 47,858,865      | 40,937,322      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |               |                 |                 |
| Cash paid for acquisition of banks, less cash acquired                              |               |                 | 6,627,197       |
| Activity in available-for-sale securities:  |               |                 |                 |
| Sales   | 38,531,378    | 18,513,440      | 85,032,949      |
| Maturities  | 881,288,653   | 1,858,293,402   | 1,915,359,555   |
| Purchases   | (898,748,116) | (1,978,123,309) | (2,167,727,922) |
| Activity in held-to-maturity securities:  |               |                 |                 |
| Maturities  | 1,570,217     | 26,173,833      | 37,442,670      |
| Purchases   | (1,000,000)   |                 | (620,000)       |
| Net increase in loans   | (159,437,929) | (87,566,639)    | (737,957)       |
| Purchases of bank premises and equipment and computer software                      | (8,330,954)   | (7,370,681)     | (10,316,540)    |
| Proceeds from sale of other assets  | 2,567,705     | 707,035         | 5,639,596       |
| Net cash used in investing activities   | (143,559,046) | (169,372,919)   | (129,300,452)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |               |                 |                 |
| Net increase in noninterest-bearing deposits  | 53,845,237    | 62,179,901      | 56,687,234      |



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|  |                |                |                |
|--|----------------|----------------|----------------|
| Net increase (decrease) in interest-bearing deposits | 108,213,734    | (44,432,986)   | 77,889,442     |
| Net increase in short-term borrowings                | 23,022,079     | 69,005,371     | 32,922,243     |
| Common stock transactions:                           |                |                |                |
| Proceeds of stock issuances                          | 526,636        | 440,716        | 428,176        |
| Dividends paid                                       | (24,927,542)   | (24,011,155)   | (23,003,227)   |
| Net cash provided by financing activities            | 160,680,144    | 63,181,847     | 144,923,868    |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 71,911,723     | (58,332,207)   | 56,560,738     |
| CASH AND CASH EQUIVALENTS, beginning of year         | 192,976,653    | 251,308,860    | 194,748,122    |
| CASH AND CASH EQUIVALENTS, end of year               | \$ 264,888,376 | \$ 192,976,653 | \$ 251,308,860 |

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2007, 2006 and 2005**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

**Nature of Operations**

First Financial Bankshares, Inc. (a Texas corporation) ( Bankshares , Company , we or us ) is a financial holding company which owns (through its wholly-owned Delaware subsidiary) all of the capital stock of ten banks located in Texas as of December 31, 2007. Those subsidiary banks are First Financial Bank, National Association, Abilene; Hereford State Bank; First Financial Bank, National Association, Sweetwater; First Financial Bank, National Association, Eastland; First Financial Bank, National Association, Cleburne; First Financial Bank, National Association, Stephenville; San Angelo National Bank; Weatherford National Bank; First Financial Bank, National Association, Southlake and First Financial Bank, Mineral Wells. Each subsidiary bank's primary source of revenue is providing loans and banking services to consumers and commercial customers in the market area in which the subsidiary is located. In addition, the Company owns First Financial Trust & Asset Management Company, National Association and First Technology Services, Inc., an information technology subsidiary.

A summary of significant accounting policies of Bankshares and subsidiaries (collectively, the Company ) applied in the preparation of the accompanying consolidated financial statements follows. The accounting principles followed by the Company and the methods of applying them are in conformity with both U.S. generally accepted accounting principles and prevailing practices of the banking industry.

**Stock Transactions**

Average share information and earnings per share data related to our common stock have been adjusted to give effect to all stock splits and stock dividends, including the four-for-three stock split in the form of a 33% stock dividend effective June 1, 2005 for shareholders of record on May 16, 2005.

On April 25, 2006, the shareholders of the Company approved an amendment to our Corporate Charter at the Annual Shareholders Meeting to change the par value of our common stock from \$10.00 to \$0.01 per share. In the second quarter of 2006, the Company transferred appropriate amounts from common stock to capital surplus in the consolidated financial statements to reflect this change in par value.

On April 24, 2006, the Company's Board of Directors authorized the repurchase of up to 500,000 shares of common stock over the next three years. The plan authorizes management to repurchase the stock at such time as repurchases are considered beneficial to stockholders. Any repurchases of the stock will be through the open market or in privately negotiated transactions in accordance with applicable laws and regulations. No stock has been repurchased under this plan as of December 31, 2007.

**Use of Estimates in Preparation of Financial Statements**

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 disclosure of contingent assets and liabilities at the date of the financial statements and 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 relate to the determination of the allowance for loan

losses, valuation of investment securities, the valuation of foreclosed real estate, deferred income tax assets, and the fair value of financial instruments.

**Consolidation**

The accompanying consolidated financial statements include the accounts of Bankshares and its subsidiaries, all of which are wholly-owned. All significant intercompany accounts and transactions have been eliminated. Certain reclasses have been made to 2005 and 2006 financial statements to conform to the 2007 presentation.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

**Investment Securities**

Management classifies debt and equity securities as held-to-maturity, available-for-sale, or trading based on its intent. Debt securities that management has the positive intent and ability to hold to maturity are classified as held-to-maturity and recorded at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income using the interest method. Securities not classified as held-to-maturity or trading are classified as available-for-sale and recorded at estimated fair value, adjusted for amortization of premiums and accretion of discounts, with all unrealized gains and unrealized losses judged to be temporary, net of deferred income taxes, excluded from earnings and reported as a separate component of shareholders' equity. Available-for-sale securities that have unrealized losses that are judged other than temporary are included in gain (loss) on sale of securities and a new cost basis is established. Securities classified as trading are recorded at estimated fair value, with unrealized gains and losses included in earnings. The Company had no trading securities at December 31, 2007, 2006, or 2005.

**Loans and Allowance for Loan Losses**

Loans are stated at the amount of unpaid principal, reduced by unearned income and an allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amounts outstanding. The Company defers and amortizes net loan origination fees and costs as an adjustment to yield. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes the collectibility of the principal is unlikely.

The allowance is an amount management believes will be adequate to absorb estimated inherent losses on existing loans that are deemed uncollectible based upon management's review and evaluation of the loan portfolio. The allowance for loan losses is comprised of three elements: (i) specific reserves determined in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS 118 and SFAS No. 5, Accounting for Contingencies, based on probable losses on specific classified loans; (ii) general reserve determined in accordance with SFAS No. 5 that consider historical loss rates; and (iii) a qualitative reserve determined in accordance with SFAS 5 based upon general economic conditions and other qualitative risk factors both internal and external to the Company. The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Management's periodic evaluation of the adequacy of the allowance is based on general economic conditions, the financial condition of borrowers, the value and liquidity of collateral, delinquency, prior loan loss experience, and the results of periodic reviews of the portfolio. For purposes of determining our general reserve, the loan portfolio, less cash secured loans, government guaranteed loans and classified loans, is multiplied by the Company's historical loss rate. Our methodology is constructed so that specific allocations are increased in accordance with deterioration in credit quality and a corresponding increase in risk of loss. In addition, we adjust our allowance for qualitative factors such as current local economic conditions and trends, changes in lending staff, policies and procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans. This additional allocation based on qualitative factors serves to compensate for additional areas of uncertainty inherent in our portfolio. Accrual of interest is discontinued on a loan and payments applied to principal when management believes, after considering economic and business conditions and collection efforts, the borrower's financial condition is such that collection of interest is doubtful. Generally all loans past due greater than 90 days, based on contractual terms, are placed on non-accrual.

The Company's policy requires measurement of the allowance for an impaired collateral dependent loan based on the fair value of the collateral. Other loan impairments are measured based on the present value of expected future cash flows or the loan's observable market price. At December 31, 2007 and 2006, all significant impaired loans have been determined to be collateral dependent and the allowance for loss has been measured utilizing the estimated fair value of the collateral.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

The Company originates (1) mortgage loans primarily for sale in the secondary market and (2) student loans for sale to another financial institution. Accordingly, these loans are classified as held for sale and are carried at the lower of cost or fair value. The mortgage loans sales contracts contain indemnification clauses should the loans default, generally in the first sixty to ninety days. The student loans are guaranteed by an agency of the U.S. Government.

**Other Real Estate**

Other real estate is foreclosed property held pending disposition and is valued at the lower of its fair value, less estimated costs to sell, or the recorded investment in the related loan. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Company's recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating and holding expenses of such properties, net of related income, and gains and losses on their disposition are included in noninterest expense.

**Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed principally on a straight-line basis over the estimated useful lives of the related assets. Leasehold improvements are amortized over the life of the respective lease or the estimated useful lives of the improvements, whichever is shorter.

**Business Combinations, Goodwill and Other Intangible Assets**

The Company accounts for all business combinations under the purchase method of accounting. Tangible and intangible assets and liabilities of the acquired entity are recorded at fair value on the purchase date. Intangible assets with finite useful lives continue to be amortized and goodwill and intangible assets with indefinite lives are not amortized, but rather tested annually for impairment as of June 30 each year. There was no impairment recorded for the years ended December 31, 2007, 2006 and 2005.

Other identifiable intangible assets recorded by the Company represent the future benefit associated with the acquisition of the core deposits and are being amortized over seven years, utilizing a method that approximates the expected attrition of the deposits.

The carrying amount of goodwill and other intangible assets arising from acquisitions that qualify as an asset purchase for federal income tax purposes amounting to approximately \$41,883,000 and \$42,856,000, respectively, at December 31, 2007 and 2006, is deductible for federal income tax purposes.

**Securities Sold Under Agreements To Repurchase**

Securities sold under agreements to repurchase, which are classified as short-term borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of the cash received in connection with the transaction. The Company may be required to provide additional collateral based on the estimated fair value of the underlying securities.

**Segment Reporting**

The Company has determined that its banking subsidiaries meet the aggregation criteria of SFAS No. 131, Segment Disclosures and Related Information since each of its community banks offers similar products and services, operates in a similar manner, has similar customers and reports to the same regulatory authority, and therefore operates one line of business (community banking) located in a single geographic area (Texas).

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

**Statements of Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, including interest bearing deposits, and federal funds sold.

**Accumulated Other Comprehensive Income (Loss)**

Unrealized gains (losses) on the Company's available-for-sale securities (after applicable income tax expense or benefit) totaling \$6,780,000 and (\$3,538,000) at December 31, 2007 and 2006, respectively, and the minimum pension liability adjustment (after applicable income tax benefit) totaling \$2,963,000 and \$3,044,000 at December 31, 2007 and 2006, respectively, are included in accumulated other comprehensive income (loss).

**Income Taxes**

The Company's provision for income taxes is based on income before income taxes adjusted for permanent differences between financial reporting and taxable income. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

**Stock Based Compensation**

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. SFAS No. 123R, Share-Based Payment, became effective January 1, 2006 and requires companies to recognize in the statement of earnings the grant-date fair value of stock options issued to employees. The Company recorded stock option expense totaling \$220,000 and \$157,000 for the years ended December 31, 2007 and 2006, respectively, using the modified prospective method for transition to the new rules whereby grants after the implementation date, as well as unvested awards granted prior to the implementation date, are measured and accounted for under SFAS No. 123R.

Prior to 2006, the Company accounted for stock option grants using the intrinsic value method prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under APB 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense was recognized. Had compensation costs for the plan been determined consistent with SFAS No. 123, Accounting for Stock-Based Compensation, the Company's net earnings and earnings per share would have been reduced by insignificant amounts on a pro forma basis for the year ended December 31, 2005.



**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****Advertising Costs**

Advertising costs are expensed as incurred.

**Per Share Data**

Net earnings per share ( EPS ) are computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the period. The Company calculates dilutive EPS assuming all outstanding options to purchase common stock have been exercised at the beginning of the year (or the time of issuance, if later.) The dilutive effect of the outstanding options is reflected by application of the treasury stock method, whereby the proceeds from the exercised options are assumed to be used to purchase common stock at the average market price during the period. The following table reconciles the computation of basic EPS to dilutive EPS:

|   | <b>Net<br/>Earnings</b> | <b>Weighted<br/>Average<br/>Shares</b> | <b>Per Share<br/>Amount</b> |
|---|-------------------------|--|-----------------------------|
| For the year ended December 31, 2007      |                         |  |                             |
| Net earnings per share, basic             | \$ 49,489,605           | 20,757,868                             | \$ 2.38                     |
| Effect of stock options                   |                         | 42,242                                 |                             |
| Net earnings per share, assuming dilution | \$ 49,489,605           | 20,800,110                             | \$ 2.38                     |
| For the year ended December 31, 2006:     |                         |  |                             |
| Net earnings per share, basic             | \$ 46,029,216           | 20,725,432                             | \$ 2.22                     |
| Effect of stock options                   |                         | 62,137                                 |                             |
| Net earnings per share, assuming dilution | \$ 46,029,216           | 20,787,569                             | \$ 2.21                     |
| For the year ended December 31, 2005:     |                         |  |                             |
| Net earnings per share, basic             | \$ 44,022,980           | 20,696,980                             | \$ 2.13                     |
| Effect of stock options                   |                         | 80,538                                 |                             |
| Net earnings per share, assuming dilution | \$ 44,022,980           | 20,777,518                             | \$ 2.12                     |

**New Accounting Pronouncements**

In June 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax

positions recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. If the tax position meets the more-likely-than-not recognition threshold, the tax effect is recognized at the largest amount of the benefit that is greater than 50% likely of being realized upon ultimate settlement. Any difference between the tax position taken in the tax return and the tax position recognized in the financial statements using the criteria above results in the recognition of a liability in the financial statements for the unrecognized benefit. Similarly, if a tax position fails to meet the more-likely-than-not recognition threshold, the benefit taken in tax return will also result in the recognition of a liability in the financial statements for the full amount of the unrecognized benefit. FIN 48 became effective January 1, 2007. The Company did not experience a material effect on its financial position, results of operations or cash flows, as a result of implementation of FIN 48.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Continued)**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 clarifies the definition of exchange price as the price between market participants in an orderly transaction to sell an asset or transfer a liability in the market in which the reporting entity would transact for the asset or liability that is the principal or most advantageous market for the asset or liability. The changes to current practice resulting from the application of this statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective beginning January 1, 2008. The Company does not anticipate that the adoption of this new accounting principle will have a material effect on its financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option of Financial Assets and Financial Liabilities, which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS No. 159 further established certain additional disclosure requirements. SFAS No. 159 became effective for the Company in 2008. The Company does not anticipate that the adoption of this new accounting principle will have a material effect on its financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations a replacement of FASB No. 141. SFAS 141R replaces SFAS 141, Business Combinations, and applies to all transactions and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. SFAS 141R is expected to have a significant impact on the Company's accounting for business combinations closing on or after January 1, 2009.

In November 2007, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings (SAB 109). SAB No. 109 supersedes SAB 105, Application of Accounting Principles to Loan Commitments, and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. The guidance in SAB 109 is applied on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. SAB 109 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.



**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****2. CASH AND INVESTMENT SECURITIES:**

The amortized cost, estimated fair values, and gross unrealized gains and losses of the Company's investment securities as of December 31, 2007 and 2006 are as follows:

|  | <b>December 31, 2007</b> |                   |                   |                   |
|--|--------------------------|-------------------|-------------------|-------------------|
|  | <b>Amortized</b>         | <b>Gross</b>      | <b>Gross</b>      | <b>Estimated</b>  |
|  | <b>Cost Basis</b>        | <b>Unrealized</b> | <b>Unrealized</b> | <b>Fair Value</b> |
|  |                          | <b>Holding</b>    | <b>Holding</b>    |                   |
|  |                          | <b>Gains</b>      | <b>Losses</b>     |                   |
| Securities held-to-maturity:   |                          |                   |                   |                   |
| Obligations of state and political subdivisions  | \$ 25,041,674            | \$ 847,037        | \$ (28,210)       | \$ 25,860,501     |
| Other  | 4,000                    |                   |                   | 4,000             |
| Mortgage-backed securities   | 1,373,366                | 19,542            | (4,042)           | 1,388,866         |
| Total debt securities held-to-maturity   | \$ 26,419,040            | \$ 866,579        | \$ (32,252)       | \$ 27,253,367     |
| Securities available-for-sale:   |                          |                   |                   |                   |
| U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 314,893,622           | \$ 3,804,878      | \$ (317,678)      | \$ 318,380,822    |
| Obligations of state and political subdivisions  | 286,292,954              | 5,157,715         | (736,804)         | 290,713,865       |
| Corporate bonds and other  | 62,933,146               | 528,497           | (79,125)          | 63,382,518        |
| Mortgage-backed securities   | 427,504,026              | 3,768,693         | (1,676,288)       | 429,596,431       |
| Total securities available-for-sale  | \$ 1,091,623,748         | \$ 13,259,783     | \$ (2,809,895)    | \$ 1,102,073,636  |
|  |                          |                   |                   |                   |
|  | <b>December 31, 2006</b> |                   |                   |                   |
|  | <b>Amortized</b>         | <b>Gross</b>      | <b>Gross</b>      | <b>Estimated</b>  |
|  | <b>Cost Basis</b>        | <b>Unrealized</b> | <b>Unrealized</b> | <b>Fair Value</b> |
|  |                          | <b>Holding</b>    | <b>Holding</b>    |                   |
|  |                          | <b>Gains</b>      | <b>Losses</b>     |                   |
| Securities held-to-maturity:   |                          |                   |                   |                   |
| Obligations of state and political subdivisions  | \$ 25,006,789            | \$ 955,447        | \$ (81,054)       | \$ 25,881,182     |
| Other  | 4,000                    |                   |                   | 4,000             |
| Mortgage-backed securities   | 1,974,781                | 19,763            | (2,767)           | 1,991,777         |

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|  |                  |              |                 |                  |
|--|------------------|--------------|-----------------|------------------|
| Total debt securities held-to-maturity   | \$ 26,985,570    | \$ 975,210   | \$ (83,821)     | \$ 27,876,959    |
| Securities available-for-sale:   |                  |              |                 |                  |
| U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 407,794,929   | \$ 102,813   | \$ (4,043,004)  | \$ 403,854,738   |
| Obligations of state and political subdivisions  | 242,747,658      | 4,788,430    | (578,364)       | 246,957,724      |
| Corporate bonds and other  | 81,433,637       | 299,939      | (231,604)       | 81,501,972       |
| Mortgage-backed securities   | 375,793,882      | 550,221      | (6,331,314)     | 370,012,789      |
| Total securities available-for-sale  | \$ 1,107,770,106 | \$ 5,741,403 | \$ (11,184,286) | \$ 1,102,327,223 |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The Company invests in mortgage-backed securities that have expected maturities that differ from their contractual maturities. These differences arise because borrowers may have the right to call or prepay obligations with or without a prepayment penalty. These securities include collateralized mortgage obligations (CMOs) and other asset backed securities. The expected maturities of these securities at December 31, 2007 and 2006, were computed by using scheduled amortization of balances and historical prepayment rates. At December 31, 2007 and 2006, the Company did not hold any CMOs that entail higher risks than standard mortgage-backed securities.

The amortized cost and estimated fair value of debt securities at December 31, 2007, by contractual and expected maturity, are shown below (in thousands):

|  | <b>Held-to-Maturity</b>             |                                 | <b>Available-for-Sale</b>       |                                 |
|--|-------------------------------------|---------------------------------|---------------------------------|---------------------------------|
|  | <b>Amortized<br/>Cost<br/>Basis</b> | <b>Estimated<br/>Fair Value</b> | <b>Amortized<br/>Cost Basis</b> | <b>Estimated<br/>Fair Value</b> |
| Due within one year                    | \$ 1,966                            | \$ 1,973                        | \$ 173,302                      | \$ 173,388                      |
| Due after one year through five years  | 22,131                              | 22,937                          | 278,609                         | 285,095                         |
| Due after five years through ten years | 615                                 | 625                             | 136,155                         | 138,340                         |
| Due after ten years                    | 334                                 | 329                             | 76,054                          | 75,655                          |
|  | 25,046                              | 25,864                          | 664,120                         | 672,478                         |
| Mortgage-backed securities             | 1,373                               | 1,389                           | 427,504                         | 429,596                         |
| Total                                  | \$ 26,419                           | \$ 27,253                       | \$ 1,091,624                    | \$ 1,102,074                    |

The following table discloses, as of December 31, 2007 and 2006, the Company's investment securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

|   | <b>Less than 12 Months</b> |                            | <b>12 Months or Longer</b> |                            | <b>Total</b>          |                            |
|---|----------------------------|----------------------------|----------------------------|----------------------------|-----------------------|----------------------------|
|   | <b>Fair<br/>Value</b>      | <b>Unrealized<br/>Loss</b> | <b>Fair<br/>Value</b>      | <b>Unrealized<br/>Loss</b> | <b>Fair<br/>Value</b> | <b>Unrealized<br/>Loss</b> |
| <b>December 31, 2007</b>  |                            |                            |                            |                            |                       |                            |
| U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 8,978                   | \$ 28                      | \$ 93,466                  | \$ 290                     | \$ 102,444            | \$ 318                     |
| Obligations of state and political subdivisions   | 40,622                     | 353                        | 26,521                     | 412                        | 67,143                | 765                        |
| Mortgage-backed securities  | 55,676                     | 80                         | 115,141                    | 1,600                      | 170,817               | 1,680                      |
| Corporate bonds   | 7,021                      | 60                         | 5,231                      | 19                         | 12,252                | 79                         |

|       |            |        |            |          |            |          |
|-------|------------|--------|------------|----------|------------|----------|
| Total | \$ 112,297 | \$ 521 | \$ 240,359 | \$ 2,321 | \$ 352,656 | \$ 2,842 |
|-------|------------|--------|------------|----------|------------|----------|

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

| <b>December 31, 2006</b>  | <b>Less than 12 Months</b> |                        | <b>12 Months or Longer</b> |                        | <b>Total</b>      |                        |
|---|----------------------------|------------------------|----------------------------|------------------------|-------------------|------------------------|
|   | <b>Fair Value</b>          | <b>Unrealized Loss</b> | <b>Fair Value</b>          | <b>Unrealized Loss</b> | <b>Fair Value</b> | <b>Unrealized Loss</b> |
| U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies | \$ 115,335                 | \$ 163                 | \$ 250,271                 | \$ 3,880               | \$ 365,606        | \$ 4,043               |
| Obligations of state and political subdivisions   | 24,557                     | 78                     | 30,860                     | 581                    | 55,417            | 659                    |
| Mortgage-backed securities  | 57,382                     | 302                    | 255,592                    | 6,032                  | 312,974           | 6,334                  |
| Corporate bonds   | 13,845                     | 32                     | 23,585                     | 200                    | 37,430            | 232                    |
| <b>Total</b>  | <b>\$ 211,119</b>          | <b>\$ 575</b>          | <b>\$ 560,308</b>          | <b>\$ 10,693</b>       | <b>\$ 771,427</b> | <b>\$ 11,268</b>       |

The number of investment positions in this unrealized loss position totaled 425 at December 31, 2007. We do not believe these unrealized losses are other than temporary as (1) the Company has the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value and, (2) it is not probable that the Company will be unable to collect the amounts contractually due. The unrealized losses noted are interest rate related due to rising short-term and intermediate interest rates during the next three years. We have reviewed the financial condition and near term prospects of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities.

Securities, carried at approximately \$640,744,000 and \$509,951,000 at December 31, 2007 and 2006, respectively, were pledged as collateral for public or trust fund deposits and for other purposes required or permitted by law.

During 2007, 2006, and 2005, sales of investment securities that were classified as available-for-sale totaled approximately \$38,531,000, \$18,513,000, and \$85,033,000 respectively. Gross realized gains and losses from 2007 securities sales were approximately \$243,000 and \$93,000, respectively. Gross realized gains and losses for 2006 sales were approximately \$104,000 and \$42,000, respectively. Gross realized gains and losses for 2005 sales were approximately \$401,000 and \$166,000, respectively. The specific identification method was used to determine cost in computing the realized gains and losses.

Certain subsidiary banks are required to maintain reserve balances with the Federal Reserve Bank. At December 31, 2007 and 2006, such balances totaled approximately \$10,127,000 and \$9,769,000, respectively.

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES:**

Major classifications of loans are as follows:

|             |                     |
|-------------|---------------------|
|             | <b>December 31,</b> |
| <b>2007</b> | <b>2006</b>         |

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|  |                  |                  |
|--|------------------|------------------|
| Commercial, financial and agricultural | \$ 493,478,236   | \$ 430,285,775   |
| Real estate construction               | 196,250,070      | 155,284,753      |
| Real estate mortgage                   | 626,145,282      | 591,892,720      |
| Consumer                               | 212,146,001      | 196,271,372      |
| Total loans                            | \$ 1,528,019,589 | \$ 1,373,734,620 |

Included in real estate-mortgage and consumer loans above are \$3.5 million and \$32.3 million, respectively, in loans held for sale at December 31, 2007 and \$5.8 million and \$31.1 million, respectively, in loans held for sale at December 31, 2006 in which the carrying amounts approximate market.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The Company's recorded investment in impaired loans and the related valuation allowance are as follows:

| <b>December 31, 2007</b>   |                            | <b>December 31, 2006</b>   |                            |
|----------------------------|----------------------------|----------------------------|----------------------------|
| <b>Recorded Investment</b> | <b>Valuation Allowance</b> | <b>Recorded Investment</b> | <b>Valuation Allowance</b> |
| \$ 3,189,067               | \$ 477,873                 | \$ 3,528,894               | \$ 433,128                 |

The average recorded investment in impaired loans for the years ended December 31, 2007, 2006, and 2005 was approximately \$3,359,000, \$3,526,000, and \$3,292,000 respectively. The Company had approximately \$4,731,000, \$4,111,000 and \$4,244,000 in nonperforming assets at December 31, 2007, 2006 and 2005, respectively. No additional funds are committed to be advanced in connection with impaired loans.

Interest payments received on impaired loans are recorded as interest income unless collections of the remaining recorded investment are doubtful, at which time payments received are recorded as reductions of principal. The Company recognized interest income on impaired loans of approximately \$100,000, \$91,000 and \$62,000 during the years ended December 31, 2007, 2006, and 2005, respectively. If interest on impaired loans had been recognized on a full accrual basis during the years ended December 31, 2007, 2006, and 2005, respectively, such income would have approximated \$358,000, \$396,000 and \$163,000.

The allowance for loan losses as of December 31, 2007 and 2006, is presented below. Management has evaluated the adequacy of the allowance for loan losses by estimating the losses in various categories of the loan portfolio which are identified below:

|  | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| Allowance for loan losses provided for:  |               |               |
| Loans specifically evaluated as impaired | \$ 477,873    | \$ 433,128    |
| Remaining portfolio                      | 16,983,641    | 15,767,676    |
| Total allowance for loan losses          | \$ 17,461,514 | \$ 16,200,804 |

Changes in the allowance for loan losses are summarized as follows:

|                              | <b>2007</b>   | <b>December 31, 2006</b> | <b>2005</b>   |
|------------------------------|---------------|--------------------------|---------------|
| Balance at beginning of year | \$ 16,200,804 | \$ 14,719,140            | \$ 13,837,133 |
| Add:                         |               |                          |               |

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|   |               |               |               |
|---|---------------|---------------|---------------|
| Provision for loan losses                       | 2,331,172     | 2,061,088     | 1,319,816     |
| Loan recoveries                                 | 727,189       | 1,241,991     | 726,445       |
| Allowance established from purchase acquisition |               |               | 792,640       |
| Deduct:   |               |               |               |
| Loan charge-offs                                | (1,797,651)   | (1,821,415)   | (1,956,894)   |
| Balance at end of year                          | \$ 17,461,514 | \$ 16,200,804 | \$ 14,719,140 |

An analysis of the changes in loans to officers, directors, principal shareholders, or associates of such persons for the year ended December 31, 2007 (determined as of each respective year-end) follows:

|                                 | <b>Beginning<br/>Balance</b> | <b>Additional<br/>Loans</b> | <b>Payments</b> | <b>Ending<br/>Balance</b> |
|---------------------------------|------------------------------|-----------------------------|-----------------|---------------------------|
| Year ended December 31,<br>2007 | \$ 54,622,140                | \$ 159,815,768              | \$ 173,111,225  | \$ 41,326,683             |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

In the opinion of management, those loans are on substantially the same terms, including interest rates and collateral requirements, as those prevailing at the time for comparable transactions with unaffiliated persons.

Certain of our subsidiary banks have established lines of credit with the Federal Home Loan Bank of Dallas to provide liquidity and meet pledging requirements for those customers eligible to have securities pledged to secure certain uninsured deposits. At December 31, 2007, approximately \$168,514,000 in loans held by these subsidiaries were subject to blanket liens as security for letters of credit issued under these lines of credit.

During the years ended December 31, 2007 and 2006, the Company sold student loans totaling \$63.9 million and \$71.7 million, respectively, recognizing net profits of \$1.9 million and \$2.1 million, respectively, to a financial institution of which an executive officer of one of our wholly owned subsidiary banks is a board member. In the opinion of management, these loan sales are on substantially the same terms as those prevailing at the time for comparable transactions with unaffiliated persons.

**4. BANK PREMISES AND EQUIPMENT:**

The following is a summary of bank premises and equipment:

|  | Useful Life                              | December 31,  |               |
|--|--|---------------|---------------|
|  |  | 2007          | 2006          |
| Land   |  | \$ 14,887,261 | \$ 13,847,704 |
| Buildings  | 20 to 40 years                           | 61,616,881    | 61,213,343    |
| Furniture and equipment                            | 3 to 10 years                            | 35,050,420    | 36,601,454    |
| Leasehold improvements                             | Lesser of lease term or 5 to<br>15 years | 4,002,984     | 8,907,623     |
|  |  | 115,557,546   | 120,570,124   |
| Less- accumulated depreciation and<br>amortization |  | (53,887,387)  | (61,102,201)  |
|  |  | \$ 61,670,159 | \$ 59,467,923 |

Depreciation expense for the years ended December 31, 2007, 2006 and 2005 amounted to \$5,789,000, \$5,964,000, and \$5,133,000, respectively and is included in the captions net occupancy expense and equipment expense in the accompanying consolidated statements of earnings.

The Company is lessor for portions of its banking premises. Total rental income for all leases included in net occupancy expense is approximately \$1,663,000, \$1,644,000 and \$1,675,000, for the years ended December 31, 2007, 2006, and 2005, respectively.

**5. TIME DEPOSITS**

Time deposits of \$100,000 or more totaled approximately \$352,216,000 and \$356,268,000 at December 31, 2007 and 2006, respectively. Interest expense on these deposits was approximately \$17,363,000, \$13,642,000, and \$7,298,000 during 2007, 2006, and 2005, respectively.

At December 31, 2007, the scheduled maturities of time deposits (in thousands) were, as follows:

|                          |            |
|--------------------------|------------|
| Year ending December 31, |            |
| 2008                     | \$ 688,025 |
| 2009                     | 56,493     |
| 2010                     | 15,207     |
| 2011                     | 7,877      |
| 2012                     | 6,432      |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Deposits received from related parties at December 31, 2007 totaled \$111,658,000.

**6. LINE OF CREDIT**

Effective December 31, 2007, the Company renewed its line of credit with a nonaffiliated bank under which it can borrow up to \$50.0 million. The line of credit is unsecured for outstanding balances less than \$25.0 million and secured by stock of a subsidiary bank if amounts borrowed exceed \$25.0 million. The line of credit matures on December 31, 2008. The Company paid no fee to secure the unused line of credit and, accordingly, did not estimate a fair value of the unused line of credit at December 31, 2007 or 2006. The line of credit carries an interest rate of the London Interbank Offering Rate plus 1.0%. If a balance exists at December 31, 2008, the principal balance converts to a term facility payable quarterly over five years. Among other provisions in the credit agreement, the Company must satisfy certain financial covenants during the term of the loan agreement, including without limitation, covenants that require the Company to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratios. In addition, the credit agreement contains certain operational covenants, which among others, restrict the payment of dividends above 55% of consolidated net income, limit the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibit the disposal of assets except in the ordinary course of business. Management believes the Company was in compliance with the financial covenants at December 31, 2007 and 2006. There was no outstanding balance under the line of credit as of December 31, 2007 or 2006.

**7. INCOME TAXES:**

The Company files a consolidated federal income tax return. Income tax expense is comprised of the following:

|   | <b>Year Ended December 31,</b> |               |               |
|---|--------------------------------|---------------|---------------|
|   | <b>2007</b>                    | <b>2006</b>   | <b>2005</b>   |
| Current federal income tax                    | \$ 19,681,877                  | \$ 19,334,533 | \$ 18,097,847 |
| Current state income tax                      | 290,567                        | 118,861       | 161,313       |
| Deferred federal income tax expense (benefit) | 464,397                        | (26,625)      | 277,545       |
| Income tax expense                            | \$ 20,436,841                  | \$ 19,426,769 | \$ 18,536,705 |

Income tax expense, as a percentage of pretax earnings, differs from the statutory federal income tax rate as follows:

|  | <b>As a Percent of Pretax Earnings</b> |             |             |
|--|--|-------------|-------------|
|  | <b>2007</b>                            | <b>2006</b> | <b>2005</b> |
| Statutory federal income tax rate  | 35.0%                                  | 35.0%       | 35.0%       |
| Reductions in tax rate resulting from interest income exempt from federal income tax | (6.6)%                                 | (5.8)%      | (5.4)%      |

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|                            |        |        |        |
|----------------------------|--------|--------|--------|
| Effect of state income tax | 0.4%   | 0.2%   | 0.3%   |
| ESOP tax credit            | (0.4)% | (0.4)% | (0.3)% |
| Other                      | 0.8%   | 0.7%   | 0.0%   |
| Effective income tax rate  | 29.2%  | 29.7%  | 29.6%  |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The approximate effects of each type of difference that gave rise to the Company's deferred tax assets and liabilities at December 31, 2007 and 2006 are as follows:

|   | <b>2007</b>           | <b>2006</b>         |
|---|-----------------------|---------------------|
| Deferred tax assets:  |                       |                     |
| Tax basis of loans in excess of financial statement basis   | \$ 5,873,531          | \$ 5,274,589        |
| Minimum liability in defined benefit plan   | 1,595,422             | 1,639,031           |
| Recognized for financial reporting purposes but not for tax purposes:                               |                       |                     |
| Deferred compensation   | 1,324,188             | 1,264,867           |
| Write-downs and adjustments to other real estate owned and repossessed assets                       |                       | 13,172              |
| Net unrealized loss on investment securities available-for-sale                                     |                       | 1,905,009           |
| Other deferred tax assets   | 256,674               | 334,929             |
| <b>Total deferred tax assets</b>  | <b>9,049,815</b>      | <b>10,431,597</b>   |
| Deferred tax liabilities:   |                       |                     |
| Financial statement basis of fixed assets in excess of tax basis                                    | 967,135               | 1,107,379           |
| Intangible asset amortization deductible for tax purposes, but not for financial reporting purposes | 4,075,928             | 3,397,169           |
| Recognized for financial reporting purposes but not for tax purposes:                               |                       |                     |
| Accretion on investment securities  | 1,050,873             | 1,011,229           |
| Pension plan contributions  | 621,140               | 204,550             |
| Net unrealized gain on investment securities Available-for-sale                                     | 3,651,026             |                     |
| Other deferred tax liabilities  | 302,598               | 266,114             |
| <b>Total deferred tax liabilities</b>   | <b>10,668,700</b>     | <b>5,986,441</b>    |
| <b>Net deferred tax asset (liability)</b>   | <b>\$ (1,618,885)</b> | <b>\$ 4,445,156</b> |

The Company adopted the provisions of FIN 48 in 2007. The adoption did not have a significant impact on the Company's financial position, results of operations or cash flow. The Company files income tax returns in the U.S. federal jurisdiction and is no longer subject to U.S. federal income tax examinations by tax authorities for the years before 2004.

**8. FAIR VALUE OF FINANCIAL INSTRUMENTS:**

The Company is required to disclose the estimated fair value of its financial instrument assets and liabilities. For the Company, as for most financial institutions, substantially all of its assets and liabilities are considered financial instruments as defined. Many of the Company's financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction.

Estimated fair values have been determined by the Company using the best available data, as generally provided in the Company's regulatory reports, and an estimation methodology suitable for each category of financial instruments. For those loans and deposits with floating interest rates, it is presumed that estimated fair values generally approximate the carrying value.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The estimated fair values and carrying values at December 31, 2007 and 2006, were as follows:

|                                    | 2007           |                      | 2006           |                      |
|------------------------------------|----------------|----------------------|----------------|----------------------|
|                                    | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Cash and due from banks            | \$ 163,559,942 | \$ 163,559,942       | \$ 127,419,210 | \$ 127,419,210       |
| Federal funds sold                 | 99,450,000     | 99,450,000           | 64,485,000     | 64,485,000           |
| Interest-bearing deposits in banks | 1,878,434      | 1,878,434            | 1,072,443      | 1,072,443            |
| Investment securities              | 1,128,492,676  | 1,129,327,003        | 1,129,312,793  | 1,130,204,182        |
| Net loans                          | 1,510,558,075  | 1,518,677,572        | 1,357,533,816  | 1,342,010,615        |
| Accrued interest receivable        | 21,834,040     | 21,834,040           | 22,756,488     | 22,756,488           |
| Deposits with stated maturities    | 774,033,645    | 778,371,624          | 781,773,003    | 781,843,732          |
| Deposits with no stated maturities | 1,772,049,373  | 1,772,049,373        | 1,602,251,044  | 1,602,251,044        |
| Short term borrowings              | 166,266,426    | 166,266,426          | 143,244,347    | 143,244,347          |
| Accrued interest payable           | 4,654,496      | 4,654,496            | 4,366,876      | 4,366,876            |

Financial instruments actively traded in a secondary market have been valued using quoted available market prices. Financial instruments with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities. Financial instrument assets with variable rates and financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value. Changes in assumptions or estimation methodologies may have a material effect on these estimated fair values.

The carrying value and the estimated fair value of the Company's contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

Reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates which must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

**9. COMMITMENTS AND CONTINGENCIES:**

The Company is engaged in legal actions arising from the normal course of business. In management's opinion, the Company has adequate legal defenses with respect to these actions, and the resolution of these matters will have no material adverse effects upon the results of operations or financial condition of the Company.

The Company leases a portion of its bank premises and equipment under operating leases. At December 31, 2007, future minimum lease commitments were: 2008 - \$630,000; 2009 \$545,000; 2010 \$398,000; 2011 \$342,000; 2012

\$147,000 and thereafter \$12,000.

**10. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK:**

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include unfunded lines of credit, commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for unfunded lines of credit, commitments to extend credit and standby letters of credit is represented by the contractual notional amount of these instruments. The Company generally uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

|   | <b>Contract or<br/>Notional Amount at<br/>December 31, 2007</b> |
|---|---|
| Financial instruments whose contract amounts represent credit risk: |   |
| Unfunded lines of credit  | \$ 238,313,000  |
| Unfunded commitments to extend credit                               | 80,596,000  |
| Standby letters of credit   | 10,896,000  |
|   | \$ 329,805,000  |

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment, livestock, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The average collateral value held on letters of credit usually exceeds the contract amount.

The Company has no other off-balance sheet arrangements or transactions that would expose the Company to liability that is not reflected on the face of the financial statements.

**11. CONCENTRATION OF CREDIT RISK:**

The Company grants commercial, retail, agriculture and residential real estate loans to customers primarily in North Central and West Texas. Although the Company has a diversified loan portfolio, a substantial portion of its debtors ability to honor their contracts is dependent upon this local economic sector. In addition, the Company holds mortgage-backed securities which are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

**12. PENSION AND PROFIT SHARING PLANS:**

The Company's defined benefit pension plan was frozen effective January 1, 2004 whereby no additional years of service accrue to participants, unless the pension plan is reinstated at a future date. The pension plan covered substantially all of the Company's employees. The benefits were based on years of service and a percentage of the employee's qualifying compensation during the final years of employment. The Company's funding policy was and is to contribute annually the amount necessary to satisfy the Internal Revenue Service's funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of freezing the pension plan, we did not expect contributions or pension expense to be significant in future years. However, as a result of the Pension Protection Act of 2006, the Company will be required to contribute amounts over seven years to fund any shortfalls. The Company evaluated the provisions of the Act as well as Internal Revenue Service's funding standards to develop a preliminary plan for funding in future years. The Company made a contribution totaling

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

\$1.5 million in 2007 and is continuing to evaluate future funding amounts. The Company did not make a contribution to the pension plan during the year ended December 31, 2006, as permitted by the Internal Revenue Service's funding standards.

Using an actuarial measurement date of September 30, benefit obligation activity and fair value of plan assets for the years ended December 31, 2007 and 2006, and a statement of the funded status as of December 31, 2007 and 2006 are as follows:

|  | <b>2007</b>    | <b>2006</b>    |
|--|----------------|----------------|
| Reconciliation of benefit obligations:   |                |                |
| Benefit obligation at January 1  | \$ 18,471,240  | \$ 17,942,586  |
| Interest cost on projected benefit obligation  | 1,111,110      | 1,045,011      |
| Actuarial loss   | 942,799        | 318,952        |
| Benefits paid  | (912,732)      | (835,309)      |
| <br>   |                |                |
| Benefit obligation at December 31  | 19,612,417     | 18,471,240     |
| Reconciliation of fair value of plan assets:   |                |                |
| Fair value of plan assets at January 1   | 14,372,733     | 14,354,993     |
| Actual return on plan assets   | 1,868,738      | 853,049        |
| Employer contributions   | 1,500,000      |                |
| Benefits paid  | (912,732)      | (835,309)      |
| <br>   |                |                |
| Fair value of plan assets at December 31   | 16,828,739     | 14,372,733     |
| <br>   |                |                |
| Funded status  | \$ (2,783,678) | \$ (4,098,507) |
| Reconciliation of funded status to accrued pension liability:  |                |                |
| Funded status at December 31   | \$ (2,783,678) | \$ (4,098,507) |
| Unrecognized loss from past experience different than that assumed and effects of changes in assumptions | 4,881,178      | 5,005,749      |
| Additional minimum liability recorded  | (4,881,178)    | (5,005,749)    |
| <br>   |                |                |
| Accrued pension liability  | \$ (2,783,678) | \$ (4,098,507) |

In September 2006, SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R) was issued which required an employer to recognize the overfunded or underfunded status of defined benefit post-retirement benefit plans as an asset or a liability in its balance sheet. The funded status is measured as the difference between plan assets at fair value and the benefit obligation. An employer is also required to measure the funded status of a plan as of the date of its year end statement of financial position with changes in the funded status recognized through comprehensive income.

SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses. Under SFAS 158, the Company was required to recognize the funded status of its defined benefit post-retirement benefit plan in its financial statements for the year ended December 31, 2006. The Company had previously recognized the funded status of its pension plans in prior financial statements. The requirement to measure plan assets and benefit obligations as of the date of the year-end statement of financial position is effective for the Company's financial statements beginning with the year ending December 31, 2008.



**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Net periodic pension cost for the years ended December 31, 2007, 2006, and 2005, included:

|  | <b>Year Ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2007</b>                    | <b>2006</b> | <b>2005</b> |
| Service cost – benefits earned during the period | \$                             | \$          | \$          |
| Interest cost on projected benefit obligation    | 1,111,110                      | 1,045,011   | 1,013,104   |
| Expected return on plan assets                   | (998,838)                      | (901,938)   | (1,117,278) |
| Amortization of unrecognized net loss            | 197,470                        | 193,780     | 116,473     |
| Net periodic pension cost                        | \$ 309,742                     | \$ 336,853  | \$ 12,299   |

The following table sets forth the rates used in the actuarial calculations of the present value of benefit obligations and net periodic pension cost and the rate of return on plan assets:

|  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| Weighted average discount rate                 | 5.85%       | 5.85%       | 5.85%       |
| Rate of increase in future compensation levels |             |             |             |
| Expected long-term rate of return on assets    | 6.50%       | 6.50%       | 7.75%       |

The expected long-term rate of return on plan assets is based on historical returns and expectations of future returns based on asset mix, after consultation with our investment advisors and actuaries. The weighted average discount rate is estimated based on setting a discount rate to establish an obligation for pension benefits equivalent to an amount that, if invested in high quality fixed income securities, would produce a return that matches the expected benefit payment stream.

The major type of plan assets in the pension plan and the targeted allocation percentage as of December 31, 2007 and 2006 is as follows:

|                      | <b>December 31,<br/>2007<br/>Allocation</b> | <b>December 31,<br/>2006<br/>Allocation</b> | <b>Targeted<br/>Allocation</b> |
|----------------------|---|---|--------------------------------|
| Equity securities    | 71%   | 60%   | 75%                            |
| Debt securities      | 23%   | 38%   | 25%                            |
| Cash and equivalents | 6%  | 2%  |                                |

The range and weighted average final maturities of debt securities held in the pension plan as of December 31, 2007 are 2 to 20 years and approximately 7.1 years, respectively.

First Financial Trust & Asset Management Company, National Association, a wholly owned subsidiary of the Company, manages the pension plan assets as well as the profit sharing plan assets (see below). The investment strategy and targeted allocations are based on similar strategies First Financial Trust & Asset Management Company, National Association employs for most of its managed accounts whereby appropriate diversification is achieved. First Financial Trust & Asset Management Company, National Association is prohibited from holding investments deemed to be high risk by the Office of the Comptroller of the Currency.

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

An estimate of the undiscounted projected future payments to eligible participants for the next five years and the following five years in the aggregate is as follows (dollars in thousands):

|                          |          |
|--------------------------|----------|
| Year Ending December 31, |          |
| 2008                     | \$ 1,146 |
| 2009                     | 1,202    |
| 2010                     | 1,289    |
| 2011                     | 1,388    |
| 2012                     | 1,465    |
| 2013 to 2017             | 7,928    |

As of December 31, 2007 and 2006, the pension plan's assets included Company common stock valued at approximately \$773,000 and \$860,000, respectively.

The Company also provides a profit sharing plan, which covers substantially all full-time employees. The profit sharing plan is a defined contribution plan and allows employees to contribute a percentage of their base annual salary. Employees are fully vested to the extent of their contributions and become fully vested in the Company's contributions over a six-year vesting period. Costs related to the Company's defined contribution plan totaled approximately \$3,219,000, \$2,116,000, and \$2,072,000 in 2007, 2006 and 2005, respectively, and are included in salaries and employee benefits in the accompanying consolidated statements of earnings. As of December 31, 2007 and 2006, the profit sharing plan's assets included Company common stock valued at approximately \$20,709,000 and \$23,448,000, respectively.

In 2004, after freezing our pension plan, we added a safe harbor match to the 401(k) plan. We match a maximum of 4% on employee deferrals of 5% of their employee compensation. Total expense for this matching in 2007, 2006 and 2005 was \$1,127,000, \$1,041,000 and \$868,000, respectively, and is included in salaries and employee benefits in the statements of earnings.

The Company has a directors' deferred compensation plan whereby the directors may elect to defer up to 100% of their directors' fees. All deferred compensation is invested in the Company's common stock held in a rabbi trust. The stock is held in nominee name of the trustee, and the principal and earnings of the trust are held separate and apart from other funds of the Company, and are used exclusively for the uses and purposes of the deferred compensation agreement. The accounts of the trust have been consolidated in the financial statements of the Company.

**13. DIVIDENDS FROM SUBSIDIARIES:**

At December 31, 2007, approximately \$31.9 million was available for the declaration of dividends by the Company's subsidiary banks without the prior approval of regulatory agencies.

**14. REGULATORY MATTERS:**

The Company is subject to various regulatory capital requirements administered by the 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 Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, each of Bankshares subsidiaries must meet specific capital guidelines that involve quantitative measures of the subsidiaries' assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The subsidiaries' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Quantitative measures established by regulation to ensure capital adequacy require the Company and each of its subsidiaries to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes as of December 31, 2007 and 2006, that Bankshares and each of its subsidiaries meet all capital adequacy requirements to which they are subject.

As of December 31, 2007 and 2006, the most recent notification from each respective subsidiary's primary regulator categorized each of the Company's subsidiaries as well-capitalized, except that Hereford State Bank's total risk-based capital ratio was 9.92% versus the well-capitalized minimum of 10%. To be categorized as well-capitalized, the subsidiaries must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table.

There are no conditions or events since that notification that management believes have changed the institutions categories. Bankshares and its significant subsidiaries' actual capital amounts and ratios are presented in the table below:

|  | <b>Actual</b>  |              | <b>For Capital</b>          |                  | <b>To Be Well</b>          |                           | <b>Capitalized Under</b> |
|--|----------------|--------------|-----------------------------|------------------|----------------------------|---------------------------|--------------------------|
|  | <b>Amount</b>  | <b>Ratio</b> | <b>Adequacy Purposes:</b>   | <b>Ratio</b>     | <b>Prompt Corrective</b>   | <b>Action Provisions:</b> | <b>Ratio</b>             |
|  |                |              | <b>Amount</b>               |                  | <b>Amount</b>              |                           |                          |
| As of December 31, 2007:                         |                |              |                             |                  |                            |                           |                          |
| <i>Total Capital (to Risk-Weighted Assets):</i>  |                |              |                             |                  |                            |                           |                          |
| Consolidated                                     | \$ 284,250,000 | 16%          | <sup>3</sup> \$ 145,546,000 | <sup>3</sup> 38% |                            | N/A                       | <sup>3</sup> 10%         |
| First Financial Bank-Abilene                     | \$ 71,985,000  | 12%          | <sup>3</sup> \$ 46,696,000  | <sup>3</sup> 38% | <sup>3</sup> \$ 58,370,000 |                           | <sup>3</sup> 10%         |
| San Angelo National Bank                         | \$ 31,915,000  | 18%          | <sup>3</sup> \$ 14,289,000  | <sup>3</sup> 38% | <sup>3</sup> \$ 17,861,000 |                           | <sup>3</sup> 10%         |
| Weatherford National Bank                        | \$ 24,211,000  | 14%          | <sup>3</sup> \$ 14,294,000  | <sup>3</sup> 38% | <sup>3</sup> \$ 17,868,000 |                           | <sup>3</sup> 10%         |
| First Financial                                  |                |              |                             |                  |                            |                           |                          |
| Bank-Stephenville                                | \$ 26,118,000  | 12%          | <sup>3</sup> \$ 17,154,000  | <sup>3</sup> 38% | <sup>3</sup> \$ 21,443,000 |                           | <sup>3</sup> 10%         |
| First Financial                                  |                |              |                             |                  |                            |                           |                          |
| Bank-Southlake                                   | \$ 24,613,000  | 13%          | <sup>3</sup> \$ 15,461,000  | <sup>3</sup> 38% | <sup>3</sup> \$ 19,326,000 |                           | <sup>3</sup> 10%         |
| <i>Tier I Capital (to Risk-Weighted Assets):</i> |                |              |                             |                  |                            |                           |                          |
| Consolidated                                     | \$ 266,738,000 | 15%          | <sup>3</sup> \$ 72,773,000  | <sup>3</sup> 34% |                            | N/A                       | <sup>3</sup> 6%          |
| First Financial Bank-Abilene                     | \$ 67,201,000  | 12%          | <sup>3</sup> \$ 23,348,000  | <sup>3</sup> 34% | <sup>3</sup> \$ 35,022,000 |                           | <sup>3</sup> 6%          |
| San Angelo National Bank                         | \$ 30,418,000  | 17%          | <sup>3</sup> \$ 7,144,000   | <sup>3</sup> 34% | <sup>3</sup> \$ 10,717,000 |                           | <sup>3</sup> 6%          |
| Weatherford National Bank                        | \$ 22,505,000  | 13%          | <sup>3</sup> \$ 7,147,000   | <sup>3</sup> 34% | <sup>3</sup> \$ 10,721,000 |                           | <sup>3</sup> 6%          |
| First Financial                                  |                |              |                             |                  |                            |                           |                          |
| Bank-Stephenville                                | \$ 23,814,000  | 11%          | <sup>3</sup> \$ 8,577,000   | <sup>3</sup> 34% | <sup>3</sup> \$ 12,866,000 |                           | <sup>3</sup> 6%          |
| First Financial                                  |                |              |                             |                  |                            |                           |                          |
| Bank-Southlake                                   | \$ 22,516,000  | 12%          | <sup>3</sup> \$ 7,730,000   | <sup>3</sup> 34% | <sup>3</sup> \$ 11,596,000 |                           | <sup>3</sup> 6%          |
| <i>Tier I Capital (to Average Assets):</i>       |                |              |                             |                  |                            |                           |                          |
| Consolidated                                     | \$ 266,738,000 | 9%           | <sup>3</sup> \$ 86,669,000  | <sup>3</sup> 33% |                            | N/A                       | <sup>3</sup> 5%          |

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|                                      |               |     |                            |                 |                            |                 |
|--------------------------------------|---------------|-----|----------------------------|-----------------|----------------------------|-----------------|
| First Financial Bank-Abilene         | \$ 67,201,000 | 7%  | <sup>3</sup> \$ 28,574,000 | <sup>33</sup> % | <sup>3</sup> \$ 47,624,000 | <sup>35</sup> % |
| San Angelo National Bank             | \$ 30,418,000 | 10% | <sup>3</sup> \$ 9,342,000  | <sup>33</sup> % | <sup>3</sup> \$ 15,571,000 | <sup>35</sup> % |
| Weatherford National Bank            | \$ 22,505,000 | 7%  | <sup>3</sup> \$ 10,134,000 | <sup>33</sup> % | <sup>3</sup> \$ 16,891,000 | <sup>35</sup> % |
| First Financial<br>Bank-Stephenville | \$ 23,814,000 | 8%  | <sup>3</sup> \$ 9,260,000  | <sup>33</sup> % | <sup>3</sup> \$ 15,433,000 | <sup>35</sup> % |
| First Financial<br>Bank-Southlake    | \$ 22,516,000 | 8%  | <sup>3</sup> \$ 8,294,000  | <sup>33</sup> % | <sup>3</sup> \$ 13,824,000 | <sup>35</sup> % |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****15. STOCK OPTION PLAN:**

The Company has an incentive stock plan to provide for the granting of options to senior management of the Company at prices not less than market at the date of grant. At December 31, 2007, the Company had allocated 847,029 shares of stock for issuance under the plan. The plan provides that options granted are exercisable after two years from date of grant at a rate of 20% each year cumulatively during the 10-year term of the option. An analysis of stock option activity for the year ended December 31, 2007 is presented in the table and narrative below:

|                                | Shares   | Weighted-Average<br>Ex. Price | Weighted-Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value (\$000) |
|--------------------------------|----------|-------------------------------|--|---|
| Outstanding, beginning of year | 210,727  | \$ 25.23                      |  |   |
| Granted                        | 90,500   | 40.98                         |  |   |
| Exercised                      | (27,721) | 19.00                         |  |   |
| Cancelled                      | (7,332)  | 34.03                         |  |   |
| Outstanding, end of year       | 266,174  | \$ 30.99                      | 6.68   | \$ 1,772                                |
| Exercisable at end of year     | 70,191   | \$ 19.37                      | 3.74   | \$ 1,283                                |

The options outstanding at December 31, 2007, had exercise prices ranging between \$12.48 and \$40.98 with a weighted average remaining contractual life of 4.67 years. Stock options have been adjusted retroactively for the effects of stock dividends and splits.

The following table summarizes information concerning outstanding and vested stock options as of December 31, 2007:

| Exercise Price | Number<br>Outstanding | Remaining<br>Contracted<br>Life<br>(Years) | Number Vested |
|----------------|-----------------------|--|---------------|
| \$17.57        | 8,142                 | 0.2  | 8,142         |
| 12.48          | 23,520                | 2.2  | 23,520        |
| 18.30          | 2,333                 | 4.1  | 1,665         |
| 23.10          | 60,730                | 5.3  | 32,038        |
| 33.08          | 83,349                | 7.1  | 16,798        |
| 40.98          | 88,100                | 9.1  | 300           |



From inception of the plan until December 31, 2005, the Company accounted for this plan under APB 25 under which no compensation cost has been recognized for options granted. Effective January 1, 2006, the Company accounted for this plan under SFAS No. 123R whereby the fair value of options is recognized as compensation expense over the vesting period. The fair value of the options granted in 2007 and 2005, was estimated using the Black-Scholes options pricing model with the following weighted-average assumptions: risk-free interest rate of 4.26% and 4.40%; expected dividend yield of 3.39% and 3.02%; expected life of 5.61 years and 5.60 years; and expected volatility of 18.4% and 20.5%.

The weighted-average grant-date fair value of options granted during the year ended December 31, 2007 and 2005 was \$7.31 and \$6.23, respectively. There were no grants during 2006. The total intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005, was \$1,126,000, \$495,000 and \$702,000 respectively.

As of December 31, 2007, there was \$762,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 2.1 years. The total fair value of shares vested during the years ended December 31, 2007, 2006, and 2005 was \$181,000, \$103,000 and \$116,000 respectively.

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

The aggregate intrinsic value of vested stock options at December 31, 2007 totaled \$1,330,000.

**16. CONDENSED FINANCIAL INFORMATION - PARENT COMPANY:****Condensed Balance Sheets-December 31, 2007 and 2006**

|   | <b>2007</b>    | <b>2006</b>    |
|---|----------------|----------------|
| <b>ASSETS</b>   |                |                |
| Cash in subsidiary bank                               | \$ 6,855,875   | \$ 5,808,149   |
| Cash in unaffiliated bank                             | 4,859          | 4,760          |
| Interest-bearing deposits in subsidiary banks         | 29,760,871     | 14,109,723     |
| Total cash and cash equivalents                       | 36,621,605     | 19,922,632     |
| Investment in and advances to subsidiaries, at equity | 305,194,582    | 286,789,901    |
| Intangible assets                                     | 723,375        | 723,375        |
| Other assets  | 589,828        | 432,810        |
| Total assets  | \$ 343,129,390 | \$ 307,868,718 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>            |                |                |
| Total liabilities                                     | \$ 7,633,928   | \$ 6,967,680   |
| Shareholders' equity:                                 |                |                |
| Common stock  | 207,669        | 207,392        |
| Capital surplus                                       | 267,136,338    | 266,271,930    |
| Retained earnings                                     | 64,333,921     | 41,003,600     |
| Accumulated other comprehensive earnings (loss)       | 3,817,534      | (6,581,884)    |
| Total shareholders' equity                            | 335,495,462    | 300,901,038    |
| Total liabilities and shareholders' equity            | \$ 343,129,390 | \$ 307,868,718 |

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****Condensed Statements of Earnings****For the Years Ended December 31, 2007, 2006, and 2005**

|   | <b>2007</b>   | <b>2006</b>   | <b>2005</b>   |
|---|---------------|---------------|---------------|
| Income:   |               |               |               |
| Cash dividends from subsidiary banks                  | \$ 42,275,000 | \$ 39,726,766 | \$ 29,312,753 |
| Excess of earnings over dividends of subsidiary banks | 8,219,675     | 7,660,591     | 15,963,918    |
| Other income  | 1,737,370     | 1,052,705     | 1,148,038     |
|   | 52,232,045    | 48,440,062    | 46,424,709    |
| Expenses:   |               |               |               |
| Salaries and employee benefits                        | 1,936,884     | 1,783,904     | 1,488,550     |
| Other operating expenses                              | 1,690,594     | 1,704,905     | 1,899,697     |
|   | 3,627,478     | 3,488,809     | 3,388,247     |
| Earnings before income taxes                          | 48,604,567    | 44,951,253    | 43,036,462    |
| Income tax benefit                                    | 885,038       | 1,077,963     | 986,518       |
| Net earnings  | \$ 49,489,605 | \$ 46,029,216 | \$ 44,022,980 |

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****Condensed Statements of Cash Flows****For the Years Ended December 31, 2007, 2006, and 2005**

|   | <b>2007</b>   | <b>2006</b>   | <b>2005</b>   |
|---|---------------|---------------|---------------|
| Cash flows from operating activities:   |               |               |               |
| Net earnings  | \$ 49,489,605 | \$ 46,029,216 | \$ 44,022,980 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |               |               |               |
| Excess of earnings over dividends of subsidiary banks                               | (8,219,675)   | (7,660,591)   | (15,963,918)  |
| Depreciation  | 39,501        | 54,268        | 54,192        |
| Decrease (increase) in other assets   | (182,548)     | 329,034       | (13,894)      |
| (Decrease) increase in liabilities  | (514,736)     | 277,742       | (187,836)     |
| Net cash provided by operating activities   | 40,612,147    | 39,029,669    | 27,911,524    |
| Cash flows from investing activities:   |               |               |               |
| Purchases of bank premises and equipment  | (12,268)      | (9,441)       | (21,371)      |
| Repayment from (of advances related to) investment in and advances to subsidiaries  | 500,000       | (3,300,000)   | (28,569,433)  |
| Net cash provided by (used in) investing activities                                 | 487,732       | (3,309,441)   | (28,590,804)  |
| Cash flows from financing activities:   |               |               |               |
| Proceeds of stock issuances   | 526,636       | 440,716       | 428,176       |
| Cash dividends paid   | (24,927,542)  | (24,011,155)  | (23,003,227)  |
| Net cash used in financing activities   | (24,400,906)  | (23,570,439)  | (22,575,051)  |
| Net increase (decrease) in cash and cash equivalents                                | 16,698,973    | 12,149,789    | (23,254,331)  |
| Cash and cash equivalents, beginning of year  | 19,922,632    | 7,772,843     | 31,026,814    |
| Cash and cash equivalents, end of year  | \$ 36,621,605 | \$ 19,922,632 | \$ 7,772,483  |

**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)****17. ACQUISITIONS:**

On October 25, 2004, we entered into a stock purchase agreement with the shareholders of Clyde Financial Corporation, the parent company of The Peoples State Bank in Clyde, Texas. On February 1, 2005, the transaction was completed. Pursuant to the purchase agreement, we paid approximately \$25.4 million for all of the outstanding shares of Clyde Financial Corporation.

At closing, Clyde Financial Corporation and The Peoples State bank were merged into our wholly owned bank subsidiary, First Financial Bank, National Association, Abilene. The total purchase price exceeded the estimated fair value of tangible net assets acquired by approximately \$13.2 million, of which approximately \$1.9 million was assigned to an identifiable intangible asset with the balance recorded by the Company as goodwill. The identifiable intangible asset represents the future benefit associated with the acquisition of the core deposits and is being amortized over seven years, utilizing a method that approximates the expected attrition of the deposits.

The primary purpose of the acquisition was to expand the Company's market share near Abilene and along Interstate Highway 20 in West Texas. Factors that contributed to a purchase price resulting in goodwill include Peoples' historic record of earnings and its geographic location which complements the Company's existing service locations. The results of operations from this acquisition are included in the consolidated earnings of the Company commencing February 1, 2005.

The following is a condensed balance sheet disclosing the preliminary estimated fair value amounts assigned to the major asset and liability categories at the acquisition date.

| <b>ASSETS</b>                                     |  |                       |
|---|--|-----------------------|
| Cash and cash equivalents                         |  | \$ 24,269,306         |
| Interest-bearing deposit in banks                 |  | 8,500,000             |
| Investment in securities                          |  | 34,480,602            |
| Loans, net  |  | 56,267,932            |
| Goodwill  |  | 11,312,847            |
| Identifiable intangible asset                     |  | 1,914,606             |
| Other assets                                      |  | 3,151,450             |
| <b>Total assets</b>                               |  | <b>\$ 139,896,743</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |  |                       |
| Deposits  |  | \$ 113,890,662        |
| Other liabilities                                 |  | 610,081               |
| Shareholders' equity                              |  | 25,396,000            |
| <b>Total liabilities and shareholders' equity</b> |  | <b>\$ 139,896,743</b> |

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Goodwill recorded in the acquisition of The Peoples State Bank will be accounted for in accordance with SFAS No. 142. Accordingly, goodwill will not be amortized, but will be tested for impairment annually. The goodwill and identifiable intangible asset recorded are not expected to be deductible for federal income tax purposes.

Cash flow information relative to the acquisition of Clyde Financial Corporation is as follows:

|  |                |
|--|----------------|
| Fair value of assets acquired                                  | \$ 139,896,743 |
| Cash paid for the capital stock of Clyde Financial Corporation | 25,396,000     |
| Liabilities assumed  | \$ 114,500,743 |

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**FIRST FINANCIAL BANKSHARES,INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

We believe the proforma impact of this acquisition to the Company's financial statements is insignificant.

The main office of the former The Peoples State Bank was located in the City of Clyde, Callahan County, Texas, approximately 12 miles east of Abilene, Texas. The bank also operated offices in Moran, Ranger and Rising Star, Texas, for a total of 4 banking offices. Effective April 1, 2005, First Financial Bank, National Association, Abilene sold the Ranger and Rising Star banking offices acquired from The Peoples State Bank to another of our wholly owned banking subsidiaries, First Financial Bank, National Association, Eastland, Texas. The Ranger, Rising Star and Eastland offices are located in Eastland County. This transaction had no impact on our consolidated financial statements.

On August 10, 2005, we entered into an agreement and plan of merger with Bridgeport Financial Corporation, the parent company of The First National Bank of Bridgeport, Bridgeport, Texas. On December 1, 2005, the transaction was completed. Pursuant to the agreement, we paid \$20.1 million, plus the assumption of \$5.5 million in debt and trust preferred securities, for all of the outstanding shares of Bridgeport Financial Corporation.

At closing, Bridgeport Financial Corporation was merged into First Financial Bankshares of Delaware, Inc. and The First National Bank of Bridgeport was merged with our wholly owned bank subsidiary, First Financial Bank, National Association, Southlake. The total purchase price exceeded the estimated fair value of tangible net assets acquired by approximately \$14.7 million, of which approximately \$2.3 million was assigned to an identifiable intangible asset with the balance recorded by the Company as goodwill. The identifiable intangible asset represents the future benefit associated with the acquisition of the core deposits and is being amortized over seven years, utilizing a method that approximates the expected attrition of the deposits.

The primary purpose of the acquisition was to expand the Company's market share near Dallas/Ft. Worth, Texas and along Interstate Highway 35 in North Central Texas. Factors that contributed to a purchase price resulting in goodwill include Bridgeport's historic record of earnings and its geographic location which complements the Company's existing service locations. The results of operations from this acquisition are included in the consolidated earnings of the Company commencing December 1, 2005.

The following is a condensed balance sheet disclosing the preliminary estimated fair value amounts assigned to the major asset and liability categories at the acquisition date.

| <b>ASSETS</b>                 |                       |
|-------------------------------|-----------------------|
| Cash and cash equivalents     | \$ 27,805,513         |
| Investment in securities      | 45,334,311            |
| Loans, net                    | 65,863,055            |
| Goodwill                      | 12,409,306            |
| Identifiable intangible asset | 2,309,958             |
| Other assets                  | 7,411,284             |
| <b>Total assets</b>           | <b>\$ 161,133,427</b> |

**LIABILITIES AND SHAREHOLDERS EQUITY**

|   |                |
|---|----------------|
| Deposits                                  | \$ 131,997,602 |
| Other liabilities                         | 9,084,203      |
| Shareholders equity                       | 20,051,622     |
| Total liabilities and shareholders equity | \$ 161,133,427 |

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**FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Continued)**

Goodwill recorded in the acquisition of Bridgeport will be accounted for in accordance with SFAS No. 142. Accordingly, goodwill will not be amortized, but will be tested for impairment annually. The goodwill and identifiable intangible asset recorded are expected to be deductible for federal income tax purposes.

Cash flow information relative to the acquisition of Bridgeport is as follows:

|   |                |
|---|----------------|
| Fair value of assets acquired                                       | \$ 161,133,427 |
| Cash paid for the capital stock of Bridgeport Financial Corporation | 20,051,622     |
| Liabilities assumed   | \$ 141,081,805 |

We believe the proforma impact of this acquisition to the Company's financial statements is insignificant.

The First National Bank of Bridgeport is located in the City of Bridgeport, Wise County, Texas, approximately 35 miles northwest of Fort Worth, Texas. The bank also operated offices in Boyd and Decatur, Texas, for a total of three offices. The First National Bank of Bridgeport was established in 1907.

**18. CASH FLOW INFORMATION:**

Supplemental information on cash flows and noncash transactions is as follows:

|   | <b>Year Ended December 31,</b> |               |               |
|---|--------------------------------|---------------|---------------|
|   | <b>2007</b>                    | <b>2006</b>   | <b>2005</b>   |
| Supplemental cash flow information:                     |                                |               |               |
| Interest paid   | \$ 58,269,719                  | \$ 47,598,695 | \$ 26,964,956 |
| Federal income taxes paid                               | 20,537,026                     | 19,130,331    | 18,292,335    |
| Schedule of noncash investing and financing activities: |                                |               |               |
| Assets acquired through foreclosure                     | 3,412,077                      | 421,531       | 1,289,814     |
| Loans to finance the sale of other real estate          | 969,500                        |               |               |
| Investment securities purchased but not settled         | 4,161,418                      | 4,285,000     | 161,743       |