

FIRST FINANCIAL BANKSHARES INC  
Form 10-K  
February 16, 2018  
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**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, 2017**

**Commission file number 0-7674**

**First Financial Bankshares, Inc.**

**(Exact Name of Registrant as Specified in Its Charter)**

**Texas**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**75-0944023**  
**(I.R.S. Employer**  
**Identification No.)**

**400 Pine Street, Abilene, Texas**  
**(Address of Principal Executive Offices)**

**79601**  
**(Zip Code)**

**Registrant's telephone number, including area code: (325) 627-7155**

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

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

**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 whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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As of June 30, 2017, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates was \$2.78 billion.

As of February 16, 2018, there were 67,574,990 shares of common stock outstanding.

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**Documents Incorporated by Reference**

Certain information called for by Part III is incorporated by reference to the proxy statement for our 2018 annual meeting of shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2017.

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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, state and national real estate markets and employment trends;

effect of severe weather conditions, including hurricanes, tornadoes, flooding and droughts;

volatility and disruption in national and international financial and commodity markets;

government intervention in the U.S. financial system, including the effects of recent legislative, tax, accounting and regulatory actions and reforms, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Jumpstart Our Business Startups Act, the Consumer Financial Protection Bureau, the capital ratios of Basel III as adopted by the federal banking authorities and the Tax Cuts and Jobs Act;

political instability;

the ability of the Federal government to address the national economy;

changes in our competitive environment from other financial institutions and financial service providers;

the effects of and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System (the Federal Reserve Board);

the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply;

changes in the demand for loans;

fluctuations in the value of collateral securing our loan portfolio and in the level of the allowance for loan losses;

the accuracy of our estimates of future loan losses;

the accuracy of our estimates and assumptions regarding the performance of our securities portfolio;

soundness of other financial institutions with which we have transactions;

inflation, interest rate, market and monetary fluctuations;

changes in consumer spending, borrowing and savings habits;

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changes in commodity prices (e.g., oil and gas, cattle, and wind energy);

our ability to attract deposits and increase market share;

changes in our liquidity position;

changes in the reliability of our vendors, internal control system or information systems;

cyber attacks on our technology information systems, including fraud from our customers and external third party vendors;

our ability to attract and retain qualified employees;

acquisitions and integration of acquired businesses;

the possible impairment of goodwill associated with our acquisitions;

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;

changes in our compensation and benefit plans; and

acts of God or of war or terrorism.

Such forward-looking 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 (except as required by law).

**PART I**



## **ITEM 1. BUSINESS**

### **General**

First Financial Bankshares, Inc., a Texas corporation (the Company), is a financial holding company registered under the Bank Holding Company Act of 1956, as amended, or BHCA. As such, we are supervised by the Federal Reserve Board, as well as several other bank 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. On January 1, 2018, we acquired Commercial Bancshares, Inc. and its wholly owned subsidiary, Commercial State Bank, Kingwood, Texas and merged these entities with and into the Company and our subsidiary bank, respectively. On July 31, 2015, we acquired FBC Bancshares, Inc. and its wholly owned subsidiary, First Bank, N.A., Conroe, Texas and merged these entities with and into the Company and our subsidiary bank, respectively. We also completed an asset purchase of 4Trust Mortgage, Inc. on June 1, 2015 that significantly increased our residential mortgages/loan originations that are sold in the secondary market. On January 1, 2015, our technology subsidiary, First Technology Services, Inc., was contributed to our bank subsidiary, First Financial Bank, National Association, Abilene, Texas, and therefore became an indirect subsidiary of the Company. As of December 31, 2017, our subsidiaries are:

First Financial Bank, National Association, Abilene, Texas;

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First Technology Services, Inc., Abilene, Texas, a wholly owned subsidiary of First Financial Bank, National Association, Abilene, Texas;

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

First Financial Insurance Agency, Inc., Abilene, Texas; and

First Financial Investments, Inc., Abilene, Texas.

Through our subsidiaries, we conduct a full-service commercial banking business. Our banking centers are located primarily in Central, North Central, Southeast and West Texas. As of December 31, 2017, we had 69 financial centers across Texas, with eleven locations in Abilene, three locations in San Angelo and Weatherford, two locations in Cleburne, Conroe, Stephenville, and Granbury, and one location each in Acton, Albany, Aledo, Alvarado, Beaumont, Boyd, Bridgeport, Brock, Burleson, Cisco, Clyde, Cut and Shoot, Decatur, Eastland, Fort Worth, Glen Rose, Grapevine, Hereford, Huntsville, Keller, Magnolia, Mauriceville, Merkel, Midlothian, Mineral Wells, Montgomery, Moran, New Waverly, Newton, Odessa, Orange, Port Arthur, Ranger, Rising Star, Roby, Southlake, Sweetwater, Tomball, Trent, Trophy Club, Vidor, Waxahachie, Willis and Willow Park, all in Texas. On January 1, 2018, we completed our acquisition of Commercial Bancshares, Inc. and its wholly owned bank subsidiary, Commercial State Bank and, as a result, added branch locations in Kingwood, Fulshear, El Campo and Palacios.

Even though we operate in a growing number of Texas markets, we continue to believe that decisions are best made at the local level. Although we consolidated our bank charters into one charter, we continue to regionally manage our operations with local advisory boards of directors, local bank region presidents and local decision-makers. We have consolidated many of the backroom operations, such as investment securities, accounting, check processing, technology and employee benefits, which improves our efficiency and frees management of our bank regions to concentrate on serving the banking needs of their local communities. On January 1, 2016, we combined our Huntsville and Conroe Regions and our Abilene, Sweetwater and Eastland Regions and established a Fort Worth Region that previously was a branch of our Weatherford Region. On January 1, 2018, we combined our Mineral Wells and Stephenville Regions.

In the past, 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 approximately 27.9 million residents, Texas has more people than any other state except California. The population of Texas grew 19.3% from 2006-2016 according to the U.S. Census Bureau. Many of the communities in which we operate are also experiencing positive growth as shown below:

Population Growth 2006-2016\*

Bridgeport and Wise County	13.5%	Weatherford, Willow Park, Aledo and Parker County	23.6%
Fort Worth and Tarrant County	21.5%	Stephenville and Erath County	18.0%
Cleburne and Johnson County	11.7%	Conroe and Montgomery County	41.3%
Granbury and Hood County	31.1%		

\*Source: U. S. Census Bureau

These economies include dynamic centers of higher education, agriculture, wind energy and natural resources, retail, military, healthcare, tourism, retirement living, manufacturing and distribution.

We believe our community approach to 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 less intense 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 in three ways: by growing organically, by opening new branch locations and by acquiring other banks. Since 1997, we have completed thirteen bank acquisitions and have increased our total assets from \$1.57 billion to \$7.25 billion as of December 31, 2017. We have also established a trust and asset management company and a technology services company. First Financial Trust and Asset Management Company, National

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Association operates as a subsidiary of First Financial Bankshares, Inc. and First Technology Services, Inc. operates as a subsidiary of First Financial Bank, National Association, Abilene, Texas. Looking ahead, we intend to continue to grow organically 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 provide more convenient service to our customers, and we are actively pursuing acquisition opportunities by calling on banks that we are interested in possibly acquiring.

When targeting a bank for acquisition, the subject bank generally needs to be well managed and profitable, while being located in the type of community that fits our profile. We seek to enter growing communities with good amenities—schools, infrastructure, commerce and lifestyle. We prefer non-metropolitan markets, either around Dallas/Fort Worth, Houston, San Antonio or Austin or along the Interstate 35, 45, 10 and 20 corridors in Texas. We might also consider the acquisition of banks in East Texas, the Texas Hill Country area or in states contiguous to Texas. Banks between \$300 million and \$1.0 billion in asset size fit our “sweet spot” for acquisition, but we would consider banks that are larger or smaller, or that are in other areas of Texas if we believe they would be a good fit for our Company.

Information on our revenues, profits and losses and total assets appears in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained in Item 7 hereof.

### **First Financial Bankshares, Inc.**

We provide management, technical resources and policy direction to our subsidiaries, which enable them to improve or expand their 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, including advisory boards of directors for our bank regions. 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;

loan analysis;

human resources;

insurance;

capitalization;

regulatory compliance; and

internal audit.

In particular, we assist our subsidiaries with, among other things, decisions concerning major capital expenditures, employee fringe benefits, including retirement plans and group medical coverage, dividend policies, and appointment of officers and directors, including advisory 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 bank regions related to lending, investing, purchasing, advertising, public relations, and technology services.

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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 our subsidiaries, utilization of available lines of credit and future debt or equity offerings.

### **Services Offered by Our Subsidiaries**

Our subsidiary bank, First Financial Bank, National Association, is a separate legal entity that operates under the day-to-day management of its board of directors and officers. Our multiple banking regions, which operate under our subsidiary bank, each have separate advisory boards that make recommendations and provide assistance to regional management of the bank regarding the operations of their respective region. Each of our bank regions 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, remote deposit capture, internet banking, mobile banking, payroll cards, 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, our trust company. Our trust company has seven locations which are located in Abilene, Fort Worth, Odessa, Beaumont, San Angelo, Stephenville and Sweetwater, all in Texas. Through our trust company, we offer personal trust services, which include wealth management, the administration of estates, testamentary trusts, revocable and irrevocable trusts and agency accounts. We also administer all types of retirement and employee benefit accounts, which include 401(k) profit sharing plans and IRAs. In addition, we provide securities brokerage services through arrangements with an unrelated third party in our Abilene, Cleburne, San Angelo and Weatherford banking regions.

### **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 we must have the capability to compete effectively in the areas of (1) interest rates paid or charged; (2) scope of services offered; and (3) prices charged for such services. Our bank regions 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 us in terms of capital, resources and personnel.

Our business does not depend on any single customer or any few customers, and the loss of any one would not 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. Through our bank regions we may make loans to our 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 our directors, officers and their affiliates are also subject to numerous restrictions under federal and state banking laws, which we describe in greater detail below, under the heading "Supervision and Regulation - Loans to Directors, Executive Officers and Principal Shareholders."

### **Employees**

Including all of our subsidiaries, we employed approximately 1,300 full-time equivalent employees at December 31, 2017. 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 (the DIF ) of the Federal Deposit Insurance Corporation, or the FDIC. 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 subsidiaries. Recent political developments, including the change in administration of the United States federal government, have added additional uncertainty in the implementation, scope and timing of regulatory reforms.

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### *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 that 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 affiliations 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, security firms and insurance companies find it easier to acquire or affiliate with each other and cross-sell financial products. The Gramm-Leach-Bliley 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 are 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, provide merchant banking services, 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 the Gramm-Leach-Bliley Act's functional 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.).

Under the BHCA, the Company must obtain the prior approval of the Federal Reserve Board, or acting under delegated authority, the Federal Reserve Bank of Dallas before (1) acquiring direct or indirect ownership or control of



any class of voting securities of any bank or bank holding company if, after the acquisition, the Company would directly or indirectly own or control 5% or more of the class; (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging or consolidating with another bank holding company.

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The Change in Bank Control Act of 1978, as amended, or the CIBCA, and the related regulations of the Federal Reserve Board require any person or groups of persons acting in concert (except for companies required to make application under the BHCA), to file a written notice with the Federal Reserve Board before the person or group acquires control of the Company. The CIBCA defines control as the direct or indirect power to vote 25% or more of any class of voting securities or to direct the management or policies of a bank holding company or an insured bank. A rebuttable presumption of control arises under the CIBCA where a person or group controls 10% or more, but less than 25%, of a class of the voting stock of a company or insured bank which is a reporting company under the Securities Exchange Act of 1934, as amended, such as the Company, or such ownership interest is greater than the ownership interest held by any other person or group.

### *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. Effective December 30, 2012, we consolidated our then eleven bank charters into one, that being our Abilene charter. As a result, the OCC now supervises, regulates and regularly examines the following subsidiaries:

First Financial Bank, National Association, Abilene, Texas;

First Financial Trust & Asset Management Company, National Association; and

First Technology Services, Inc. (a wholly owned subsidiary of First Financial Bank, National Association)  
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.

### *Deposit Insurance Coverage and Assessments*

Our subsidiary bank is a member of the FDIC. Through the DIF, the FDIC provides deposit insurance protection that covers all deposit accounts in FDIC-insured depository institutions up to applicable limits (currently, \$250,000 per depositor).

Our subsidiary bank must pay assessments to the FDIC under a risk-based assessment system for this 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 the DIF) 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. Through June 30, 2017, the assessment rate for our subsidiary bank was at the lowest risk-based premium available, which was 3.00% of the assessment base per annum. In addition, the FDIC can impose special assessments to cover shortages in the DIF and has imposed special assessments in the past.

In October 2010, the FDIC adopted a new Restoration Plan for the DIF to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. On April 26, 2016, the FDIC adopted a rule amending pricing for deposit insurance for institutions with less than \$10 billion in assets effective the quarter after the fund reserve ratio reached 1.15%. As of June 30, 2016, the FDIC announced that the fund reserve ratio had reached 1.15%. As a result, the Company's assessment rate was decreased to the rate stated above. The Dodd-Frank Act also eliminated the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act requires the FDIC to offset the effect of increasing the reserve ratio on institutions with total consolidated assets of less than \$10 billion, such as the Company.

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As required by the Dodd-Frank Act, the FDIC also revised the deposit insurance assessment system, effective April 1, 2011, to base assessments on the average total consolidated assets of insured depository institutions during the assessment period, less the average tangible equity of the institution during the assessment period as opposed to solely bank deposits at an institution. This base assessment change necessitated that the FDIC adjust the assessment rates to ensure that the revenue collected under the new assessment system will approximately equal that under the existing assessment system.

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-receivers, 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 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.

### *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 bank and trust company subsidiaries. Described below are some of the laws and regulations that apply when either we or our subsidiaries pay or paid dividends.

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. Further, the Federal Reserve Board's policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiaries. In addition, the Federal Reserve Board has indicated that each bank holding company should carefully review its dividend policy, and has discouraged payment ratios that are at maximum allowable levels, which is the maximum dividend amount that may be issued and allow the company to still maintain its target Tier 1 capital ratio, unless both asset quality and capital are very strong.

To pay dividends, our subsidiaries must maintain adequate capital above regulatory guidelines. Under federal law, our subsidiary bank cannot pay a dividend if, after paying the dividend, the bank would be undercapitalized. In addition, if the FDIC 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 FDIC may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The FDIC 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.

National banks are required by federal law to obtain the prior approval of the OCC in order 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 subsidiaries paid aggregate dividends to us of \$30.8 million in 2017 and \$48.8 million in 2016. Under the dividend restrictions discussed above, as of December 31, 2017, our subsidiaries could have declared in the aggregate additional dividends of approximately \$205.75 million from retained net profits, without obtaining regulatory approvals.

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**Table of Contents***Federal Income Tax*

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law with sweeping modifications to the Internal Revenue Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company's deferred tax assets and liabilities were re-measured based on the income tax rates at which they are expected to reverse in the future, which is generally 21%. However, the Company continues to analyze certain aspects of the Act resulting in refinement of the calculation which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the re-measurement of the Company's deferred tax balance was \$7.65 million, a reduction of income tax expense for the year ended December 31, 2017.

*Affiliate Transactions*

The Federal Reserve Act, the Federal Deposit Insurance Act ( 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 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. The Dodd-Frank Act expanded the definition of affiliate to make any investment fund, including a mutual fund, for which a depository institution or its affiliates serve as investment advisor an affiliate of the depository institution. Covered transactions include a loan or extension of credit to a non-depository 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 Dodd-Frank Act extended the limitations to derivative transactions, repurchase agreements and securities lending and borrowing transactions that create credit exposure to an affiliate or an insider. The covered transactions that an insured depository institution and its subsidiaries are permitted to engage in with their non-depository 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 subsidiaries 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 bank to extend credit to our directors, executive officers and principal shareholders, including their immediate family members, 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 bank 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 bank makes 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 those prevailing at the time for comparable transactions with persons not affiliated with us or our subsidiary bank;

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

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

Furthermore, our 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 interested director abstaining from voting.

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*Capital*

We and our bank subsidiary are each required to comply with applicable capital adequacy standards established by the Federal Reserve Board and the OCC, respectively. The current risk-based capital standards applicable to us and our bank subsidiary, parts of which are currently in the process of being phased-in, are based on the December 2010 final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee on Banking Supervision (the Basel Committee ).

In July 2013, the federal bank regulators approved final rules (the Basel III Rules ) implementing the Basel III framework as well as certain provisions of the Dodd-Frank Act. The Basel III Rules substantially revised the risk-based capital requirements applicable to bank holding companies and their depository institution subsidiaries. The Basel III Rules became effective for us and our subsidiary bank on January 1, 2015 (subject to a phase-in period for certain provisions).

The Basel III Rules established three components of regulatory capital: (1) common equity tier 1 capital ( CET1 ), (2) additional tier 1 capital, and (3) tier 2 capital. Tier 1 capital is the sum of CET1 and additional tier 1 capital instruments meeting certain revised requirements. Total capital is the sum of tier 1 capital and tier 2 capital. Under the Basel III Rules, for most banking organizations, the most common form of additional tier 1 capital is non-cumulative perpetual preferred stock and the most common form of tier 2 capital is subordinated notes and a portion of the allocation for loan and lease losses, in each case, subject to the Basel III Rules specific requirements. As of December 31, 2017, we do not have any non-cumulative perpetual preferred stock or subordinated notes. CET1, tier 1 capital, and total capital serve as the numerators for three prescribed regulatory capital ratios. Risk-weighted assets, calculated using the standardized approach in the Basel III Capital Rules for us and our subsidiary bank, provide the denominator for such ratios. There is also a leverage ratio that compares tier 1 capital to average total assets.

Pursuant to the Basel III Rules, the effects of certain accumulated other comprehensive income or loss ( AOCI ) items are not excluded; however, non-advanced approaches banking organizations, including us and our subsidiary bank, could make a one-time permanent election to continue to exclude these items. The Company made its a one-time, permanent election to continue to exclude AOCI from capital in its filing with the Federal Reserve Board for the quarter ended March 31, 2015. If the Company would not have made this election, unrealized gains and losses would have been included in the calculation of its regulatory capital. The Basel III Rules also preclude certain hybrid securities, such as trust preferred securities issued prior to May 19, 2010, from inclusion in our Tier 1 capital, subject to grandfathering in the case of companies, such as us, that had less than \$15 billion in total consolidated assets as of December 31, 2009.

Under the Basel III Rules, the minimum capital ratios effective as of January 1, 2015 are:

4.5% CET1 to risk-weighted assets;

6.0% Tier 1 capital to risk-weighted assets;

8.0% Total capital to risk-weighted assets; and



4.0% Tier 1 capital to average consolidated assets as reported on consolidated financial statements (known as the leverage ratio ).

The Basel III Rules also establish a fully-phased capital conservation buffer of 2.5% above the new regulatory minimum risk-based capital requirements. The conservation buffer, when added to the capital requirements, results in the following minimum ratios: (i) a CET1 risk-based capital ratio of 7.0%, (ii) a Tier 1 risk-based capital ratio of 8.5%, and (iii) a total risk-based capital ratio of 10.5%. The new capital conservation buffer requirement is being phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019. At December 31, 2017, the required capital conservation buffer was 1.50%. An institution is subject to limitations on certain activities including payment of dividends, share repurchases and discretionary bonuses to executive officers if its capital level is below the buffer amount.

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The Basel III Rules prescribe a standardized approach for risk weightings that expanded the risk-weighting categories from the general risk-based capital rules to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories.

With respect to our bank subsidiary, the Basel III Rules also revise the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act, as discussed below under Prompt Corrective Action.

As of December 31, 2017, we had a total risk-based capital ratio of 19.85%, a Tier 1 capital to risk-weighted asset ratio of 18.66%, a common equity Tier 1 to risk-weighted assets ratio of 18.66% and a Tier 1 leverage ratio of 11.09%. These regulatory capital ratios were calculated under Basel III rules.

### *Prompt Corrective Action.*

A banking organization's capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators' powers depends on whether the institution in question is adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution's asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

Under current regulations, our subsidiary bank was well capitalized as of December 31, 2017.

### *Our Support of Our Subsidiaries*

Under Federal Reserve Board policy, we are expected to commit resources to act as a source of strength to support each of our subsidiaries. The Dodd-Frank Act codified this policy as a statutory requirement. 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 subsidiaries would be subordinate in right of payment to deposits and to other indebtedness of our subsidiaries. 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 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 subsidiaries may be assessed for the FDIC's loss.

### *Safe and Sound Banking Practices.*

Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board's Regulation Y, for example, generally requires a holding company to give the Federal Reserve Board prior

notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the bank holding company's consolidated net worth. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

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The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their nonbanking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as \$1.0 million for each day the activity continues.

### *Interstate Banking and Branching*

Effective June 1, 1997, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 amended the Federal Deposit Insurance Act and certain other statutes to permit state and national banks with different home states to merge across state lines, with approval of the appropriate federal banking agency, unless the home state of a participating bank had passed legislation prior to May 31, 1997 expressly prohibiting interstate mergers. Under the Riegle-Neal Act amendments, once a state or national bank has established branches in a state, that bank may establish and acquire additional branches at any location in the state at which any bank involved in the interstate merger transaction could have established or acquired branches under applicable federal or state law. If a state opted out of interstate branching within the specified time period, no bank in any other state may establish a branch in the state which has opted out, whether through an acquisition or de novo.

However, under the Dodd-Frank Act, the national branching requirements have been relaxed and national banks and state banks are able to establish branches in any state if that state would permit the establishment of the branch by a state bank chartered in that state.

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. Additionally, the Texas Department of Banking Banking Department accepts 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 depository 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 bank has taken and takes significant actions to comply with the CRA, and received 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, or BSA, we are required to monitor and report unusual or suspicious account activity that might signify money laundering, tax evasion or other criminal activities, as well as transactions involving the

transfer or withdrawal of amounts in excess of prescribed limits. The BSA is sometimes referred to as an anti-money laundering law ( AML ). Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. 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;

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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 U.S. Department of the Treasury, or 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, or OFAC, 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.

*Incentive Compensation*

In June 2010, the Federal Reserve Board, OCC and FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The Federal Reserve Board will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the

organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

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In addition, Section 956 of the Dodd-Frank Act required certain regulators (including the FDIC, SEC and Federal Reserve Board) to adopt requirements or guidelines prohibiting excessive compensation. In April and May 2016, the Federal Reserve, jointly with five other federal regulators, published a proposed rule in response to Section 956 of the Dodd-Frank Act, which requires implementation of regulations or guidelines to: (1) prohibit incentive-based payment arrangements that encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss, and (2) require those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator.

The proposed rule identifies three categories of institutions that would be covered by these regulations based on average total consolidated assets, applying less prescriptive incentive-based compensation program requirements to the smallest covered institutions (Level 3) and progressively more rigorous requirements to the larger covered institutions (Level 1). Under the proposed rule, we would fall into the smallest category (Level 3), which applies to financial institutions with average total consolidated assets greater than \$1 billion and less than \$50 billion. The proposed rules would establish general qualitative requirements applicable to all covered entities, which would include (i) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation; (ii) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss; (iii) establishing requirements for performance measures to appropriately balance risk and reward; (iv) requiring board of director oversight of incentive arrangements; and (v) mandating appropriate recordkeeping. Under the proposed rule, larger financial institutions with total consolidated assets of at least \$50 billion would also be subject to additional requirements applicable to such institutions' senior executive officers and significant risk-takers. These additional requirements would not be applicable to us because we currently have less than \$50 billion in total consolidated assets. Comments on the proposed rule were due by July 22, 2016. As of the date of this document, the final rule has not yet been published by these regulators.

In addition, the Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The new legislation also authorizes the Securities and Exchange Commission (SEC) to promulgate rules that would allow stockholders to nominate their own candidates using a company's proxy materials. Additionally, the Dodd-Frank Act directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of \$1.0 billion, regardless of whether the company is publicly traded or not. The Dodd-Frank Act gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

### *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, The Real Estate Settlement Procedures 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.



*Consumer Financial Protection Bureau*

The Dodd-Frank Act created a new, independent federal agency called the Consumer Financial Protection Bureau ( CFPB ), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary

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enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits the state attorney general to enforce compliance with both the state and federal laws and regulations.

The CFPB has finalized rules relating to, among other things, remittance transfers under the Electronic Fund Transfer Act, which requires companies to provide consumers with certain disclosures before the consumer pays for a remittance transfer. These rules became effective in October 2013. The CFPB has also amended certain rules under Regulation C relating to home mortgage disclosure to reflect a change in the asset-size exemption threshold for depository institutions based on the annual percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers. In addition, on January 10, 2013, the CFPB released its final Ability-to-Repay/Qualified Mortgage rules, which amended the Truth in Lending Act (Regulation Z). Regulation Z prohibits a creditor from making a higher-priced mortgage loan without regard to the consumer's ability to repay the loan. The final amended rule implemented sections 1411 and 1412 of the Dodd-Frank Act, which generally require creditors to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan) and establishes certain protections from liability under this requirement for qualified mortgages. The final rule also implemented section 1414 of the Dodd-Frank Act, which limits prepayment penalties. Finally, the final rule requires creditors to retain evidence of compliance with the rule for three years after a covered loan is consummated. This rule became effective January 10, 2014.

*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.

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### *Concentrated Commercial Real Estate Lending Regulations*

The federal banking agencies, including the FDIC, have promulgated guidance governing financial institutions with concentrations in commercial real estate lending. The guidance provides that a bank has a concentration in commercial real estate lending if (i) total reported loans for construction, land development, and other land represent 100% or more of total capital or (ii) total reported loans secured by multifamily and non-farm residential properties and loans for construction, land development, and other land represent 300% or more of total capital and the bank's commercial real estate loan portfolio has increased 50% or more during the prior 36 months. Owner occupied loans are excluded from this second category. If a concentration is present, management must employ heightened risk management practices that address the following key elements: including board and management oversight and strategic planning, portfolio management, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and maintenance of increased capital levels as needed to support the level of commercial real estate lending.

### *UDAP and UDAAP*

Banking regulatory agencies have increasingly used a general consumer protection statute to address unethical or otherwise bad business practices that may not necessarily fall directly under the purview of a specific banking or consumer finance law. The law of choice for enforcement against such business practices has been Section 5 of the Federal Trade Commission Act, referred to as the FTC Act, which is the primary federal law that prohibits unfair or deceptive acts or practices, referred to as UDAP, and unfair methods of competition in or affecting commerce.

Unjustified consumer injury is the principal focus of the FTC Act. Prior to the Dodd-Frank Act, there was little formal guidance to provide insight to the parameters for compliance with UDAP laws and regulations. However, UDAP laws and regulations have been expanded under the Dodd-Frank Act to apply to unfair, deceptive or abusive acts or practices, referred to as UDAAP, which have been delegated to the CFPB for supervision. The CFPB has published its first Supervision and Examination Manual that addresses compliance with and the examination of UDAAP.

### *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.

### *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.

### *Regulatory Reform and Legislation*

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or our subsidiaries could have a material effect on the Company's business, financial condition and results of operations.

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### *Dodd-Frank Wall Street Reform and Consumer Protection Act*

The Dodd-Frank Act, which was enacted in July 2010, effected a fundamental restructuring of federal banking regulation. In addition to those provisions discussed above, among the Dodd-Frank Act provisions that have affected us are the following:

creation of a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms;

elimination of the federal statutory prohibition against the payment of interest on business checking accounts;

prohibition on state-chartered banks engaging in derivatives transactions unless the loans to one borrower of the state in which the bank is chartered takes into consideration credit exposure to derivative transactions. For this purpose, derivative transactions include any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodity securities, currencies, interest or other rates, indices or other assets;

requirement that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. On June 29, 2011, the Federal Reserve Board set the interchange rate cap at \$0.21 per transaction and 5 basis points multiplied by the value of the transaction. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than \$10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks; and

restrictions under the Volcker Rule of the Company's ability to engage in proprietary trading and to invest in, sponsor and engage in certain types of transactions with certain private funds. The Company had until July 15, 2015 to fully conform to the Volcker Rules restrictions.

Many of the Dodd-Frank Act's provisions are still subject to the final rulemaking by federal banking agencies, and the implication of the Dodd-Frank Act for the Company's business will depend to a large extent on how such rules are adopted and implemented. The Company's management continues to review actively the provisions of the Dodd-Frank Act and assess its probable impact on its business, financial condition, and results of operations.

### **Available Information**

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document we file at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public at the SEC'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

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.

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**ITEM 1A. RISKFACTORS**

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, which could have an adverse effect on us.*

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 and the price of oil and gas and other commodity prices;

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, results of operations and liquidity, 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 bank regions is concentrated in Texas, primarily in the Central, North Central, Southeast and Western regions of the state. Most of our customers and revenue are derived from this area. These economies include dynamic centers of higher education, agriculture, energy and natural resources, retail, military, healthcare, tourism, retirement living, manufacturing and distribution. 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 our Texas markets. Any significant decline in one or more segments of the local economies could adversely affect our business, revenue, operations and properties.

The significant decline and volatility in oil and gas prices has resulted in uncertainty about the Texas economy. While we consider our exposure to credits related to the oil and gas industry to not be significant, at approximately 1.72% of total loans as of December 31, 2017, should the price of oil and gas decline further and/or remain at the current low price for an extended period, the general economic conditions in our Texas markets could be negatively affected, which could have a material adverse affect on our business, financial condition and results of operations.



*Our Company lends primarily to small to medium-sized businesses that may have fewer resources to weather a downturn in the economy, which could adversely impact the Company's operating results.*

The Company makes loans to privately-owned businesses, many of which are considered to be small to medium-sized businesses. Small to medium-sized businesses frequently have smaller market share than their competition, may be more vulnerable to economic downturns, often need additional capital to expand or compete and may experience more volatility in operating results. Any one or more of these factors may impair the borrower's ability to repay a loan. In addition, the success of a small to medium-sized businesses often depends on the management talents and efforts of a small group of persons, and the death, disability or resignation of one or more of these persons could have adverse impact on the business and its ability to repay our loans. Economic downturns, a sustained decline in commodity prices and other events that could negatively impact the businesses could cause the Company to incur credit losses that could negatively affect the Company's results of operations and financial condition.

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*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 collectability 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, which is an allowance established through a provision for loan losses charged to expense that represents management's best estimate of probable 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 our net income.

In addition, banking 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, financial condition and liquidity.

*Hurricanes, extended drought conditions, severe weather and natural disasters could significantly impact the Company's business.*

Hurricanes, extended drought conditions, severe weather and natural disasters and other adverse external events could have a significant impact on the Company's ability to conduct business. In late August 2017 and continuing into the fourth quarter of 2017, Houston and the surrounding area around the Gulf Coast were significantly affected by Hurricane Harvey. Our Orange and Conroe regions of the Company are in these areas and were impacted by the severe winds and floods. See Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 33 for specific information of the impact of Hurricane Harvey on our Company. Such events affect the stability of the Company's deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of the collateral securing our loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. The occurrence of any such event in the future could have a material adverse effect on the Company's business, which in turn, could have a material adverse effect on the Company's business, financial condition and result of operations.

*Changes in economic conditions could cause an increase in delinquencies and non-performing assets, including loan charge-offs, which could depress our net income and growth.*

Our loan portfolio includes 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 and a slowdown in housing. If we see negative economic conditions develop 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 net 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.

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*The value of real estate collateral may fluctuate significantly resulting in an under-collateralized loan portfolio.*

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. This could have a material adverse effect on our provision for loan losses and our operating results and financial condition.

*New lines of business or new products and services may subject the Company to additional risks.*

From time to time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or products and services the Company may invest significant time and resources. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. If we are unable to successfully manage these risks in the development and implementation of new lines of business or new products or services, it could have a material adverse effect on the Company's business, financial condition and result of operations.

*We are subject to environmental liability risk associated with lending activities.*

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Environmental reviews of real property before initiating foreclosure actions may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our business, financial condition and results of operations.

*We depend on the accuracy and completeness of information about customers and counterparties.*

In deciding whether to extend credit or enter into other transactions, we must rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. We also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on our business, financial condition and results of operations.

*The repeal of prohibitions on paying interest on demand deposits could increase our interest expense.*

Effective July 2011, all federal prohibitions on financial institutions paying interest on demand deposit accounts were repealed as part of the Dodd-Frank Act. As a result, some financial institutions have commenced and are considering offering interest on demand deposits to compete for customers. If interest rates begin to rise, our interest expense

could increase and our net interest margin could decrease if we begin offering interest on demand deposits to maintain current customers or attract new customers, which could have a material adverse effect on our financial condition and results of operations.

*We do business with other financial institutions that could experience financial difficulty.*

We do business through the purchase and sale of Federal funds, check clearing and through the purchase and sale of loan participations with other financial institutions. Because these financial institutions have many risks, as do we, we could be adversely affected should one of these financial institutions experience significant financial difficulties or fail to comply with our agreements with them.

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*If we are unable to continue to originate residential real estate loans and sell them into the secondary market for a profit, our earnings could decrease.*

We derive a portion of our noninterest income from the origination of residential real estate loans and the subsequent sale of such loans into the secondary market. If we are unable to continue to originate and sell residential real estate loans at historical or greater levels, our residential real estate loan volume would decrease, which could decrease our earnings. A rising interest rate environment, general economic conditions or other factors beyond our control could adversely affect our ability to originate residential real estate loans. We also are experiencing an increase in regulations and compliance requirements related to mortgage loan originations necessitating technology upgrades and other changes. If new regulations continue to increase and we are unable to make technology upgrades, our ability to originate mortgage loans will be reduced or eliminated. Additionally, we sell a large portion of our residential real estate loans to third party investors, and rising interest rates could negatively affect our ability to generate suitable profits on the sale of such loans. If interest rates increase after we originate the loans, our ability to market those loans is impaired as the profitability on the loans decreases. These fluctuations can have an adverse effect on the revenue we generate from residential real estate loans and in certain instances, could result in a loss on the sale of the loans.

Further, for the mortgage loans we sell in the secondary market, the mortgage loan sales contracts contain indemnification clauses should the loans default, generally in the first sixty to ninety days, or if documentation is determined not to be in compliance with regulations. While the Company's historic losses as a result of these indemnities have been insignificant, we could be required to repurchase the mortgage loans or reimburse the purchaser of our loans for losses incurred. Both of these situations could have an adverse effect on the profitability of our mortgage loan activities and negatively impact our net income.

*Difficult or changes in market conditions could adversely affect the financial services industry.*

The financial markets have experienced volatility over the past several years. In some cases, the financial markets have produced downward pressure on stock prices and credit availability for certain companies without regard to those companies' underlying financial strength. If financial market volatility worsens, or there are disruptions in these financial markets, including disruptions to the United States banking systems, there can be no assurance that we will not experience an adverse effect on our ability to access capital and our business, financial condition and result of operations could be adversely impacted.

*We may need to raise additional capital and such funds may not be available when needed.*

We may need to raise additional capital in the future to provide us with sufficient capital resources to meet our commitments and business needs, particularly if our asset quality or earnings were to deteriorate significantly. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital and financial markets at that time, which are outside of our control, and our financial performance. Economic conditions and the loss of confidence in financial institutions may increase our cost of funding and limit access to certain customary sources of capital, other financial institution borrowings and borrowings from the discount window of the Federal Reserve. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of other financial institutions, or counterparties participating in the capital markets, may adversely affect our costs and our ability to raise capital. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our financial condition and results of operations.

*We may be subject to more stringent capital and liquidity requirements which would adversely affect our net income and future growth.*

On July 2, 2013, the Federal Reserve Board, and on July 9, 2013, the FDIC and OCC, adopted a final rule that implements the Basel III changes to the international regulatory capital framework and revises the U.S. risk-based and leverage capital requirements for U.S. banking organizations to strengthen identified areas of weakness in capital rules and to address relevant provisions of the Dodd-Frank Act.

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The final rule established a stricter regulatory capital framework that requires banking organizations to hold more and higher-quality capital to act as a financial cushion to absorb losses and help banking organizations better withstand periods of financial stress. The final rule increased capital ratios for all banking organizations and introduced a capital conservation buffer which is in addition to each capital ratio. If a banking organization dips into its capital conservation buffer, it may be restricted in its ability to pay dividends and discretionary bonus payments to its executive officers. The final rule assigned a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also required unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-out is exercised. We exercised this opt-out right in our March 31, 2015 quarterly financial filing. The final rule also included changes in what constitutes regulatory capital, some of which are subject to a two-year transition period. These changes included the phasing-out of certain instruments as qualifying capital. In addition, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock are required to be deducted from capital, subject to a two-year transition period.

The final rule became effective for us on January 1, 2015. As of December 31, 2017, we met all of these new requirements, including the full capital conservation buffer.

Although we currently cannot predict the specific impact and long-term effects that Basel III will have on our Company and the banking industry more generally, the Company will be required to maintain higher regulatory capital levels which could impact our operations, net income and ability to grow. Furthermore, the Company's failure to comply with the minimum capital requirements could result in our regulators taking formal or informal actions against us which could restrict our future growth or operations.

*The trust wealth management fees we receive may decrease as a result of poor investment performance, in either relative or absolute terms, which could decrease our revenues and net earnings.*

Our trust company subsidiary derives its revenues primarily from investment management fees based on assets under management. Our ability to maintain or increase assets under management is subject to a number of factors, including investors' perception of our past performance, in either relative or absolute terms, market and economic conditions, including changes in oil and gas prices, and competition from investment management companies. Financial markets are affected by many factors, all of which are beyond our control, including general economic conditions, including changes in oil and gas prices; securities market conditions; the level and volatility of interest rates and equity prices; competitive conditions; liquidity of global markets; international and regional political conditions; regulatory and legislative developments; monetary and fiscal policy; investor sentiment; availability and cost of capital; technological changes and events; outcome of legal proceedings; changes in currency values; inflation; credit ratings; and the size, volume and timing of transactions. A decline in the fair value of the assets under management, caused by a decline in general economic conditions, would decrease our wealth management fee income.

Investment performance is one of the most important factors in retaining existing clients and competing for new wealth management clients. Poor investment performance could reduce our revenues and impair our growth in the following ways:

existing clients may withdraw funds from our wealth management business in favor of better performing products;



asset-based management fees could decline from a decrease in assets under management;

our ability to attract funds from existing and new clients might diminish; and

our wealth managers and investment advisors may depart, to join a competitor or otherwise.

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Even when market conditions are generally favorable, our investment performance may be adversely affected by the investment style of our wealth management and investment advisors and the particular investments that they make. To the extent our future investment performance is perceived to be poor in either relative or absolute terms, the revenues and profitability of our wealth management business will likely be reduced and our ability to attract new clients will likely be impaired. As such, fluctuations in the equity and debt markets can have a direct impact upon our net earnings.

*Certain of our investment advisory and wealth management contracts are subject to termination on short notice, and termination of a significant number of investment advisory contracts could have a material adverse impact on our revenue.*

Certain of our investment advisory and wealth management clients can terminate, with little or no notice, their relationships with us, reduce their aggregate assets under management, or shift their funds to other types of accounts with different rate structures for any number of reasons, including investment performance, changes in prevailing interest rates, inflation, changes in investment preferences of clients, changes in our reputation in the marketplace, change in management or control of clients, loss of key investment management personnel and financial market performance. We cannot be certain that our trust company subsidiary will be able to retain all of its clients. If its clients terminate their investment advisory and wealth management contracts, our trust company subsidiary, and consequently we, could lose a substantial portion of our revenues.

*We are subject to possible claims and litigation pertaining to fiduciary responsibility.*

From time to time, customers could make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether customer claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect our market perception of our products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

*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 Board, the OCC, and the FDIC. 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.

The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the recent performance of and government intervention in the financial services sector. Other changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to reduced revenues, additional costs, limit the types of financial services and products the Company may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the

Company's business, financial condition and results of operations. Additionally, the banking regulations could prohibit and significantly delay the Company's acquisition of other financial institutions.

Included in the Dodd-Frank Act are, for example, changes related to interchange fees and overdraft services. While the changes for interchange fees that can be charged for electronic debit transactions by payment card issuers relate only to banks with assets greater than \$10 billion, concern exists that the regulations will also impact our Company. Beginning in the third quarter of 2010, we were prohibited from charging customers fees for paying overdrafts on automated teller machine and debit card transactions, unless the consumer opts in. We continue to monitor the impact of these new regulations and other developments on our service charge revenue.

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*Federal income tax reform could have unforeseen effects on our financial condition and results of operations.*

On December 22, 2017, the President of the United States signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The Company is still in the process of analyzing the Tax Cuts and Jobs Act and its possible effects on the Company. The Tax Cuts and Jobs Act includes a number of provisions, including the lowering of the U.S. corporate tax rate from 35 percent to 21 percent, effective January 1, 2018. There are also provisions that may partially offset the benefit of such rate reduction. Financial statement impacts include adjustments for, among other things, the re-measurement of deferred tax assets and liabilities. While there are benefits, there is also substantial uncertainty regarding the details of U.S. Tax Reform. The intended and unintended consequences of Tax Cuts and Jobs Act on our business and on holders of our common shares is uncertain and could be adverse. The Company anticipates that the impact of Tax Cuts and Jobs Act may be material to our business, financial condition and results of operations.

*A new accounting standard will result in a significant change in how we recognize credit losses and may have a material impact on our financial condition or results of operations.*

In June 2016, the Financial Accounting Standards Board ( FASB ) issued an accounting standard update, Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments, which replaces the current incurred loss model for recognizing credit losses with an expected loss model referred to as the Current Expected Credit Loss ( CECL ) model. Under the CECL model, we will be required to present certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the incurred loss model required under current generally accepted accounting principles ( GAAP ), which delays recognition until it is probable a loss has been incurred. Accordingly, we expect that the adoption of the CECL model will materially affect how we determine our allowance for loan losses and could require us to significantly increase our allowance. Moreover, the CECL model may create more volatility in the level of our allowance for loan losses. If we are required to materially increase our level of allowance for loan losses for any reason, such increase could adversely affect our business, financial condition and results of operations.

The new CECL standard will become effective for us for fiscal years beginning after December 15, 2019 and for interim periods within those fiscal years. We are currently evaluating the impact the CECL model will have on our accounting, but we expect to recognize a one-time cumulative-effect adjustment to our allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, consistent with regulatory expectations set forth in interagency guidance issued at the end of 2016. We cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our business, financial condition and results of operations.

*Our FDIC insurance assessments could increase substantially resulting in higher operating costs.*

We have historically paid the lowest premium rate available due to our sound financial position. Should the number of bank failures increase, FDIC premiums could increase or additional special assessments could be imposed. These increased premiums would have an adverse effect on our net income and results of operations.

*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

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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, results of operations and liquidity.

*We are subject to interest rate risk.*

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 highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of the Company's securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and investments, our net interest income, and earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although we have implemented strategies which we believe reduce the potential effects of adverse 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, financial condition and liquidity.

*We are subject to liquidity risk.*

The Company requires liquidity to meet our deposit and other obligations as they come due. The Company's access to funding sources in amounts adequate to finance its activities or on terms that are acceptable to it could be impaired by factors that affect it specifically or the financial services industry or the general economy. Factors that could reduce its access to liquidity sources include a downturn in the Texas market, difficult credit markets or adverse regulatory actions against the Company. The Company's access to deposits may also be affected by the liquidity needs of its depositors. In particular, a substantial majority of the Company's liabilities are demand, savings, interest checking and money market deposits, which are payable on demand or upon several days' notice, while by comparison, a substantial portion of its assets are loans, which cannot be called or sold in the same time frame. The Company may not be able to replace maturing deposits and advances as necessary in the future, especially if a large number of its depositors sought to withdraw their accounts, regardless of the reason. A failure to maintain adequate liquidity could have a material adverse effect on the Company's business, financial condition and result of operations.

*The value of certain securities in our investment portfolio may be negatively affected by changes or disruptions in the market for these securities.*

Our investment portfolio securities include obligations of, and mortgage-backed securities guaranteed by, government sponsored enterprises such as the Federal National Mortgage Association, referred to as Fannie Mae, the Government National Mortgage Association, referred to as Ginnie Mae, the Federal Home Loan Mortgage Corporation, referred to as Freddie Mac, and the Federal Home Loan Bank or otherwise backed by Federal Housing Administration or

Veteran's Administration guaranteed loans; however, volatility or illiquidity in financial markets may cause investment securities held within our investment portfolio to fall in value or become less liquid. The FRB's actions to increase interest rates may cause a decline in the value of securities held by the Company. Uncertainty surrounding the credit risk associated with mortgage collateral or guarantors may cause material discrepancies in valuation estimates obtained from third parties. Volatile market conditions may reduce valuations due to the perception of heightened credit and liquidity risks in addition to interest rate risk typically associated with these securities. There can be no assurance that declines in market value associated with these disruptions will not result in impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our results of operations, equity and capital ratios.

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*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 paid by 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 and trust subsidiaries may pay to First Financial Bankshares, Inc. In the event our subsidiaries are unable to pay dividends to First Financial Bankshares, Inc., First Financial Bankshares, Inc. may not be able to service debt, if any, or pay dividends on the Company's common stock. The inability to receive dividends from our subsidiaries could have a material adverse effect on the Company's business, financial condition, results of operations and liquidity.

*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.

*We may not be able to complete future acquisitions, may not be successful in realizing the benefits of any acquisitions that are completed, or may choose not to pursue acquisition opportunities we might find beneficial.*

A substantial part of our historical growth has been a result of acquisitions of other financial institutions, and we may, from time to time, evaluate and engage in the acquisition of other financial institutions. We must generally satisfy a number of conditions prior to completing any such transaction, including certain bank regulatory approvals. Bank regulators consider a number of factors with regard to all institutions involved in the transaction when determining whether to approve a proposed transaction, including, among others, the ratings and compliance history, anti-money laundering and Bank Secrecy Act compliance history, CRA examination results and the effect of the proposed transaction on the financial stability of the institutions involved and the market as a whole.

The process for obtaining required regulatory approvals has become substantially more difficult, time-consuming and unpredictable as a result of the financial crisis. We may fail to pursue, evaluate or complete strategic and competitively significant business opportunities as a result of our inability, or our perceived inability, to obtain required regulatory approvals in a timely manner or at all.

Assuming we are able to successfully complete one or more transactions, we may not be able to successfully integrate and realize the expected synergies from any completed transaction in a timely manner or at all. In particular, we may be charged by federal and state regulators with regulatory and compliance failures at an acquired business prior to the date of the acquisition, and these failures by the acquired company may have negative consequences for us, including the imposition of formal or informal enforcement actions. Completion and integration of any transaction may also divert management's attention from other matters, result in additional costs and expenses, or adversely affect our relationships with our customers and employees, any of which may adversely affect our business or results of operations. As a result, our financial condition may be affected, and we may become more susceptible to general economic conditions and competitive pressures.

*Use of our common stock for future acquisitions or to raise capital may be dilutive to existing stockholders.*



When we determine that appropriate strategic opportunities exist, we may acquire other financial institutions and related businesses, subject to applicable regulatory requirements. We may use our common stock for such acquisitions. We may also seek to raise capital through selling additional common stock, although we have not historically done so. It is possible that the issuance of additional common stock in such acquisition or capital transactions may be dilutive to the interests of our existing shareholders.

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*Our accounting estimates and risk management processes rely on analytical and forecasting models.*

The processes we use to estimate our allowance for loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates depends upon the use of analytical and forecasting models. In addition, these models are used to calculate fair value of our assets and liabilities when we acquire other financial institutions. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models we use to measure the fair value financial instruments is inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

*The value of our goodwill and other intangible assets may decline in the future.*

As of December 31, 2017, we had \$141.14 million of goodwill and other intangible assets and will add approximately \$31.24 million of goodwill with our acquisition of Commercial Bancshares, Inc. effective January 1, 2018. A significant decline in our financial condition, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock may necessitate taking charges in the future related to the impairment of our goodwill and other intangible assets. If we were to conclude that a future write-down of goodwill and other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our financial condition and results of operations.

*We rely heavily on our management team, and the unexpected loss of key management or inability to recruit qualified personnel in the future 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 the 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 agreements 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. In addition, the scope and content of U.S. banking regulators' policies on incentive compensation, as well as changes to these policies, could adversely affect our ability to hire, retain and motivate our key employees.

*The Company's stock price can be volatile.*

Stock price volatility may make it more difficult for our shareholders to resell their common stock when they want and at prices they find attractive. The Company's stock price can fluctuate significantly in response to a variety of factors including, among other things:

actual or anticipated variations in quarterly results of operations;

recommendations by securities analysts;

operating and stock price performance of other companies that investors deem comparable to the Company;

new reports relating to trends, concerns and other issues in the financial services industry or Texas economy, including oil and gas and cattle prices;

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perceptions in the marketplace regarding the Company and/or its competitors;

new technology used, or services offered, by competitors;

significant acquisitions or business combinations involving the Company or its competitors; and

changes in government regulations, including tax laws.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends could also cause the Company's stock price to decrease regardless of operational results.

*We may not continue to pay dividends on our common stock in the future.*

Holders of our common stock are only entitled to receive such dividends as our board of directors may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so and may reduce or eliminate our common stock dividends in the future. This could adversely affect the market price of our common stock. Also, we are a bank holding company, and our ability to declare and pay dividends is dependent on certain federal regulatory considerations, including the guidelines of the Federal Reserve Board regarding capital adequacy and dividends.

*Certain banking laws may have an anti-takeover effect.*

Provisions of federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. These provisions effectively inhibit a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of our common stock.

*The trading volume in our common stock is less than other larger financial institutions.*

Although the Company's common stock is listed for trading on the Nasdaq Global Select Market, the trading volume in our common stock is less than that of other, larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. Given the lower trading volume of the Company's common stock, significant sales of the Company's common stock, or the expectation of these sales, could cause the Company's stock price to fall.

*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.

*Our operations rely on certain external vendors.*

We rely on certain external vendors to provide products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted agreements under service level agreements. The failure of an external vendor to perform in accordance with the contracted arrangements under service level agreements, because of changes in the vendor's organizational structure, financial condition, support for existing products or services or strategic focus or for any other reason, could be disruptive to our operations, which could have a material adverse effect on our business and, in turn, our financial condition and results of operations.

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*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 larger 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 cybersecurity breaches of our network security could subject us to increased operating costs as well as litigation and other potential losses.*

The computer systems and network infrastructure we use could be vulnerable to unforeseen hardware and cybersecurity issues, including hacking and identity theft. 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, including our Internet banking activities, against damage from physical break-ins, cybersecurity 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, damage our reputation and inhibit current and potential customers from our Internet banking services. Each year, we add additional security measures to our computer systems and network infrastructure to mitigate the possibility of cybersecurity breaches including firewalls and penetration testing. We continue to investigate cost effective measures as well as insurance protection.

Furthermore, our customers could incorrectly blame the Company and terminate their accounts with the Company for a cyber-incident which occurred on their own system or with that of an unrelated third party. In addition, a security breach could also subject us to additional regulatory scrutiny and expose us to civil litigation and possible financial liability.

*Our business may be adversely affected by security breaches at third parties.*

Our customers interact with their own and other third party systems, which pose operational risks to us. We may be adversely affected by data breaches at retailers and other third parties who maintain data relating to our customers that involve the theft of customers data, including the theft of customers debit card, merchant credit card, wire transfer and other identifying and/or access information used to make purchases or payments at such retailers and to other third parties.

In the event of a data breach at one or more retailers of considerable magnitude, the Company's business, financial condition and results of operations may be adversely affected.

*We are subject to claims and litigation pertaining to intellectual property.*

We rely on technology companies to provide information technology products and services necessary to support our day-to-day operations. Technology companies frequently enter into litigation based on allegations of patent infringement or other violations of intellectual property rights. In addition, patent holding companies seek to monetize patents they have purchased or otherwise obtained. Competitors of our vendors, or other individuals or companies, have from time to time claimed to hold intellectual property sold to us by its vendors. Such claims may increase in the future as the financial services sector becomes more reliant on information technology vendors. The plaintiffs in these actions frequently seek injunctions and substantial damages.

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Regardless of the scope or validity of such patents or other intellectual property rights, or the merits of any claims by potential or actual litigants, we may have to engage in litigation that could be expensive, time-consuming, disruptive to our operations, and distracting to management. If we are found to infringe one or more patents or other intellectual property rights, we may be required to pay substantial damages or royalties to a third-party. In certain cases, we may consider entering into licensing agreements for disputed intellectual property, although no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. These licenses may also significantly increase our operating expenses. If legal matters related to intellectual property claims were resolved against us or settled, we could be required to make payments in amounts that could have a material adverse effect on our business, financial condition and results of operations.

*An investment in our common stock is not an insured deposit.*

Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund, or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this Report. As a result, if you acquire our common stock, you may lose some or all of your investment.

## **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 four spaces in buildings owned by First Financial Bank, National Association, Abilene totaling approximately 9,000 square feet. As of December 31, 2017, our subsidiaries collectively own 63 banking facilities, some of which are detached drive-ins, and also lease 15 banking facilities and 16 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 subsidiaries requirements for the foreseeable future.

## **ITEM 3. LEGAL PROCEEDINGS**

From time to time, we and our subsidiaries 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 subsidiaries 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. MINE SAFETY DISCLOSURES**

Not applicable.

## **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 Global Select Market for our common stock for the periods indicated.

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**Record Holders**

As of February 1, 2018, we had 1,148 registered shareholders of record with our stock transfer agent.

**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.

**Equity Compensation Plans**

See Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters .

**Table of Contents****PERFORMANCE GRAPH**

The following performance graph compares cumulative total shareholder returns for our common stock, the Russell 3000 Index, and the SNL Bank Index, which is a banking index prepared by SNL Financial LC and is comprised of banks with \$5 billion to \$10 billion in total assets, for a five-year period (December 31, 2012 to December 31, 2017). The performance graph assumes \$100 invested in our common stock at its closing price on December 31, 2012, 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 represent 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.

*First Financial Bankshares, Inc.*

<i>Index</i>	<b>Period Ending</b>					
	<b>12/31/12</b>	<b>12/31/13</b>	<b>12/31/14</b>	<b>12/31/15</b>	<b>12/31/16</b>	<b>12/31/17</b>
First Financial Bankshares, Inc.	100.00	172.67	158.94	163.76	250.31	253.94
Russell 3000	100.00	133.55	150.32	151.04	170.28	206.26
SNL Bank \$5B-\$10B Index	100.00	154.28	158.92	181.04	259.37	258.40

**Source : SNL Financial, an offering of S&P Global Market Intelligence**

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The selected financial data presented below as of and for the years ended December 31, 2017, 2016, 2015, 2014, and 2013, 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 and accompanying notes presented elsewhere in this Form 10-K. The results of operations presented below are not necessarily indicative of the results of operations that may be achieved in the future. Management's Discussion and Analysis of Financial Condition and Results of Operations incorporates information required to be disclosed by the SEC's Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

	Year Ended December 31,				
	2017	2016	2015	2014	2013
	(dollars in thousands, except per share data)				
<b>Summary Income Statement Information:</b>					
Interest income	\$ 245,975	\$ 232,288	\$ 221,623	\$ 198,539	\$ 176,369
Interest expense	9,288	5,451	4,088	4,181	4,088
Net interest income	236,687	226,837	217,535	194,358	172,281
Provision for loan losses	6,530	10,212	9,685	4,465	3,753
Noninterest income	91,017	85,132	73,432	66,624	62,052
Noninterest expense	173,986	165,830	149,464	137,925	126,012
Earnings before income taxes	147,188	135,927	131,818	118,592	104,568
Income tax expense	26,817	31,153	31,437	29,033	25,700
Net earnings	\$ 120,371	\$ 104,774	\$ 100,381	\$ 89,559	\$ 78,868
<b>Per Share Data:</b>					
Earnings per share, basic	\$ 1.82	\$ 1.59	\$ 1.55	\$ 1.40	\$ 1.24
Earnings per share, assuming dilution	1.81	1.59	1.54	1.39	1.24
Cash dividends declared	0.75	0.70	0.62	0.55	0.52
Book value at period-end	13.93	12.68	12.20	10.63	9.18
<b>Earnings performance ratios:</b>					
Return on average assets	1.72%	1.59%	1.61%	1.65%	1.64%
Return on average equity	13.63	12.36	13.60	14.00	13.75
<b>Summary Balance Sheet Data (Period-end):</b>					
Securities	\$ 3,087,473	\$ 2,860,958	\$ 2,734,177	\$ 2,416,297	\$ 2,058,407
Loans	3,500,699	3,384,205	3,350,593	2,937,991	2,689,448
Total assets	7,254,715	6,809,931	6,665,070	5,848,202	5,222,208
Deposits	5,962,961	5,478,539	5,190,169	4,750,255	4,135,075
Total liabilities	6,331,947	5,972,046	5,860,084	5,166,665	4,634,561
Total shareholders' equity	922,768	837,885	804,986	681,537	587,647
<b>Asset quality ratios:</b>					

Allowance for loan losses/period-end loans	1.38%	1.35%	1.25%	1.25%	1.26%
Nonperforming assets/period-end loans plus foreclosed assets	0.57	0.86	0.89	0.74	1.16
Net charge offs/average loans	0.12	0.19	0.15	0.06	0.15
<b>Capital ratios:</b>					
Average shareholders equity/average assets	12.65%	12.85%	11.86%	11.78%	11.95%
Leverage ratio (1)	11.09	10.71	9.96	9.89	9.84
Tier 1 risk-based capital (2)	18.66	17.30	15.90	16.05	15.82
Common equity tier 1 capital (3)	18.66	17.30	15.90		
Total risk-based capital (4)	19.85	18.45	16.97	17.16	16.92
Dividend payout ratio	41.24	44.14	40.20	39.34	41.62

- (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 by risk-adjusted assets.

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- (4) 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**

The following discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results may 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 in the Cautionary Statement Regarding Forward-Looking Statements notice on page 1.

### **Introduction**

As a 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 bank subsidiary, First Financial Bank, National Association, Abilene, Texas. Our largest expenses are salaries and related employee benefits. We 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.

The following discussion and analysis of the major elements of our consolidated balance sheets as of December 31, 2017 and 2016, and consolidated statements of earnings for the years 2015 through 2017 should be read in conjunction with our consolidated financial statements, accompanying notes, and selected financial data presented elsewhere in this Form 10-K.

### **Critical Accounting Policies**

We prepare consolidated financial statements based on generally accepted accounting principles ( GAAP ) 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.

We deem our most critical accounting policies to be (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities. 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. A discussion of (1) our allowance for loan losses and our provision for loan losses and (2) our valuation of securities is included in Note 1 to our Consolidated Financial Statements beginning on page F-7.

### **Hurricane Harvey**

Houston and the surrounding Gulf Coast region were significantly affected by Hurricane Harvey beginning in late August 2017 and continuing into the fourth quarter of 2017. Our Company has locations (i) north of Houston in Conroe, Willis, Tomball, Huntsville, Montgomery, Magnolia, New Waverly and Cut and Shoot and (ii) in Southeast Texas in Orange, Beaumont, Vidor, Newton, Mauriceville and Port Arthur. We continue to evaluate the effect of the hurricane on our branch facilities and our loan and investment portfolios. Our initial assessment of our physical buildings and equipment indicates damage primarily at our Mauriceville branch, and amounts not covered by insurance do not appear to be significant. At December 31, 2017, we had loans totaling \$446.62 million in our Conroe region and \$396.55 million in the Southeast Texas/Orange region. We are evaluating these loans and the related collateral and business operations underlying such loans. At December 31, 2017, we provided additional

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allowance for loan losses as deemed appropriate based on this analysis. We continue to evaluate these loans as we learn more information about the damage caused by the hurricane. Our tax exempt municipal bonds in the counties of Texas effected by the hurricane have been evaluated, including insurance on the bonds. At December 31, 2017, our municipal bonds in these counties totaled \$458.16 million, but only \$92.75 million do not have bond insurance. Based on analysis of these bonds and the related municipality, at December 31, 2017, we do not believe we have any credit related losses other than temporary impairment.

**Acquisitions and Asset Purchase**

On October 12, 2017, we entered into an agreement and plan of reorganization to acquire Commercial Bancshares, Inc. and its wholly owned bank subsidiary, Commercial State Bank, Kingwood, Texas. On January 1, 2018, the transaction closed. Pursuant to the agreement, we issued 1,289,371 shares of the Company's common stock in exchange for all of the outstanding shares of Commercial Bancshares, Inc. In addition, in accordance with the plan of reorganization, Commercial Bancshares, Inc. paid a special dividend totaling \$22.08 million to its shareholders prior to the closing of this transaction. At the closing, Kingwood Merger Sub., Inc., a wholly-owned subsidiary of the Company, merged into Commercial Bancshares Inc., with Commercial Bancshares, Inc. surviving as a wholly-owned subsidiary of the Company. Immediately following such merger, Commercial Bancshares, Inc. was merged into the Company and Commercial State Bank, Kingwood, Texas was merged into First Financial Bank, National Association, Abilene, Texas, a wholly owned subsidiary of the Company. The total purchase price exceeded the estimated fair value net of assets acquired by approximately \$31.24 million and the Company recorded such excess as goodwill. The balance sheet and results of operations of Commercial Bancshares, Inc. will be included in the financial statements of the Company effective January 1, 2018.

On April 1, 2015, we entered into an agreement and plan of reorganization to acquire FBC Bancshares, Inc. and its wholly owned bank subsidiary, First Bank, N.A., Conroe, Texas. On July 31, 2015, the transaction was completed, which we refer to herein as the Conroe acquisition. Pursuant to the agreement, we issued 1,755,374 shares of the Company's common stock in exchange for all of the outstanding shares of FBC Bancshares, Inc. At closing, FBC Bancshares, Inc. was merged into the Company and First Bank, N.A., Conroe, Texas, was merged into First Financial Bank, National Association, Abilene, Texas, a wholly owned subsidiary of the Company. The total purchase price exceeded the estimated fair value net of assets acquired by approximately \$43.92 million and the Company recorded such excess as goodwill.

On April 8, 2015, the Company announced that it had entered into an asset purchase agreement with 4Trust Mortgage, Inc. for a cash purchase price of \$1.90 million. The asset purchase was finalized on June 1, 2015, which we refer to herein as the 4Trust asset purchase. The total asset purchase price exceeded the estimated fair value net of assets purchased by approximately \$1.75 million and the Company recorded such excess as goodwill.

**Results of Operations**

*Performance Summary.* Net earnings for 2017 were \$120.37 million, an increase of \$15.60 million over net earnings for 2016 of \$104.77 million. Of the \$15.60 million increase in net income during 2017 when compared to 2016, \$7.65 million resulted from the recent enactment of tax legislation that reduced the corporate income tax rate from 35 percent to 21 percent. This amount represents the net effect of the Company's revaluation of its deferred tax assets and liabilities using the new tax rate. Net earnings for 2015 were \$100.38 million. Disregarding the increase that resulted from the change in tax rates, the increases in net earnings for 2017 over 2016 and 2016 over 2015 were primarily attributable to growth in net interest income and noninterest income.



On a basic net earnings per share basis, net earnings were \$1.82 for 2017, as compared to \$1.59 for 2016 and \$1.55 for 2015. The return on average assets was 1.72% for 2017, as compared to 1.59% for 2016 and 1.61% for 2015. The return on average equity was 13.63% for 2017, as compared to 12.36% for 2016 and 13.60% for 2015. Excluding the \$7.65 million tax adjustment mentioned above, the Company's basic earnings per share would have been \$1.70, its return on average assets would have been 1.61% and its return on average equity would have been 12.77% for 2017.

*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

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investment securities. Our liabilities to fund those assets consist primarily of noninterest-bearing and interest-bearing deposits. Tax-equivalent net interest income was \$262.18 million in 2017, as compared to \$251.78 million in 2016 and \$240.48 million in 2015. The increases in 2017 compared to 2016 were largely attributable to increases in the volume of earning assets offset by rate increases on our interest bearing liabilities. Average earning assets were \$6.54 billion in 2017, as compared to \$6.17 billion in 2016 and \$5.84 billion in 2015. Average earning assets increased \$373.50 million in 2017, when compared to 2016, due primarily from increases in loans and taxable securities. Average earning assets increased \$333.39 million in 2016, when compared to 2015, due primarily from increases in loans and tax exempt securities. Average interest bearing liabilities were \$4.21 billion in 2017, as compared to \$4.02 billion in 2016 and \$3.80 billion in 2015. The yield on earning assets decreased two basis points in 2017 due to the mix of earnings assets, whereas the rate paid on interest-bearing liabilities increased eight basis points when compared to 2016. The yield on earning assets decreased two basis points in 2016, whereas the rate paid on interest-bearing liabilities increased three basis points when compared to 2015.

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):**

	2017 Compared to 2016			2016 Compared to 2015		
	Change Attributable to Volume	Rate	Total Change	Change Attributable to Volume	Rate	Total Change
Short-term investments	\$ 443	\$ 899	\$ 1,342	\$ 23	\$ 111	\$ 134
Taxable investment securities	3,464	1,735	5,199	(1,218)	(829)	(2,047)
Tax-exempt investment securities (1)	1,173	677	1,850	6,548	(1,687)	4,861
Loans (1) (2)	4,998	851	5,849	12,037	(2,320)	9,717
Interest income	10,078	4,162	14,240	17,390	(4,725)	12,665
Interest-bearing deposits	409	3,300	3,709	219	643	862
Short-term borrowings	(223)	351	128	24	477	501
Interest expense	186	3,651	3,837	243	1,120	1,363
Net interest income	\$ 9,892	\$ 511	\$ 10,403	\$ 17,147	\$ (5,845)	\$ 11,302

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

(2) Non-accrual loans are included in loans.

The net interest margin in 2017 was 4.01%, a decrease of seven basis points from 2016 which also decreased an additional four basis points from 2015. The continued decrease in our net interest margin in 2017 was largely the result of the extended period of historically low levels of short-term interest rates. We have been able to somewhat mitigate the impact of low short-term interest rates by establishing minimum interest rates on certain of our loans, improving the pricing for loan risk, and minimizing rates paid on interest bearing liabilities. The Federal Reserve increased rates 75 basis points in 2017 and 25 basis points in both 2016 and 2015 and continues to issue forward guidance plans to increase rates further in 2018. Although increasing, we expect interest rates to remain at lower levels, which will continue the downward pressure on our net interest margin.



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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 2015 through 2017.

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

	2017			2016			2015		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
<b>Assets</b>									
Short-term investments (1)	\$ 144,464	\$ 1,684	1.17%	\$ 63,882	\$ 342	0.54%	\$ 57,500	\$ 208	0.36%
Taxable investment securities (2)	1,479,698	32,825	2.22	1,314,820	27,626	2.10	1,371,110	29,673	2.16
Tax-exempt investment securities (2)(3)	1,484,952	68,118	4.59	1,459,121	66,268	4.54	1,318,531	61,407	4.66
Loans (3)(4)	3,435,447	168,843	4.91	3,333,241	162,994	4.89	3,090,538	153,277	4.96
<b>Total earning assets</b>	<b>6,544,561</b>	<b>\$ 271,470</b>	<b>4.15%</b>	<b>6,171,064</b>	<b>\$ 257,230</b>	<b>4.17%</b>	<b>5,837,679</b>	<b>\$ 244,565</b>	<b>4.19%</b>
Cash and due from banks	162,255			152,648			148,369		
Bank premises and equipment, net	123,595			120,538			109,725		
Other assets	56,007			55,694			49,647		
Goodwill and other intangible assets, net	142,473			143,986			117,491		
Allowance for loan losses	(47,380)			(44,811)			(39,107)		
<b>Total assets</b>	<b>\$ 6,981,511</b>			<b>\$ 6,599,119</b>			<b>\$ 6,223,804</b>		
<b>Liabilities and Shareholders Equity</b>									
Interest-bearing deposits	\$ 3,783,960	\$ 8,213	0.22%	\$ 3,469,005	\$ 4,504	0.13%	\$ 3,272,150	\$ 3,642	0.11%
Short-term borrowings	422,285	1,075	0.25	552,041	947	0.17	524,365	446	0.08
<b>Total interest-bearing liabilities</b>	<b>4,206,245</b>	<b>\$ 9,288</b>	<b>0.22%</b>	<b>4,021,046</b>	<b>\$ 5,451</b>	<b>0.14%</b>	<b>3,796,515</b>	<b>\$ 4,088</b>	<b>0.11%</b>
Noninterest-bearing deposits	1,843,973			1,666,598			1,634,669		
Other liabilities	48,480			63,609			54,331		

Total liabilities	6,098,698	5,751,253	5,485,515
Shareholders equity	882,813	847,866	738,289
Total liabilities and shareholders equity	\$ 6,981,511	\$ 6,599,119	\$ 6,223,804
Net interest income	\$ 262,182	\$ 251,779	\$ 240,477
<b>Rate Analysis:</b>			
Interest income/earning assets	4.15%	4.17%	4.19%
Interest expense/earning assets	0.14	0.09	0.07
Net yield on earning assets	4.01%	4.08%	4.12%

- (1) Short-term investments are comprised of Fed Funds sold, interest bearing deposits in banks and interest bearing time deposits in banks.
- (2) Average balances include unrealized gains and losses on available-for-sale securities.
- (3) Computed on a tax-equivalent basis assuming a marginal tax rate of 35%.
- (4) Nonaccrual loans are included in loans.

*Noninterest Income.* Noninterest income for 2017 was \$91.02 million, an increase of \$5.89 million, or 6.91%, as compared to 2016. Increases in certain categories of noninterest income included (1) trust fees of \$4.06 million (2) ATM, interchange and credit card fees of \$1.78 million and (3) service charges on deposit accounts of \$1.03 million when compared to 2016. The increase in trust fees resulted from an increase in assets under management over the prior year and higher oil and gas prices that increased related to trust fees by \$364 thousand over 2016. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheets, totaled \$5.13 billion at December 31, 2017, as compared to \$4.37 billion at December 31, 2016. The increases in ATM, interchange and credit card fees and service charges on deposit accounts are primarily a result of increases in the number of net new accounts and debit cards. Offsetting these increases were decreases in net recoveries of \$984 thousand and real estate mortgage fees of \$977 thousand.

Noninterest income for 2016 was \$85.13 million, an increase of \$11.70 million, or 15.93%, as compared to 2015. Increases in certain categories of noninterest income included (1) real estate mortgage fees of \$5.68 million, (2) ATM, interchange and credit card fees of \$2.05 million, (3) service charges on deposit accounts of \$1.22 million and (4) trust fees of \$384 thousand when compared to 2015. The increase in real estate mortgage fees primarily resulted from a stronger mortgage market and the 4Trust asset purchase on June 1, 2015. The increases in ATM, interchange and credit card fees and service charges are primarily a result of increases in the number of net new accounts and debit cards boosted by the Conroe acquisition on July 31, 2015. The increase in trust fees resulted from an increase in assets under management over the prior year offsetting the effect of the decline in oil and gas prices that reduced related trust fees by \$296 thousand in 2016 compared to 2015. The fair value of our trust assets managed, which are not reflected in our consolidated balance sheets, totaled \$4.37 billion at December 31, 2016 as compared to \$3.87 billion at December 31, 2015.



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ATM and interchange fees are charges that merchants pay to us and other card-issuing banks for processing electronic payment transactions. ATM and interchange fees consist of income from debit card usage, point of sale income for debit card transactions and ATM service fees. Federal Reserve rules applicable to financial institutions that have assets of \$10 billion or more provide that the maximum permissible interchange fee for an electronic debit transaction in the sum of 21 cents per transaction and five basis points multiplied by the value of the transaction. While we currently have assets under \$10 billion, we are monitoring the effect of this reduction in per transaction fee income as we approach the \$10 billion asset level.

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

	<b>2017</b>	<b>Increase (Decrease)</b>	<b>2016</b>	<b>Increase (Decrease)</b>	<b>2015</b>
Trust fees	\$ 23,694	\$ 4,058	\$ 19,636	\$ 384	\$ 19,252
Service charges on deposit accounts	19,416	1,030	18,386	1,215	17,171
ATM, interchange and credit card fees	25,686	1,776	23,910	2,050	21,860
Real estate mortgage operations	15,109	(977)	16,086	5,677	10,409
Net gain on sale of available-for-sale securities	1,828	558	1,270	838	432
Net gain (loss) on sale of foreclosed assets	(50)	(506)	456	(82)	538
Net gain (loss) on sale of assets	(396)	(564)	168	988	(820)
Interest on loan recoveries	1,128	(984)	2,112	1,062	1,050
Other:					
Check printing fees	173	(17)	190	(40)	230
Safe deposit rental fees	529	(2)	531	7	524
Credit life and debt protection fees	617	(2)	619	(44)	663
Brokerage commissions	1,290	717	573	(190)	763
Miscellaneous income	1,993	798	1,195	(165)	1,360
<b>Total other</b>	<b>4,602</b>	<b>1,494</b>	<b>3,108</b>	<b>(432)</b>	<b>3,540</b>
<b>Total Noninterest Income</b>	<b>\$ 91,017</b>	<b>\$ 5,885</b>	<b>\$ 85,132</b>	<b>\$ 11,700</b>	<b>\$ 73,432</b>

*Noninterest Expense.* Total noninterest expense for 2017 was \$173.99 million, an increase of \$8.16 million, or 4.92%, as compared to 2016. Noninterest expense for 2016 amounted to \$165.83 million, an increase of \$16.37 million, or 10.95%, as compared to 2015. An important measure in determining whether a financial institution 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 2017 was 49.26%, as compared to 49.22% for 2016 and 47.61% for 2015.

Salaries and employee benefits for 2017 totaled \$95.29 million, an increase of \$4.55 million, or 5.01%, as compared to 2016. The increase was primarily driven by (i) annual merit pay increases that were effective March 1, 2017 (ii) an increase in our profit sharing expenses and (iii) an increase in stock option and stock grant expense of due to the stock option grant in June 2017 and restricted stock grant in October 2017.

All other categories of noninterest expense for 2017 totaled \$78.70 million, an increase of \$3.61 million, or 4.80%, as compared to 2016. The increase in noninterest expense was largely attributable to increases in software amortization

and expense of \$1.29 million from the write-off of internally developed software, operational and other losses of \$1.02 million due to fraud and weather related losses and professional and service fees of \$1.19 million. Offsetting these increases in 2017 were a decrease of \$463 thousand in FDIC insurance due to the lower rate charged by the FDIC beginning in the third quarter of 2016.

Salaries and employee benefits for 2016 totaled \$90.74 million, an increase of \$9.74 million, or 12.02%, as compared to 2015. The increase was primarily driven by the addition of employees from the Conroe acquisition and the 4Trust asset purchase, annual merit pay increases and increases in healthcare claims. Offsetting these increases was a reduction in profit sharing and officer bonus expenses in 2016 when compared to 2015, which was caused by less net income growth in 2016 when compared to the prior year.



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All other categories of noninterest expense for 2016 totaled \$75.09 million, an increase of \$6.63 million, or 9.68%, as compared to 2015. The increase in noninterest expense was largely attributable to increases in equipment expense of \$1.26 million, largely resulting from the Company's acquisition of Conroe. Telephone expenses increased \$1.05 million due to costs to improve our technology infrastructure and professional and service fees increased \$2.05 million due primarily to outsourcing expenses for certain technology providers, which offset salary costs. Offsetting these increases in 2016 were a decrease of \$473 thousand in FDIC insurance due to the lower rate charged by the FDIC beginning in the third quarter of 2016.

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

	2017	Increase (Decrease)	2016	Increase (Decrease)	2015
Salaries	\$ 72,132	\$ 2,135	\$ 69,997	\$ 7,294	\$ 62,703
Medical	8,585	(174)	8,759	3,066	5,693
Profit sharing	4,735	1,514	3,221	(2,234)	5,455
Pension	127	(232)	359	342	17
401(k) match expense	2,392	61	2,331	288	2,043
Payroll taxes	5,009	200	4,809	427	4,382
Stock option expense	1,745	863	882	238	644
Restricted stock expense	562	181	381	319	62
Total salaries and employee benefits	95,287	4,548	90,739	9,740	80,999
Loss from partial settlement of pension plan		(267)	267	267	
Net occupancy expense	10,521	101	10,420	106	10,314
Equipment expense	13,765	286	13,479	1,257	12,222
FDIC insurance premiums	2,217	(463)	2,680	(473)	3,153
ATM, interchange and credit card expenses	7,452	221	7,231	847	6,384
Professional and service fees	8,063	1,186	6,877	2,046	4,831
Printing, stationery and supplies	1,989	(104)	2,093	(185)	2,278
Amortization of intangible assets	613	(125)	738	177	561
Other:					
Data processing fees	1,119	656	463	63	400
Postage	1,663	(1)	1,664	(41)	1,705
Advertising	3,515	(21)	3,536	353	3,183
Correspondent bank service charges	868	(96)	964	39	925
Telephone	3,108	(145)	3,253	1,053	2,200
Public relations and business development	2,819	71	2,748	48	2,700
Directors' fees	1,553	233	1,320	218	1,102
Audit and accounting fees	1,629	(83)	1,712	55	1,657
Legal fees	1,780	(316)	2,096	95	2,001
Regulatory exam fees	1,177	46	1,131	43	1,088
Travel	1,210	(32)	1,242	28	1,214
Courier expense	879	31	848	39	809
Operational and other losses	3,192	1,022	2,170	281	1,889
Other real estate	188	6	182	58	124
Software amortization and expense	3,294	1,288	2,006	(116)	2,122

Other miscellaneous expense	6,085	114	5,971	368	5,603
<b>Total other</b>	<b>34,079</b>	<b>2,773</b>	<b>31,306</b>	<b>2,584</b>	<b>28,722</b>
Total Noninterest Expense	\$ 173,986	\$ 8,156	\$ 165,830	\$ 16,366	\$ 149,464

*Income Taxes.* Income tax expense was \$26.82 million for 2017, as compared to \$31.15 million for 2016 and \$31.44 million for 2015. Our effective tax rates on pretax income were 18.22%, 22.92% and 23.85%, respectively, for the years 2017, 2016 and 2015. The effective tax rates differ from the statutory federal tax rate of 35.0% 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 income tax deductions from the partial donation of two of our branch buildings to municipalities.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law with sweeping modifications to the Internal Revenue Code. The primary change for the Company was to lower the corporate income tax rate to 21% from 35%. The Company's deferred tax assets and liabilities were re-measured based on the income tax rates at which they are expected to reverse in the future, which is generally 21%. However, the Company continues to analyze certain aspects of the Act resulting in refinement of the calculation which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the re-measurement of the Company's deferred tax balance was \$7.65 million, a reduction of income tax expense for the year ended December 31, 2017.

**Table of Contents****Balance Sheet Review**

*Loans.* Our portfolio is comprised of loans made to businesses, professionals, individuals, and farm and ranch operations located in the primary trade areas served by our subsidiary bank. Real estate loans represent loans primarily for 1-4 family residences and commercial real estate, which are primarily owner-occupied. The structure of loans in the real estate mortgage area generally provides re-pricing intervals to minimize the interest rate risk inherent in long-term fixed rate loans. As of December 31, 2017, total loans held for investment were \$3.49 billion, an increase of \$128.26 million, as compared to December 31, 2016. As compared to year-end 2016, real estate loans increased \$113.15 million, commercial loans increased \$9.69 million, agricultural loans increased \$10.52 million and consumer loans decreased \$5.10 million. Loans averaged \$3.44 billion during 2017, an increase of \$102.21 million over the 2016 average balances.

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

	December 31,				
	2017	2016	2015	2014	2013
Commercial	\$ 684,099	\$ 674,410	\$ 696,163	\$ 639,954	\$ 596,730
Agricultural	94,543	84,021	102,351	105,694	75,928
Real estate	2,302,998	2,189,844	2,136,233	1,822,854	1,678,514
Consumer	403,929	409,032	382,303	360,686	333,113
<b>Total loans held-for-investment</b>	<b>\$ 3,485,569</b>	<b>\$ 3,357,307</b>	<b>\$ 3,317,050</b>	<b>\$ 2,929,188</b>	<b>\$ 2,684,285</b>

As of December 31, 2017, our real estate loans represent approximately 66.07% of our loan portfolio and are comprised of (i) commercial real estate loans of 24.84%, generally owner occupied, (ii) 1-4 family residence loans of 45.80%, (iii) residential development and construction loans of 8.28%, which includes our custom and speculation home construction loans, (iv) commercial development and construction loans of 6.21% and (v) other loans, which includes ranches, hospitals and universities of 14.87%.

Loans held-for-sale, consisting of secondary market mortgage loans, totaled \$15.13 million and \$26.90 million at December 31, 2017 and 2016, respectively, which are valued using the lower of cost or market method.

The Company has certain lending policies and procedures in place that are designed to maximize loan income with an acceptable level of risk. Management reviews and approves these policies and procedures on an annual basis and makes changes as appropriate. Management receives and reviews monthly reports related to loan originations, quality, concentrations, delinquencies, nonperforming and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions, both by type of loan and geographic location.

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and effectively. Underwriting standards are designed to determine whether the borrower possesses sound business ethics and practices and to evaluate current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and, secondarily, on the underlying collateral provided by the borrower. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and include personal guarantees.

Agricultural loans are subject to underwriting standards and processes similar to commercial loans. These agricultural loans are based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. Most agricultural loans are secured by the agriculture related assets being financed, such as farm land, cattle or equipment, and include personal guarantees.

Real estate loans are also subject to underwriting standards and processes similar to commercial and agricultural loans. These loans are underwritten primarily based on projected cash flows and, secondarily, as loans secured by real estate. The repayment of real estate loans is generally largely dependent on the successful operation of the property securing the loans or the business conducted on the property securing the loan. Real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing

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the Company's real estate portfolio are generally diverse in terms of type and geographic location within Texas. This diversity helps reduce the exposure to adverse economic events that affect any single market or industry. Generally, real estate loans are owner-occupied which further reduces the Company's risk.

Consumer loan underwriting utilizes methodical credit standards and analysis to supplement the Company's underwriting policies and procedures. The Company's loan policy addresses types of consumer loans that may be originated and the collateral, if secured, which must be perfected. The relatively smaller individual dollar amounts of consumer loans that are spread over numerous individual borrowers also minimize the Company's risk.

**Table 6 Maturity Distribution and Interest Sensitivity of Loans at December 31, 2017 (in thousands):**

The following tables summarize maturity and repricing information for the commercial and agricultural and the real estate-construction portion of our loan portfolio as of December 31, 2017:

	One Year or less	After One Year Through Five Years	After Five Years	Total
Commercial and agricultural	\$ 348,129	\$ 222,342	\$ 208,171	\$ 778,642
Real estate construction	133,621	64,896	210,911	409,428

	Maturities After One Year
Loans with fixed interest rates	\$ 414,091
Loans with floating or adjustable interest rates	292,229

*Asset Quality.* Our loan portfolio is subject to periodic reviews by our centralized independent loan review group as well as periodic examinations by bank regulatory agencies. Loans are placed on nonaccrual status when, in the judgment of management, the collectability of principal or interest under the original terms becomes doubtful. Nonaccrual, past due 90 days or more and still accruing, and restructured loans plus foreclosed assets were \$20.12 million at December 31, 2017, as compared to \$29.00 million at December 31, 2016 and \$29.77 million at December 31, 2015. As a percent of loans and foreclosed assets, these assets were 0.57% at December 31, 2017, as compared to 0.86% at December 31, 2016 and 0.89% at December 31, 2015. As a percent of total assets, these assets were 0.28% at December 31, 2017, as compared to 0.43% at December 31, 2016 and 0.45% at December 31, 2015. We believe the level of these assets to be manageable and are not aware of any material classified credits not properly disclosed as nonperforming at December 31, 2017.

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*Supplemental Oil and Gas Information.* At December 31, 2017, the Company's exposure to the oil and gas industry was 1.72% of gross loans, or \$60.16 million, down 23.34% from December 31, 2016 year-end levels, and consisted (based on collateral supporting the loan) of (i) development and production loans of 2.72%, (ii) oil and gas field servicing loans of 7.51%, (iii) real estate loans of 47.28%, (iv) accounts receivable and inventory of 24.47% and (v) other of 18.02%. These loans have experienced increased stress due to lower oil and gas prices although such prices improved in 2017. The Company instituted additional monitoring procedures for these loans and has classified, downgraded and charged-off loans as appropriate. The following oil and gas information is as of and for the years ended December 31, 2017 and 2016:

	<b>December 31,</b>	
	<b>2017</b>	<b>2016</b>
Oil and gas related loans	\$ 60,164	\$ 78,483
Oil and gas related loans as a % of total loans	1.72%	2.32%
Classified oil and gas related loans	\$ 20,346	\$ 32,518
Nonaccrual oil and gas related loans	1,414	4,092
Net charge-offs for oil and gas related loans	50	1,145
Allowance for oil and gas related loans as a % of oil and gas loans	7.90%	6.28%

**Table 7 Nonaccrual, Past Due 90 Days or More and Still Accruing, Restructured Loans and Foreclosed Assets (in thousands, except percentages):**

	<b>At December 31,</b>				
	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>
Nonaccrual loans*	\$ 17,670	\$ 27,371	\$ 28,601	\$ 20,194	\$ 27,926
Loans still accruing and past due 90 days or more	288	284	341	261	133
Troubled debt restructured loans**	627	701	199	226	
Nonperforming loans	18,585	28,356	29,141	20,681	28,059
Foreclosed assets	1,532	644	627	1,035	3,069
Total nonperforming assets	\$ 20,117	\$ 29,000	\$ 29,768	\$ 21,716	\$ 31,128
As a % of loans and foreclosed assets	0.57%	0.86%	0.89%	0.74%	1.16%
As a % of total assets	0.28	0.43	0.45	0.37	0.60

\* Includes \$618 thousand, \$1.26 million, \$2.18 million, \$2.15 million and \$2.71 million, respectively, of purchased credit impaired loans as of December 31, 2017, 2016, 2015, 2014 and 2013.

\*\* Troubled debt restructured loans of \$4.63 million, \$6.86 million, \$6.11 million, \$9.07 million and \$13.30 million, respectively, whose interest collection, after considering economic and business conditions and collection efforts, is doubtful are included in non-accrual loans as of December 31, 2017, 2016, 2015,

2014 and 2013.

We record interest payments received on non-accrual loans as reductions of principal. Prior to the loans being placed on non-accrual, we recognized interest income on impaired loans as of December 31, 2017 of approximately \$263 thousand during the year ended December 31, 2017. If interest on these impaired loans had been recognized on a full accrual basis during the year ended December 31, 2017, such income would have approximated \$2.15 million.

See Note 3 to the Consolidated Financial Statements beginning on page F-16 for more information on these assets.

*Provision and Allowance for Loan Losses.* The allowance for loan losses is the amount we determine as of a specific date to be appropriate to absorb probable losses on existing loans in which full collectability is unlikely based on our review and evaluation of the loan portfolio. For a discussion of our methodology, see our accounting policies in Note 1 to the Consolidated Financial Statements beginning on page F-7. The provision for loan losses was \$6.53 million in 2017, as compared to \$10.21 million in 2016 and \$9.69 million in 2015. The continued provision for loan losses in 2017 reflects the continued growth in the loan portfolio, the continued levels of gross charge-offs and the effects related to Hurricane Harvey on the loan portfolio. As a percent of average loans, net loan charge-offs were 0.12% during 2017, 0.19% during 2016 and 0.15% during 2015. The allowance for loan losses as a percent of loans was 1.38% as of December 31, 2017, as compared to 1.35% as of December 31, 2016, and 1.25% as of December 31, 2015. Included in Tables 8 and 9 are further analysis of our allowance for loan losses.

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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 or lower employment could result in increased levels of nonaccrual, past due 90 days or more and still accruing, restructured loans, foreclosed assets, charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of their examination process, bank regulatory agencies periodically review the adequacy of our allowance for loan losses. The banking agencies could require additions to the loan loss allowance based on their judgment of information available to them at the time of their examinations of our bank subsidiary.

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

	2017	2016	2015	2014	2013
Balance at January 1,	\$ 45,779	\$ 41,877	\$ 36,824	\$ 33,900	\$ 34,839
Charge-offs:					
Commercial	3,018	6,990	3,734	583	1,283
Agricultural	71	219	164	2	100
Real estate	1,215	682	441	1,075	1,970
Consumer	1,517	1,925	1,700	1,222	1,268
Total charge-offs	5,821	9,816	6,039	2,882	4,621
Recoveries:					
Commercial	942	952	344	346	402
Agricultural	33	25	55	18	39
Real estate	192	2,021	558	505	239
Consumer	501	508	450	472	337
Total recoveries	1,668	3,506	1,407	1,341	1,017
Net charge-offs	4,153	6,310	4,632	1,541	3,604
Transfer of off-balance sheet exposure to other liabilities					(1,088)
Provision for loan losses	6,530	10,212	9,685	4,465	3,753
Balance at December 31,	\$ 48,156	\$ 45,779	\$ 41,877	\$ 36,824	\$ 33,900
Loans at year-end	\$ 3,500,699	\$ 3,384,205	\$ 3,350,593	\$ 2,937,991	\$ 2,689,448
Average loans	3,435,447	3,333,241	3,090,538	2,786,011	2,431,872
Net charge-offs/average loans	0.12%	0.19%	0.15%	0.06%	0.15%
Allowance for loan losses/year-end loans*	1.38	1.35	1.25	1.25	1.26
Allowance for loan losses/nonaccrual, past due 90 days still accruing and restructured loans	259.11	161.44	143.70	178.06	120.82



\* Reflects the impact of loans acquired in the Orange acquisition in 2013 and the Conroe acquisition in 2015, which were initially recorded at fair value with no allocated allowance for loan losses.

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

	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>Allocation</b>	<b>Allocation</b>	<b>Allocation</b>	<b>Allocation</b>	<b>Allocation</b>
	<b>Amount</b>	<b>Amount</b>	<b>Amount</b>	<b>Amount</b>	<b>Amount</b>
Commercial	\$ 10,865	\$ 11,707	\$ 12,644	\$ 7,990	\$ 6,440
Agricultural	1,305	1,101	1,191	527	383
Real estate	29,896	26,864	24,375	26,657	24,940
Consumer	6,090	6,107	3,667	1,650	2,137
<b>Total</b>	<b>\$ 48,156</b>	<b>\$ 45,779</b>	<b>\$ 41,877</b>	<b>\$ 36,824</b>	<b>\$ 33,900</b>

**Table of Contents****Percent of Loans in Each Category of Total Loans:**

	2017	2016	2015	2014	2013
Commercial	19.63%	20.09%	20.99%	21.84%	22.23%
Agricultural	2.71	2.50	3.09	3.61	2.83
Real estate	66.07	65.23	64.40	62.23	62.53
Consumer	11.59	12.18	11.52	12.32	12.41

Included in our loan portfolio are certain other loans not included in Table 7 that are deemed to be potential problem loans. Potential problem loans are those loans that are currently performing, but for which known information about trends, 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 \$4.37 million as of December 31, 2017.

*Interest-Bearing Deposits in Banks.* The Company had interest-bearing deposits in banks of \$164.22 million and \$50.28 million at December 31, 2017 and 2016, respectively. At December 31, 2017, our interest-bearing deposits in banks included \$162.09 million maintained at the Federal Reserve Bank of Dallas, \$1.46 million invested in FDIC-insured certificates of deposit and \$677 thousand on deposit with the Federal Home Loan Bank of Dallas (FHLB). The average balance of interest-bearing deposits in banks was \$141.37 million, \$58.25 million and \$49.69 million in 2017, 2016 and 2015, respectively. The average yield on interest-bearing deposits in banks was 1.17%, 0.55% and 0.36% in 2017, 2016 and 2015, respectively.

*Available-for-Sale and Held-to-Maturity Securities.* At December 31, 2017, securities with a fair value of \$3.09 billion were classified as securities available-for-sale. There were no securities classified as held-to-maturity at December 31, 2017. As compared to December 31, 2016, the available-for-sale portfolio at December 31, 2017, reflected (1) a decrease of \$10.67 million in U.S. Treasury securities; (2) a decrease of \$53.37 million in obligations of U.S. government sponsored enterprises and agencies; (3) a decrease of \$143.43 million in obligations of states and political subdivisions; (4) a decrease of \$40.93 million in corporate bonds and other; and (5) an increase of \$475.04 million in mortgage-backed securities. As compared to December 31, 2015, the available-for-sale portfolio at December 31, 2016, reflected (1) a decrease of \$127 thousand in U.S. Treasury securities; (2) a decrease of \$34.85 million in obligations of U.S. government sponsored enterprises and agencies; (3) an increase of \$113.15 million in obligations of states and political subdivisions; (4) a decrease of \$35.56 million in corporate bonds and other; and (5) an increase of \$84.33 million in mortgage-backed securities. Securities-available-for-sale included fair value adjustments of \$44.86 million, \$33.07 million and \$79.01 million at December 31, 2017, 2016 and 2015, respectively. We did not hold any collateralized mortgage obligations or structured notes as of December 31, 2017 that we consider to be high risk. Our mortgage related securities are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

See Table 10 and Note 2 to the Consolidated Financial Statements for additional disclosures relating to the maturities and fair values of the investment portfolio at December 31, 2017 and 2016.

**Table 10 Maturities and Yields of Available-for-Sale Held at December 31, 2017 (in thousands, except percentages):****Maturing**

Available-for-Sale:	One Year or Less		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Obligations of U.S. government sponsored enterprises and agencies	\$ 34,981	1.30%	\$ 25,349	1.51%	\$	%\$	%\$	%\$	60,330	1.39%
Obligations of states and political subdivisions	139,568	5.03	628,506	5.13	650,699	4.74	2,077	6.68	1,420,850	4.94
Corporate bonds and other securities	10,998	2.96	237	1.15	224	2.64			11,459	2.92
Mortgage-backed securities	55,430	1.66	1,027,515	2.31	459,286	2.69	52,603	2.93	1,594,834	2.42
<b>Total</b>	<b>\$ 240,977</b>	<b>3.62%</b>	<b>\$ 1,681,607</b>	<b>3.35%</b>	<b>\$ 1,110,209</b>	<b>3.89%</b>	<b>\$ 54,680</b>	<b>3.08%</b>	<b>\$ 3,087,473</b>	<b>3.56%</b>

Amounts for held-to-maturity securities are not included herein due to insignificance.

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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. Maturities of other securities are reported at the earlier of maturity date or call date.

As of December 31, 2017, the investment portfolio had an overall tax equivalent yield of 3.56%, a weighted average life of 4.29 years and modified duration of 3.82 years.

*Deposits.* Deposits held by our subsidiary bank represent our primary source of funding. Total deposits were \$5.96 billion as of December 31, 2017, as compared to \$5.48 billion as of December 31, 2016 and \$5.19 billion as of December 31, 2015. Table 11 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 11 Composition of Average Deposits and Remaining Maturity of Time Deposits of \$100,000 or More (in thousands, except percentages):**

	2017		2016		2015	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing deposits	\$ 1,843,973		\$ 1,666,598		\$ 1,634,669	
Interest-bearing deposits						
Interest-bearing checking	1,902,699	0.27%	1,713,498	0.12%	1,622,331	0.09%
Savings and money market accounts	1,401,804	0.13	1,195,671	0.09	1,021,222	0.05
Time deposits under \$100,000	267,754	0.13	237,419	0.18	261,255	0.20
Time deposits of \$100,000 or more	211,703	0.40	322,417	0.31	367,342	0.31
Total interest-bearing deposits	3,783,960	0.22%	3,469,005	0.13%	3,272,150	0.11%
Total average deposits	\$ 5,627,933		\$ 5,135,603		\$ 4,906,819	

	As of December 31, 2017
Three months or less	\$ 81,918
Over three through six months	64,396
Over six through twelve months	70,470
Over twelve months	33,670
Total time deposits of \$100,000 or more	\$ 250,454

*Borrowings.* Included in borrowings were federal funds purchased, securities sold under repurchase agreements and advances from the FHLB of \$331.00 million, \$445.77 million and \$615.68 million at December 31, 2017, 2016 and 2015, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds for which we pledge certain securities that have a fair value equal to at least the amount of the short-term borrowing. The average balances of federal funds purchased, securities

sold under repurchase agreements and advances from the FHLB were \$422.29 million, \$552.04 million and \$524.37 million in 2017, 2016 and 2015, respectively. The average rates paid on federal funds purchased, securities sold under repurchase agreements and advances from the FHLB were 0.25%, 0.17% and 0.08% for the years ended December 31, 2017, 2016 and 2015, respectively. The weighted average interest rate on federal funds purchased, securities sold under repurchase agreements and advances from the FHLB was 0.10%, 0.12% and 0.17% at December 31, 2017, 2016 and 2015, respectively. The highest amount of federal funds purchased, securities sold under repurchase agreements and advances from the FHLB at any month end during 2017, 2016 and 2015 was \$611.30 million, \$598.77 million and \$647.72 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.

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Total shareholders' equity was \$922.77 million, or 12.72% of total assets at December 31, 2017, as compared to \$837.89 million, or 12.30% of total assets at December 31, 2016. During 2017, total shareholders' equity averaged \$882.81 million, or 12.65% of average assets, as compared to \$847.87 million, or 12.85% of average assets during 2016.

Banking regulators measure capital adequacy by means of the risk-based capital ratios and leverage ratio under the Basel III regulatory capital framework and prompt corrective action regulations. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories. 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.

Beginning in January 2016, under the Basel III regulatory capital framework, the implementation of the capital conservation buffer was effective for the Company starting at the 0.625% level and increasing 0.625% each year thereafter, until it reaches 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress and requires increased capital levels for the purpose of capital distributions and other payments. Failure to meet the amount of the buffer will result in restrictions on the Company's ability to make capital distributions, including dividend payments and stock repurchase, and to pay discretionary bonuses to executive officers.

As of December 31, 2017 and 2016, we had a total risk-based capital ratio of 19.85% and 18.45%, a Tier 1 capital to risk-weighted assets ratio of 18.66% and 17.30%, a common equity Tier 1 capital to risk-weighted ratio of 18.66% and 17.30% and a Tier 1 leverage ratio of 11.09% and 10.71%, respectively. The regulatory capital ratios as of December 31, 2017 and 2016 were calculated under Basel III rules. There is no threshold for well-capitalized status for bank holding companies.

We performed a preliminary assessment using the regulatory capital estimation tool made available by the OCC and believe the Company and Bank are prepared to meet the new requirements upon full implementation of the Basel III rules that will be effective December 31, 2019.

Our subsidiary bank made the election to continue to exclude most AOCI from capital in connection with its March 31, 2015 quarterly financial filing and, in effect, to retain the AOCI treatment under the prior capital rules.

*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.

Our subsidiary bank has an asset liability management committee that monitors interest rate risk and compliance with investment policies. The subsidiary bank utilizes 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 twelve 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 twelve months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the re-pricing and maturity characteristics of the existing and projected balance sheet.

As of December 31, 2017, the model simulations projected that 100 and 200 basis point increases in interest rates would result in variances in net interest income of positive 0.58% and positive 0.50%, respectively, relative to the current financial statement structure over the next twelve months, while a decrease in interest rates of 100 basis points would result in a variance in a net interest income of negative 3.84% relative to the current financial statement structure over the next twelve months. We consider the likelihood of a decrease in interest rates beyond 100 basis points after December 31, 2017 remote given current interest rate levels. 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

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instantaneous and sustained across the yield curve regardless of duration of pricing characteristics on 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 re-price 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 committee oversees and monitors 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 12 and 13. 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 bank. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondent banks, sales of securities under agreements to repurchase and advances from the FHLB, which amounted to \$331.00 million at December 31, 2017, and an unfunded \$25.00 million revolving line of credit established with Frost Bank, a nonaffiliated bank, which matures on June 2019 (see next paragraph). Our subsidiary bank also has federal funds purchased lines of credit with two non-affiliated banks totaling \$130.00 million. At December 31, 2017, there were no amounts drawn on these lines of credit. Our subsidiary bank also has available a line of credit with the FHLB totaling \$1.22 billion at December 31, 2017, secured by portions of our loan portfolio and certain investment securities. At December 31, 2017, no amounts were outstanding under this line of credit.

The Company renewed its loan agreement, effective June 30, 2017, with Frost Bank. Under the loan agreement, as renewed and amended, we are permitted to draw up to \$25.00 million on a revolving line of credit. Prior to June 30, 2019, interest is paid quarterly at *The Wall Street Journal* Prime Rate and the line of credit matures June 30, 2019. If a balance exists at June 30, 2019, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at our election at *The Wall Street Journal* Prime Rate plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured. 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, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits 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. The Company was in compliance with the financial and operational covenants at December 31, 2017. There was no outstanding balance under the line of credit as of December 31, 2017 or 2016.



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 and cash equivalents at our parent company, which totaled \$78.47 million at December 31, 2017, investment securities which totaled \$8.52 million at December 31, 2017 which matures over 6 to 13 years, available dividends from our subsidiaries which totaled \$205.75 million at December 31, 2017, 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.

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

**Table 12 Contractual Obligations as of December 31, 2017 (in thousands):**

	Total Amounts	Payment Due by Period			
		Less than 1 year	More than 1 year but less than 3 years	More than 3 year but less than 5 years	Over 5 years
Deposits with stated maturity dates	\$ 451,255	\$ 384,668	\$ 52,638	\$ 13,949	\$
Pension obligation	10,567	1,064	2,054	2,140	5,309
Operating leases	909	385	476	48	
Outsourcing service contracts	3,610	2,077	1,533		
<b>Total Contractual Obligations</b>	<b>\$ 466,341</b>	<b>\$ 388,194</b>	<b>\$ 56,701</b>	<b>\$ 16,137</b>	<b>\$ 5,309</b>

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 federal funds sold to correspondent banks 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.

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 13 Commitments as of December 31, 2017 (in thousands):**

	<b>Total Notional Amounts Committed</b>	<b>Less than 1 year</b>	<b>More than 1 year but less than 3 years</b>	<b>More than 3 year but less than 5 years</b>	<b>Over 5 years</b>
Unfunded lines of credit	\$ 534,468	\$ 492,138	\$ 24,394	\$ 13,327	\$ 4,609
Unfunded commitments to extend credit	244,658	147,735	18,401	11,781	66,741
Standby letters of credit	28,858	22,245	6,613		
<b>Total Commercial Commitments</b>	<b>\$ 807,984</b>	<b>\$ 662,118</b>	<b>\$ 49,408</b>	<b>\$ 25,108</b>	<b>\$ 71,350</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.

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*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 subsidiaries. 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 subsidiaries. At December 31, 2017, approximately \$205.75 million was available for the payment of intercompany dividends by our subsidiaries without the prior approval of regulatory agencies. Our subsidiaries paid aggregate dividends to us of \$30.80 million in 2017 and \$48.80 million in 2016.

*Dividends.* Our long-term dividend policy is to pay cash dividends to our shareholders of approximately 40% of annual net earnings while maintaining adequate capital to support growth. We are also restricted by a loan covenant within our line of credit agreement with Frost Bank to dividend no greater than 55% of net income, as defined in such loan agreement. The cash dividend payout ratios have amounted to 41.24%, 44.14% and 40.20% of net earnings, respectively, in 2017, 2016 and 2015. Given our current capital position, projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy.

Our bank subsidiary, which is a national banking association and a member of the Federal Reserve System, is required by federal law to obtain the prior approval of the OCC 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.

To pay dividends, we and our subsidiary bank 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, the FDIC 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, 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**

Management considers interest rate risk to be a significant market risk for the Company. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources Interest Rate Risk for disclosure regarding this market risk.

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

Our consolidated financial statements and the report of our independent registered public accounting firm begin on page F-1.

**Table of Contents****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 the fiscal years of 2017 and 2016. 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.

	2017			
	4 <sup>th</sup>	3 <sup>rd</sup>	2 <sup>nd</sup>	1 <sup>st</sup>
	(dollars in thousands, except per share amounts)			
<b>Summary Income Statement Information:</b>				
Interest income	\$ 63,456	\$ 62,554	\$ 61,182	\$ 58,783
Interest expense	2,562	2,866	2,097	1,763
Net interest income	60,894	59,688	59,085	57,020
Provision for loan losses	1,440	1,415	1,725	1,950
Net interest income after provision for loan losses	59,454	58,273	57,360	55,070
Noninterest income	22,298	23,185	22,423	21,283
Net gain on securities transactions	3	1,075	747	3
Noninterest expense	44,095	43,964	43,775	42,152
Earnings before income taxes	37,660	38,569	36,755	34,204
Income tax expense	1,517	9,195	8,500	7,605
Net earnings	\$ 36,143	\$ 29,374	\$ 28,255	\$ 26,599
<b>Per Share Data:</b>				
Earnings per share, basic	\$ 0.55	\$ 0.44	\$ 0.43	\$ 0.40
Earnings per share, assuming dilution	0.54	0.44	0.43	0.40
Cash dividends declared	0.19	0.19	0.19	0.18
Book value at period-end	13.93	13.69	13.41	12.99
<b>Common stock sales price:</b>				
High	\$ 48.85	\$ 46.00	\$ 44.80	\$ 46.45
Low	43.05	37.31	36.85	37.55
Close	45.05	45.20	44.20	40.10

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	2016			
	4 <sup>th</sup>	3 <sup>rd</sup>	2 <sup>nd</sup>	1 <sup>st</sup>
	(dollars in thousands, except per share amounts)			
<b>Summary Income Statement Information:</b>				
Interest income	\$ 57,979	\$ 58,093	\$ 57,881	\$ 58,335
Interest expense	1,443	1,366	1,330	1,312
Net interest income	56,536	56,727	56,551	57,023
Provision for loan losses	1,993	3,833	2,058	2,328
Net interest income after provision for loan losses	54,543	52,894	54,493	54,695
Noninterest income	21,604	21,913	20,526	19,819
Net gain (loss) on securities transactions	117	239	912	2
Noninterest expense	41,990	42,003	40,756	41,081
Earnings before income taxes	34,274	33,043	35,175	33,435
Income tax expense	7,608	7,440	8,366	7,739
Net earnings	\$ 26,666	\$ 25,603	\$ 26,809	\$ 25,696
<b>Per Share Data:</b>				
Earnings per share, basic	\$ 0.40	\$ 0.39	\$ 0.41	\$ 0.39
Earnings per share, assuming dilution	0.40	0.39	0.41	0.39
Cash dividends declared	0.18	0.18	0.18	0.16
Book value at period-end	12.68	13.14	13.11	12.70
<b>Common stock sales price:</b>				
High	\$ 46.70	\$ 37.06	\$ 34.50	\$ 30.75
Low	35.05	30.95	27.72	24.12
Close	45.20	36.44	32.79	29.58

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

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

As of December 31, 2017, 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 (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934). Our management, which includes our principal executive officer and our 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

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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 were effective at the reasonable assurance level as of December 31, 2017.

Subsequent to our evaluation, there were no significant changes in our internal control over financial reporting or other factors that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **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 reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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, 2017. In making this assessment, it used the criteria for effective internal control over financial reporting set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) (COSO) in *Internal Control – Integrated Framework*. Based on our assessment we believe that, as of December 31, 2017, the Company's internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934, is effective based on those criteria.

First Financial Bankshares, Inc. and subsidiaries' independent auditors have issued an audit report, dated February 16, 2018, on the effectiveness of the Company's internal control over financial reporting as of December 31, 2017.

### **REPORT OF INDEPENDENT PUBLIC ACCOUNTING FIRM**

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

#### **Opinion on Internal Control over Financial Reporting**

We have audited First Financial Bankshares, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, First Financial Bankshares, Inc. and subsidiaries (the Company) maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets as of December 31, 2017 and 2016, 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, 2017 and related notes and our report dated February 16, 2018 expressed an unqualified opinion thereon.





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**Basis for Opinion**

The Company'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 are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. 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.

**Definition and Limitations of Internal Control over Financial Reporting**

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 of 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.

/s/ Ernst & Young LLP

Dallas, Texas

February 16, 2018

**ITEM 9B. OTHER INFORMATION**

None.



Table of Contents**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 2018 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2017.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 is hereby incorporated by reference from our proxy statement for our 2018 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2017.

**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 proxy statement for our 2018 annual meeting of shareholders. The following chart gives aggregate information under our equity compensation plans as of December 31, 2017.

	<b>Number of Securities To be Issued Upon Exercise of Outstanding Options, Warrants and Rights</b>	<b>Weighted Average Exercise Price of Outstanding Options, Warrants and Rights</b>	<b>Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Far Left Column)</b>
Equity compensation plans approved by security holders	1,325,965	\$ 33.01	2,267,193
Equity compensation plans not approved by security holders			
<b>Total</b>	<b>1,325,965</b>	<b>\$ 33.01</b>	<b>2,267,193</b>

The remainder of the information required by Item 12 is incorporated by reference from our proxy statement for our 2018 annual meeting of shareholders.

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

The information required by Item 13 is hereby incorporated by reference from our proxy statement for our 2018 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2017.

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

The information required by Item 14 is hereby incorporated by reference from our proxy statement for our 2018 annual meeting of shareholders which will be filed with the SEC not later than 120 days after December 31, 2017.

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**PART IV**

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

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

(1) Financial Statements:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2017 and 2016

Consolidated Statements of Earnings for the years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Comprehensive Earnings for the years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Shareholders' Equity for the years ended December 31, 2017, 2016 and 2015

Consolidated Statements of Cash Flows for the years ended December 31, 2017, 2016 and 2015

Notes to the Consolidated Financial Statements

(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.

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**Exhibits Index**

The following exhibits are filed as part of this report:

- 2.1 Agreement and Plan of Reorganization, dated October 12, 2017, by and among First Financial Bankshares, Inc., Kingwood Merger Sub, Inc., and Commercial Bancshares, Inc. (schedules have been omitted pursuant to Item 601(b)(2) of Regulation S-K) (incorporated by reference from Exhibit 2.1 to Registrant's Form 8-K filed October 12, 2017).
- 3.1 Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant's Form 8-K filed April 30, 2015).
- 3.2 Amended and Restated Bylaws of the Registrant (incorporated by reference from Exhibit 99.1 of the Registrant's Form 8-K filed January 24, 2012).
- 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 2002 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.3 of the Registrant's Form 10-Q filed May 4, 2010).++
- 10.2 2012 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant's Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 1, 2012).++
- 10.3 Loan Agreement, dated June 30, 2013, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed July 1, 2013).
- 10.4 First Amendment to Loan Agreement, dated June 30, 2015, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed June 30, 2015).
- 10.5 Second Amendment to Loan Agreement, dated June 30, 2017, between First Financial Bankshares, Inc. and Frost Bank (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed June 30, 2017).
- 10.6 2015 Restricted Stock Plan (incorporated by reference from Appendix A of the Registrant's Definitive Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 filed March 2, 2015).++
- 10.7 Form of Executive Recognition Agreement (incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K filed August 26, 2016).++
- 21.1 Subsidiaries of 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.\*

31.2	<u>Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.*</u>
32.1	<u>Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.+</u>
32.2	<u>Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.+</u>
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*

\* Filed herewith.

+ Furnished herewith. This Exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that Section, and shall not be deemed to be incorporated into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

++ Management contract or compensatory plan on arrangement.



Table of Contents**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.

Date: February 16, 2018

By: /s/ F. SCOTT DUESER  
F. SCOTT DUESER  
Chairman of the Board, Director, President and  
Chief Executive Officer

(Principal Executive Officer)

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.

Name	Title	Date
/s/ F. SCOTT DUESER  F. Scott Dueser	Chairman of the Board, Director, President, and Chief Executive  Officer  (Principal Executive Officer)	February 16, 2018
/s/ J. BRUCE HILDEBRAND  J. Bruce Hildebrand	Executive Vice President and Chief Financial Officer  (Principal Financial Officer and Principal Accounting Officer)	February 16, 2018
/s/ APRIL K. ANTHONY  April K. Anthony	Director	February 16, 2018
/s/ STEVEN L. BEAL	Director	February 16, 2018

Steven L. Beal

/s/ TUCKER S.  
BRIDWELL

a combination of any such methods of sale; and

Tucker S. Bridwell

· any other method permitted pursuant to applicable law.

The selling stockholders may also sell shares under Rule 144 under the Securities Act, if available, or Regulation S, rather than under this prospectus. The selling stockholders shall have the sole and absolute discretion not to accept any purchase offer or make any sale of shares if they deem the purchase price to be unsatisfactory at any particular time.

The selling stockholders or their respective pledgees, donees, transferees or other successors in interest, may also sell the shares directly to market makers acting as principals and/or broker-dealers acting as agents for themselves or their customers. Such broker-dealers may receive compensation in the form of discounts, concessions or commissions from the selling stockholders and/or the purchasers of shares for whom such broker-dealers may act as agents or to whom they sell as principal or both, which compensation as to a particular broker-dealer might be in excess of customary commissions. Market makers and block purchasers purchasing the shares will do so for their own account and at their own risk. It is possible that a selling stockholder will attempt to sell shares of common stock in block transactions to market makers or other purchasers at a price per share which may be below the then market price. The selling stockholders cannot assure that all or any of the shares offered in this prospectus will be issued to, or sold by, the selling stockholders. The selling stockholders and any brokers, dealers or agents, upon effecting the sale of any of the shares offered in this prospectus, may be deemed to be "underwriters" as that term is defined under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, or the rules and regulations under such acts. In such event, any commissions received by such broker-dealers or agents and any profit on the resale of the shares purchased by them may be deemed to be underwriting commissions or discounts under the Securities Act.

We are required to pay all fees and expenses incident to the registration of the shares, including fees and disbursements of counsel to the selling stockholders, but excluding brokerage commissions or underwriter discounts.

The selling stockholders, alternatively, may sell all or any part of the shares offered in this prospectus through an underwriter. No selling stockholder has entered into any agreement with a prospective underwriter and there is no assurance that any such agreement will be entered into.

The selling stockholders may pledge their shares to their brokers under the margin provisions of customer agreements. If a selling stockholders defaults on a margin loan, the broker may, from time to time, offer and sell the pledged shares. The selling stockholders and any other persons participating in the sale or distribution of the shares will be subject to applicable provisions of the Securities Exchange Act of 1934, as amended, and the rules and regulations under such act, including, without limitation, Regulation M. These provisions may restrict certain activities of, and limit the timing of purchases and sales of any of the shares by, the selling stockholders or any other such person. In the event that the selling stockholders are deemed affiliated purchasers or distribution participants within the meaning of Regulation M, then the selling stockholders will not be permitted to engage in short sales of common stock. Furthermore, under Regulation M, persons engaged in a distribution of securities are prohibited from simultaneously engaging in market making and certain other activities with respect to such securities for a specified period of time prior to the commencement of such distributions, subject to specified exceptions or exemptions.

We have agreed to indemnify the selling stockholders, or their transferees or assignees, against certain liabilities, including liabilities under the Securities Act of 1933, as amended, or to contribute to payments the selling stockholders or their respective pledgees, donees, transferees or other successors in interest, may be required to make in respect of such liabilities.

If the selling stockholders notify us that they have a material arrangement with a broker-dealer for the resale of the common stock, then we would be required to amend the registration statement of which this prospectus is a part, and file a prospectus supplement to describe the agreements between the selling stockholders and the broker-dealer.

## PENNY STOCK

The Securities and Exchange Commission has adopted Rule 15g-9 which establishes the definition of a "penny stock," for the purposes relevant to us, as any equity security that has a market price of less than \$5.00 per share or with an exercise price of less than \$5.00 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, the rules require:

- that a broker or dealer approve a person's account for transactions in penny stocks; and
- the broker or dealer receive from the investor a written agreement to the transaction, setting forth the identity and quantity of the penny stock to be purchased.

In order to approve a person's account for transactions in penny stocks, the broker or dealer must

- obtain financial information and investment experience objectives of the person; and
- make a reasonable determination that the transactions in penny stocks are suitable for that person and the person has sufficient knowledge and experience in financial matters to be capable of evaluating the risks of transactions in penny stocks.

The broker or dealer must also deliver, prior to any transaction in a penny stock, a disclosure schedule prescribed by the Commission relating to the penny stock market, which, in highlight form:

- sets forth the basis on which the broker or dealer made the suitability determination; and
- that the broker or dealer received a signed, written agreement from the investor prior to the transaction.

Disclosure also has to be made about the risks of investing in penny stocks in both public offerings and in secondary trading and about the commissions payable to both the broker-dealer and the registered representative, current quotations for the securities and the rights and remedies available to an investor in cases of fraud in penny stock transactions. Finally, monthly statements have to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks.

**SELLING STOCKHOLDERS**

The table below sets forth information concerning the resale of the shares of common stock by the selling stockholders. We will not receive any proceeds from the resale of the common stock by the selling stockholders. We will receive proceeds from the exercise of the warrants. Assuming all the shares registered below are sold by the selling stockholders, none of the selling stockholders will continue to own any shares of our common stock.

The following table also sets forth the name of each person who is offering the resale of shares of common stock by this prospectus, the number of shares of common stock beneficially owned by each person, the number of shares of common stock that may be sold in this offering and the number of shares of common stock each person will own after the offering, assuming they sell all of the shares offered.

Name	Total Shares of Common Stock Issuable Upon Conversion of Notes and/or Warrants*	Total Percentage of Common Stock, Assuming Full Conversion	Shares of Common Stock Included in Prospectus (1)	Beneficial Ownership Before the Offering**	Percentage of Common Stock Owned Before Offering**	Beneficial Ownership After the Offering (7)	Pe Cor O
AJW Offshore, Ltd. (2)	20,440,000(3)	10.38%	Up to 20,440,000 shares of common stock	9,825,690	4.99%	—	
AJW Qualified Partners, LLC (2)	13,320,000(4)	6.77%	Up to 13,320,000 shares of common stock	9,825,690	4.99%	—	
AJW Partners, LLC (2)	5,600,000(5)	2.84%	Up to 5,600,000 shares of common stock	5,600,000	2.84%	—	
New Millennium Capital Partners II, LLC (2)	640,000(6)	***	Up to 640,000 shares of common stock	640,000	***	—	

\* This column represents an estimated number based on a conversion price as of a recent date of August 24, 2005 of \$.033, divided into the principal amount.

\*\* These columns represent the aggregate maximum number and percentage of shares that the selling stockholders can own at one time (and therefore, offer for resale at any one time) due to their 4.99% limitation.

\*\*\* Less than 1%

The number and percentage of shares beneficially owned is determined in accordance with Rule 13d-3 of the Securities Exchange Act of 1934, and the information is not necessarily indicative of beneficial ownership for any other purpose. Under such rule, beneficial ownership includes any shares as to which the selling stockholders has sole or shared voting power or investment power and also any shares, which the selling stockholders has the right to acquire within 60 days. The actual number of shares of common stock issuable upon the conversion of the secured convertible notes is subject to adjustment depending on, among other factors, the future market price of the common stock, and could be materially less or more than the number estimated in the table.

(1) Includes a good faith estimate of the shares issuable upon conversion of the secured convertible notes and exercise of warrants, based on current market prices. Because the number of shares of common stock issuable upon conversion of the secured convertible notes is dependent in part upon the market price of the common stock prior to a conversion, the actual number of shares of common stock that will be issued upon conversion will fluctuate daily and cannot be determined at this time. Under the terms of the secured convertible notes, if the secured convertible notes had actually been converted on August 24, 2005, the secured convertible notes would have had a conversion price of \$.033. The actual number of shares of common stock offered in this prospectus, and included in the registration statement of which this prospectus is a part, includes such additional number of shares of common stock as may be issued or issuable upon conversion of the secured convertible notes and exercise of the related warrants by reason of any stock split, stock dividend or similar transaction involving the common stock, in accordance with Rule 416 under the Securities Act of 1933. However the selling stockholders have contractually agreed to restrict their ability to convert their secured convertible notes or exercise their warrants and receive shares of our common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock as determined in accordance with Section 13(d) of the Exchange Act. Accordingly, the number of shares of common stock set forth in the table for the selling stockholders exceeds the number of shares of common stock that the selling stockholders could own beneficially at any given time through their ownership of the secured convertible notes and the warrants. In that regard, the beneficial ownership of the common stock by the selling stockholder set forth in the table is not determined in accordance with Rule 13d-3 under the Securities Exchange Act of 1934, as amended.

(2) The selling stockholders are affiliates of each other because they are under common control. AJW Partners, LLC is a private investment fund that is owned by its investors and managed by SMS Group, LLC. SMS Group, LLC, of which Mr. Corey S. Ribotsky is the fund manager, has voting and investment control over the shares listed below owned by AJW Partners, LLC. AJW Offshore, Ltd., formerly known as AJW/New Millennium Offshore, Ltd., is a private investment fund that is owned by its investors and managed by First Street Manager II, LLC. First Street Manager II, LLC, of which Corey S. Ribotsky is the fund manager, has voting and investment control over the shares owned by AJW Offshore, Ltd. AJW Qualified Partners, LLC, formerly known as Pegasus Capital Partners, LLC, is a private investment fund that is owned by its investors and managed by AJW Manager, LLC, of which Corey S. Ribotsky and Lloyd A. Groveman are the fund managers, have voting and investment control over the shares listed below owned by AJW Qualified Partners, LLC. New Millennium Capital Partners II, LLC, is a private investment fund that is owned by its investors and managed by First Street Manager II, LLC. First Street Manager II, LLC, of which Corey S. Ribotsky is the fund manager, has voting and investment control over the shares owned by New Millennium Capital Partners II, LLC. We have been notified by the selling stockholders that they are not broker-dealers or affiliates of broker-dealers and that they believe they are not required to be broker-dealers.

(3) Includes (i) 20,128,801 shares of common stock issuable upon conversion of secured convertible notes, and (ii) 311,199 shares of common stock issuable upon exercise of common stock purchase warrants.

(4) Includes (i) 13,117,203 shares of common stock issuable upon conversion of secured convertible notes, and (ii) 202,797 shares of common stock issuable upon exercise of common stock purchase warrants.

(5) Includes (i) 5,514,740 shares of common stock issuable upon conversion of secured convertible notes, and (ii) 85,260 shares of common stock issuable upon exercise of common stock purchase warrants.

(6) Includes (i) 630,256 shares of common stock issuable upon conversion of secured convertible notes, and (ii) 9,744 shares of common stock issuable upon exercise of common stock purchase warrants.

(7) Assumes that all securities registered will be sold.

#### **TERMS OF SECURED CONVERTIBLE NOTES AND THE WARRANTS**

To obtain funding for our ongoing operations, we entered into a Securities Purchase Agreement with four accredited investors on July 15, 2005 for the sale of (i) \$3,250,000 in secured convertible notes and (ii) warrants to buy 3,000,000 shares of our common stock.

The investors are obligated to provide us with the funds (gross proceeds) as follows:

- \$250,000 was disbursed on July 15, 2005;

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- \$1,000,000 was disbursed on August 1, 2005, upon receipt by the investors of a certificate representing the pledged shares of Dr. John W. Whitney, our President, as security for repayment of the secured convertible notes in the aggregate amount of 14,550,558 shares pursuant to the Guaranty and Pledge Agreement dated as of July 15, 2005;
- \$1,000,000 will be disbursed within five days of the filing of this registration statement; and
- \$1,000,000 will be disbursed within five days of the effectiveness of this prospectus.

The secured convertible notes bear interest at 8% per annum, mature three years from the date of issuance, and are convertible into our common stock, at the investors' option, at the lower of:

- \$0.10; or
- a 45% discount to the average of the three lowest intraday trading prices for the common stock on a principal market for the 20 trading days before but not including the conversion date.

We have a call option under the terms of the secured convertible notes. The call option provides us with the right to prepay all of the outstanding secured convertible notes at any time, provided we are not in default and our stock is trading at or below \$.10 per share. Prepayment of the notes is to be made in cash equal to either (i) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the secured convertible notes; (ii) 135% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the secured convertible notes; and (iii) 150% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the secured convertible notes.

Our right to repay the notes is exercisable on not less than ten trading days prior written notice to the holders of the secured convertible notes. For notice purposes, a trading day is any day on which our common stock is traded for any period on the OTC Bulletin Board. Notwithstanding the notice of prepayment, the holders of the secured convertible notes have the right at all times to convert all or any portion of the secured convertible notes prior to payment of the prepayment amount.

We also have a partial call option under the terms of the secured convertible notes in any month in which the current price of our common stock is below \$0.065. Under the terms of the partial call option, we have the right to pay the outstanding principal amount of the secured convertible notes plus one-month's interest for that month, which will stay any conversions of the secured convertible notes by the holders for that month. The principal amount of the secured convertible notes to be repaid is determined by dividing the then outstanding principal amount of the notes by the maturity of the notes in months, or 36, plus one month's interest.

The full principal amount of the secured convertible notes is due upon default under the terms of secured convertible notes. In addition, we have granted the investors a security interest in substantially all of our assets and intellectual property and registration rights. We are liable for breach of any covenant, representation or warranty contained in the Securities Purchase Agreement for a period of two years from the date that the investors distribute the final \$1,000,000. In the event that we breach any representation or warranty regarding the condition of our company as set forth in the Securities Purchase Agreement, we are liable to pay liquidated damages in shares or cash, at our election, equal to three percent of the outstanding amount of the secured convertible notes per month plus accrued and unpaid interest. In the event that we breach any covenant as set forth in the Securities Purchase Agreement, including the failure to comply with blue sky laws, timely file all public reports, use the proceeds from the sale of the secured convertible notes in the agreed upon manner, obtain written consent from the investors to negotiate or contract with a party for additional financing, reserve and have authorized the required number of shares of common stock or the maintenance of our shares of common stock on an exchange or automated quotation system, then we are liable to pay liquidated damages in shares or cash, at our election, equal to three percent of the outstanding amount of the secured convertible notes per month plus accrued and unpaid interest.





In connection with the Securities Purchase Agreement, we executed a Security Agreement and an Intellectual Property Security Agreement in favor of the investors granting them a first priority security interest in all of our goods, inventory, contractual rights and general intangibles, receivables, documents, instruments, chattel paper, and intellectual property. Under the Security Agreement and Intellectual Property Security Agreement, events of default occur upon:

- The occurrence of an event of default (as defined in the secured convertible notes) under the secured convertible notes;
- Any representation or warranty we made in the Security Agreement or in the Intellectual Property Security Agreement shall prove to have been incorrect in any material respect when made;
- The failure by us to observe or perform any of our obligations under the Security Agreement or in the Intellectual Property Security Agreement for ten (10) days after receipt of notice of such failure from the investors; and
  - Any breach of, or default under, the Warrants.

An event of default under the secured convertible notes occurs if we:

- Fail to pay the principal or interest when due;
- Do not issue shares of common stock upon receipt of a conversion notice;
- Fail to file a registration statement within 45 days after July 15, 2005 or fail to have the registration statement effective by November 11, 2005;
- Breach any material covenant or other material term or condition in the secured convertible notes or the Securities Purchase Agreement;
- Breach any representation or warranty made in the Securities Purchase Agreement or other document executed in connection therewith;
- Apply for or consent to the appointment of a receiver or trustee for us or any of our subsidiaries or for a substantial part of our of our subsidiaries' property or business, or such a receiver or trustee shall otherwise be appointed;
- Have any money judgment, writ or similar process shall be entered or filed against us or any of our subsidiaries or any of our property or other assets for more than \$50,000, and shall remain unvacated, unbonded or unstayed for a period of twenty (20) days unless otherwise consented to by the investors;
- Institute or have instituted against us or any of our subsidiaries any bankruptcy, insolvency, reorganization or liquidation proceedings or other proceedings for relief under any bankruptcy law or any law for the relief of debtors;
- Fail to maintain the listing of our common stock on one of the OTCBB or an equivalent replacement exchange, the Nasdaq National Market, the Nasdaq SmallCap Market, the New York Stock Exchange, or the American Stock Exchange; or
  - Default under any other secured convertible note issued pursuant to the Securities Purchase Agreement.

Upon occurrence of any event of default under either the Security Agreement or the Intellectual Property Security Agreement, the investors shall have the right to exercise all of the remedies conferred under the Security Agreement, the Intellectual Property and under the secured convertible notes, including:

- Taking possession of all of our assets, including, but not limited to, our inventory, receivables, equipment, contract rights and other general intangibles, as well as our intellectual property; and
- Operating our business using the collateral as set forth above with the right to assign, sell, lease or otherwise dispose of and deliver all or any part of the collateral, at public or private sale or otherwise, for cash or on credit

The warrants are exercisable until five years from the date of issuance at a purchase price of \$0.15 per share. The selling stockholders will be entitled to exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event that the selling stockholder exercises the warrants on a cashless basis, then we will not receive any proceeds. In addition, the exercise price of the warrants will be adjusted in the event we issue common stock at a price below market, with the exception of any securities issued as of the date of this warrant or issued in connection with the secured convertible notes issued pursuant to the Securities Purchase Agreement, dated July 15, 2005.

Upon the issuance of shares of common stock below the market price, the exercise price of the warrants will be reduced accordingly. The market price is determined by averaging the last reported sale prices for our shares of common stock for the five trading days immediately preceding such issuance as set forth on our principal trading market. The exercise price shall be determined by multiplying the exercise price in effect immediately prior to the dilutive issuance by a fraction. The numerator of the fraction is equal to the sum of the number of shares outstanding immediately prior to the offering plus the quotient of the amount of consideration received by us in connection with the issuance divided by the market price in effect immediately prior to the issuance. The denominator of such issuance shall be equal to the number of shares outstanding after the dilutive issuance.

The conversion price of the secured convertible notes and the exercise price of the warrants may be adjusted in certain circumstances such as if we pay a stock dividend, subdivide or combine outstanding shares of common stock into a greater or lesser number of shares, or take such other actions as would otherwise result in dilution of the selling stockholder's position.

The selling stockholders have contractually agreed to restrict their ability to convert their secured convertible notes or exercise their warrants and receive shares of our common stock such that the number of shares of common stock held by them and their affiliates in the aggregate after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock.

Confin International Investments (the "Selling Agent") acted as selling agent in connection with the offering. We will issue up an amount of warrants to the Selling Agent not to exceed the amount of warrants which the selling stockholders have been issued and the Selling Agent received gross fees of \$260,000, representing 8% of the total gross proceeds received by us, as consideration for services performed in connection with the issuance of the secured convertible notes and warrants to the investors pursuant to the July 2005 Securities Purchase Agreement. Payment of both the cash and warrants is dependent on the future completion of the filing and effectiveness of this registration statement.

A complete copy of the Securities Purchase Agreements and related documents are incorporated by reference as exhibits to our Form SB-2 registration statement relating to this prospectus.

### **Sample Conversion Calculation**

The number of shares of common stock issuable upon conversion of the secured convertible notes is determined by dividing that portion of the principal of the notes to be converted and interest, if any, by the conversion price. For example, assuming conversion of the \$3,250,000 of secured convertible notes on August 25, 2005, at a conversion price of \$0.033, the number of shares issuable upon conversion would be:

$$\$3,250,000/\$0.033 = 98,484,849 \text{ shares}$$

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The following is an example of the amount of shares of our common stock that are issuable, upon conversion of the principal amount of our secured convertible notes, based on market prices 25%, 50% and 75% below the market price as of August 24, 2005 of \$0.08.

<u>% Below Market</u>	<u>Price Per Share</u>	<u>With Discount at 45%</u>	<u>Number of Shares Issuable</u>	<u>% of Outstanding Stock</u>
25%	\$.06	\$.033	98,484,848	33.34%
50%	\$.04	\$.022	147,727,273	42.86%
75%	\$.02	\$.011	295,454,545	60.01%

### LEGAL MATTERS

Sichenzia Ross Friedman Ference LLP, New York, New York will issue an opinion with respect to the validity of the shares of common stock being offered hereby.

### CHANGE IN ACCOUNTANTS

On November 7, 2003 Kafoury, Armstrong & Co. (“Kafoury”) resigned as our independent auditors because Kafoury had not registered with the Public Company Accounting Oversight Board (PCAOB) and was discontinuing its SEC practice.

For each of the two fiscal years prior to Kafoury’s resignation, the certifying accountant’s report on our financial statements was modified as to an uncertainty. The uncertainty in each of the two years was a substantial doubt about our ability to continue as a going concern.

During the two fiscal years ended December 31, 2002 and subsequent interim periods through November 7, 2003, there have been no disagreements between us and Kafoury regarding accounting principles or practices, financial statement disclosure, or auditing scope or procedures and Kafoury has not advised us of any of the matters identified in paragraph (a)(1)(v) of Item 304 of Regulation S-K.

On November 7, 2003 we appointed Cacciamatta Accountancy Corporation (“Cacciamatta”) of Irvine, California as our independent registered public accounting firm. During the two fiscal years ended December 31, 2002 and through November 7, 2003, we have not consulted Cacciamatta with respect to either (a) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our financial statements; or (b) any matter that was either subject of a disagreement (as defined in paragraph 304(a)(1)(iv) or a reportable event (as described in paragraph 304(a)(1)(v) of Item 304 of Regulation S-K).

To our knowledge, there is no accounting or financial disclosure dispute involving any present or former accountant.

### EXPERTS

Cacciamatta Accountancy Corporation, independent registered public accounting firm, have audited, as set forth in their report thereon appearing elsewhere herein, our financial statements at December 31, 2004 and for the two years then ended that appear in the prospectus. The financial statements referred to above are included in this prospectus with reliance upon the independent registered public accounting firm’s opinion based on its expertise in accounting and auditing.

### AVAILABLE INFORMATION

We have filed a registration statement on Form SB-2 under the Securities Act of 1933, as amended, relating to the shares of common stock being offered by this prospectus, and reference is made to such registration statement. This prospectus constitutes the prospectus of Itronics Inc., filed as part of the registration statement, and it does not contain all information in the registration statement, as certain portions have been omitted in accordance with the rules and regulations of the Securities and Exchange Commission.

We are subject to the informational requirements of the Securities Exchange Act of 1934 which requires us to file reports, proxy statements and other information with the Securities and Exchange Commission. Such reports, proxy statements and other information may be inspected at public reference facilities of the SEC at 100 F Street N.E. Washington, D.C. 20549. Copies of such material can be obtained from the Public Reference Section of the SEC at 100 F Street N.E. Washington, D.C. 20549 at prescribed rates. Because we file documents electronically with the SEC, you may also obtain this information by visiting the SEC's Internet website at <http://www.sec.gov>.

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ITRONICS INC.

INDEX TO FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Itronics Inc.

We have audited the accompanying consolidated balance sheet of Itronics Inc. (a Texas corporation) and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to in the first paragraph present fairly, in all material respects, the consolidated financial position of Itronics Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As of December 31, 2004, the Company has an accumulated deficit of \$22,944,959, a negative working capital of \$3,215,298, and a stockholders' deficit balance of \$2,564,270. The Company's ability to continue as a going concern is contingent upon (a) future profitable operations and (b) the ability to generate sufficient cash to meet obligations as they become due. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding this matter are described in Note 13. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/S/ Cacciamatta Accountancy Corporation

Irvine, California

May 19, 2005

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ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2004 AND 2003

## ASSETS

	2004	2003
<b>CURRENT ASSETS</b>		
Cash	\$ 5,180	\$ 34,499
Accounts receivable, less allowance for doubtful accounts, 2004, \$5,700; 2003, \$5,700	188,805	96,384
Marketable securities, available for sale	26,180	413,240
Inventories	571,704	425,525
Prepaid expenses	142,509	53,073
<b>Total Current Assets</b>	<b>934,378</b>	<b>1,022,721</b>
<b>PROPERTY AND EQUIPMENT</b>		
Land	215,000	215,000
Building and improvements	1,167,315	1,167,315
Design and construction in progress, manufacturing facility	121,171	102,203
Equipment and furniture	2,071,998	1,861,917
Vehicles	133,028	133,028
Equipment under capital lease-equipment and furniture	1,008,432	989,015
Equipment under capital lease-vehicles	87,672	87,672
	4,804,616	4,556,150
Less: Accumulated depreciation and amortization	1,670,668	1,383,307
	3,133,948	3,172,843
<b>OTHER ASSETS</b>		
Intangibles less accumulated amortization 2004, \$26,011; 2003, \$25,963	8,435	8,483
Marketable securities, available for sale	-	120,000
Deferred loan fees, net of accumulated amortization 2004, \$203,288; 2003, \$162,056	48,654	89,886
Deposits	22,525	26,575
	79,614	244,944
	\$ 4,147,940	\$ 4,440,508

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



ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2004 AND 2003  
(continued)

## LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

	2004	2003
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 609,795	\$ 517,989
Accrued management salaries	389,127	218,185
Accrued expenses	398,731	213,295
Insurance contracts payable	15,048	9,458
Interest payable on stockholder advances	6,307	42,876
Interest payable	204,909	174,728
Current maturities of long-term debt	522,845	537,031
Current maturities of capital lease obligations	807,746	994,456
Current maturities of advances from stockholders	161,525	248,168
Current maturities of capital lease due stockholder	5,420	4,869
Current maturities of convertible notes and accrued interest	1,020,946	1,686,286
Other	21,429	27,056
<b>Total Current Liabilities</b>	<b>4,163,828</b>	<b>4,674,397</b>
<b>LONG-TERM LIABILITIES</b>		
Long-term debt, less current maturities	97,022	123,059
Convertible promissory notes	1,517,000	2,376,100
Accrued interest, convertible notes	925,216	879,126
Capital lease obligations, less current maturities	-	75,391
Capital lease due stockholder, less current maturities	9,144	14,117
<b>Total Long-Term Liabilities</b>	<b>2,548,382</b>	<b>3,467,793</b>
<b>Commitments and Contingencies</b>	<b>-</b>	<b>-</b>
	<b>6,712,210</b>	<b>8,142,190</b>
<b>STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Preferred stock, par value \$0.001 per share; authorized 999,500 shares; issued and outstanding 2004, 0 shares; 2003, 0 shares	-	-
Common stock, par value \$0.001 per share; authorized 250,000,000 shares; issued and outstanding 2004, 164,863,938; 2003, 122,373,953	164,864	122,374
Additional paid-in capital	19,438,213	15,234,212
Accumulated deficit	(22,944,959)	(20,105,087)
Common stock to be issued	786,426	672,255
Accumulated other comprehensive income	(9,568)	374,346
Common stock options outstanding, net	754	218

(2,564,270) (3,701,682)

\$ 4,147,940 \$ 4,440,508

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

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ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
<b>REVENUES</b>		
Photochemical fertilizer	\$ 1,422,929	\$ 936,913
Mining technical services	297,120	331,874
<b>Total Revenues</b>	<b>1,720,049</b>	<b>1,268,787</b>
<b>COST OF REVENUES (exclusive of depreciation and amortization shown separately below)</b>		
Photochemical fertilizer	1,457,616	1,119,831
Mining technical services	230,137	308,809
<b>Total Cost of Revenues</b>	<b>1,687,753</b>	<b>1,428,640</b>
<b>Gross Profit (Loss) (exclusive of depreciation and amortization shown separately below)</b>	<b>32,296</b>	<b>(159,853)</b>
<b>OPERATING EXPENSES</b>		
Depreciation and amortization	325,404	336,738
Research and development	165,083	69,353
Sales and marketing	971,988	739,043
Delivery and warehousing	78,565	47,211
General and administrative	897,882	841,747
	2,438,922	2,034,092
<b>Operating (Loss)</b>	<b>(2,406,626)</b>	<b>(2,193,945)</b>
<b>OTHER INCOME (EXPENSE)</b>		
Interest	(790,027)	(965,071)
Gain on sale of investments	168,937	449,606
Other	187,844	(42,881)
<b>Total Other Income (Expense)</b>	<b>(433,246)</b>	<b>(558,346)</b>
<b>(Loss) before provision for income tax</b>	<b>(2,839,872)</b>	<b>(2,752,291)</b>
Provision for income tax	-	-
<b>Net Income(Loss)</b>	<b>(2,839,872)</b>	<b>(2,752,291)</b>
<b>Other comprehensive income</b>		
Unrealized gains on securities	(383,914)	132,693
<b>Comprehensive Income (Loss)</b>	<b>\$ (3,223,786)</b>	<b>\$ (2,619,598)</b>
Weighted average number of shares outstanding,		

basic and diluted	141,941,235	103,994,400
Earnings (Loss) per share, basic and diluted	\$ (0.020)	\$ (0.026)

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

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ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)  
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	COMMON STOCK			ACCUMULATED DEFICIT	COMMON STOCK TO BE ISSUED	ACCUMULATED	
	NUMBER OF SHARES (1,000's)	AMOUNT	ADDITIONAL PAID-IN CAPITAL			OTHER COMPREHENSIVE INCOME	STOCK OPTIONS NEEDED
Balance, Dec. 31, 2002	88,690	\$ 88,690	\$ 11,748,423	\$(17,352,796)	\$ 576,998	\$ 241,653	\$ 109,000
Issue of common stock:							
For cash	12,583	12,583	1,011,287	-	(15,000)	-	-
For services	7,808	7,808	891,576	-	233,395	-	-
For debt conversion	11,627	11,627	1,434,817	-	(13,863)	-	-
For asset acquisition	1,666	1,666	148,109	-	(109,275)	-	-
Net (loss) for the year ended Dec. 31, 2003	-	-	-	(2,752,291)	-	-	-
Other comprehensive income for the year ended Dec. 31, 2003	-	-	-	-	-	132,693	-
Common stock options outstanding	-	-	-	-	-	-	(108,000)
Balance, Dec. 31, 2003	122,374	122,374	15,234,212	(20,105,087)	672,255	374,346	-
Issue of common stock							
For cash	12,983	12,983	1,095,018	-	(27,500)	-	-
For services	8,935	8,935	793,618	-	(16,292)	-	-
For debt conversion	18,311	18,311	2,128,152	-	157,963	-	-
For asset acquisition	2,261	2,261	187,213	-	-	-	-
Net (loss) for the year ended Dec. 31, 2004	-	-	-	(2,839,872)	-	-	-
Other comprehensive income for the	-	-	-	-	-	(383,914)	-

year ended  
Dec. 31, 2004  
Common stock  
options  
outstanding

- - - - -

Balance,  
Dec. 31,  
2004

\$ 164,864 \$ 164,864 \$ 19,438,213 \$ (22,944,959) \$ 786,426 \$ (9,568)\$

The accompanying notes are an integral part of these financial statements

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ITRONICS INC, AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
Cash flows from operating activities		
Net income (loss)	\$(2,839,872)	\$(2,752,291)
Adjustments to reconcile net loss to cash used by operating activities:		
Depreciation and amortization	325,404	336,738
Interest on convertible notes	483,868	606,754
Marketable securities received for services	(35,748)	(53,050)
Gains on investments	(168,937)	(449,604)
Addition of silver in solution inventory by offsetting photochemical processing fees	(166,993)	(97,389)
Gain on debt forgiveness	(187,814)	-
Other	-	20,395
Stock option compensation	536	(108,955)
Expenses paid with issuance of common stock:		
Interest expense	94,299	109,362
Consulting expenses	281,643	225,976
Directors fees	3,450	4,125
Salaries	297,536	448,624
Operating expenses	5,000	76,492
(Increase) decrease in:		
Trade accounts receivable	(92,421)	(8,160)
Inventories	20,814	9,017
Prepaid expenses, deposits and other	14,896	(20,415)
Increase (decrease) in:		
Accounts payable	105,762	(12,593)
Accrued management salaries	170,942	39,157
Accrued expenses and contracts payable	269,785	(720)
Net cash used by operating activities	(1,417,850)	(1,626,537)
Cash flows from investing activities:		
Acquisition of property and equipment	(56,756)	(47,837)
Acquisition of investments	-	(9,000)
Sale of investments	356,107	786,381
Net cash provided (used) by investing activities	299,351	729,544
Cash flows from financing activities:		
Proceeds from sale of stock	1,080,501	1,008,870
Proceeds from stockholders/short-term debt	150,000	-
Account receivable factoring, net	13,224	38,005
Payments on debt	(154,545)	(172,584)
Net cash provided by financing activities	1,089,180	874,291

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Net increase (decrease) in cash	(29,319)	(22,702)
Cash, beginning of year	34,499	57,201
Cash, end of year	\$ 5,180	\$ 34,499

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

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## ITRONICS INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(continued)

	2004	2003
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for interest	\$ 158,587	\$ 164,423
Schedule of non-cash financing transactions:		
Settlement of debt/accruals by issuance of common stock:		
Accounts payable	27,178	118,194
Accrued management salaries	-	162,250
Convertible notes and accrued interest	1,962,219	1,420,471
Short-term debt and accrued interest due an officer/stockholder	315,029	12,110
Equipment financed with capital leases	2,236	31,008
Acquisition of assets by issuance of common stock:		
Minority interest in American Gold & Silver Ltd.	-	40,500
Equipment	189,474	-
Officer/stockholder loan of marketable securities	28,276	-
Payment of short-term debt due an officer/stockholder with marketable securities	-	55,275

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

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ITRONICS INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 DECEMBER 31, 2004 AND 2003

## NOTE 1 - Summary of Significant Accounting Policies:

## Company's Activities:

Itronics Inc., through its subsidiaries, (the Company) is involved in mining technical services, photochemical recycling and related silver recovery, and liquid fertilizer manufacturing.

## Financial Statement Estimates and Assumptions:

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. 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.

## Principles of Consolidation:

The consolidated financial statements include the accounts of Itronics Inc. and its subsidiaries:

	2004 PERCENTAGE	2003 PERCENTAGE
Whitney & Whitney, Inc.	100.00	100.00
Itronics Metallurgical, Inc.	100.00	100.00
Itronics California, Inc.	100.00	100.00
Nevada Hydrometallurgical Project (A Partnership)	92.50	92.50
American Hydromet (A Joint Venture)	82.53	82.53
American Gold & Silver (A Limited Partnership)	47.77	47.77

Whitney & Whitney, Inc. is the general partner for American Gold & Silver. As such, the Company has control over American Gold & Silver and has included it in its consolidation.

American Gold & Silver and Nevada Hydrometallurgical Project possess no material tangible assets or liabilities.

No amount for minority interests is reflected in the consolidated balance sheets as the equity of minority interests in the net losses exceed the carrying value of the minority interests.

No amount for minority interests is reflected in the consolidated statement of operations since losses applicable to the minority interest in each subsidiary exceed the minority interest in the equity capital of each subsidiary. As a result, losses applicable to the minority interest are charged against the majority interest. When future earnings materialize, the majority interest will be credited to the extent of such losses previously absorbed.

All significant intercompany accounts and transactions have been eliminated in the consolidation.

ITRONICS INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2004 AND 2003

Revenue recognition:

The Company manufactures fertilizer from used photochemical solutions. Revenues are generated in three distinct areas: (1) fees associated with removing used photochemical solutions from customer sites and sales of photochemical concentrators, (2) sales of fertilizer and (3) sales of silver. Fertilizer and silver sales are recognized when goods are shipped to our customers. Returns and allowances have been nominal. Service fees from photochemical recycling are recorded after the photochemical solutions have been picked up and transported from our customers to our manufacturing facility.

The Company provides consulting services to various entities in the mining industry. Revenue is recognized as services are delivered. When the mining technical services segment of the Company is responsible for the procurement of materials and equipment, property, or subcontracts in its consulting business, it includes such amounts in both revenues and cost of sales. The amount of such pass-through costs included in both mining consulting revenues and cost of sales for the year ended December 31, 2004 and 2003 were \$108,254 and \$118,735, respectively.

Cash and Cash Equivalents:

At present, cash includes only deposits in checking and money market accounts and does not include any cash equivalents.

Accounts Receivable Allowance Account:

The Company uses the allowance method to account for uncollectible accounts receivable.

Marketable Securities:

The Company maintains investments in marketable securities, received as payment from one technical services customer. All of these equity securities are available for sale and are recorded at fair value. The change in fair value is recorded as an unrealized gain or loss in other comprehensive income. Upon sale of the security, the company recognizes a realized gain or loss, based on specific identification of security sold. Unrealized losses are charged against net earnings when a decline in fair value is determined to be other than temporary.

Inventories:

Inventory is carried on the balance sheet at the lower of cost or market value using the average cost valuation method and consists primarily of unprocessed silver bearing photochemicals, fertilizer raw materials and saleable fertilizer. Because a large part of our inventory is silver contained in used photochemical solution and the market value of silver changes daily on the commodities market, we regularly monitor the carrying value of our silver in solution inventory to ensure it is carried at the lower of cost or its current market value. If silver on the open market were less than our carrying value, then we would write down the carrying value of our inventory by reducing recorded inventory and increasing cost of sales. If the amount of the write down were material, we would separately include the item in our statement of operations. The raw material balances below include \$396,614 and \$233,908 in unprocessed silver bearing photochemicals as of December 31, 2004 and 2003, respectively.

Following is a summary of finished goods, work in progress, and raw materials inventories as of December 31, 2004 and 2003:

	2004	2003
Finished goods	\$ 63,615	\$ 60,553
Work in progress	-	15,150
Raw materials	508,089	349,822
	\$ 571,704	\$ 425,525

#### Accounts Receivable and Inventory Factoring:

The Company factors some of its receivables and inventory with unrelated third parties. A liability is recorded when cash is received; interest is recorded over the period the liability is outstanding. The liability and accrued interest is repaid within a day or two of when the Company is paid by the customer. Interest rates range from 2 to 3% per month, or 24 to 36% annually. Additionally, while the Company does not have any formal limits on the amounts it can factor, typically no more than \$120,000 in assets is factored at any given time.

#### Property and Equipment:

Property and equipment are stated at cost. Costs associated with creating website content and graphics are capitalized under EITF 00-2, "Accounting for Web Site Development Costs." Depreciation is computed by accelerated and straight-line methods. Capital lease equipment is amortized using accelerated and straight-line methods. Accumulated amortization on capital lease equipment is \$474,340 and \$376,996 at December 31, 2004 and 2003, respectively. Property and equipment is depreciated or amortized over the following periods.

Building and improvements	20 - 40 years
Equipment and furniture	5 - 20 years
Vehicles	5 years
Equipment under capital lease-equipment and furniture	5 - 20 years
Equipment under capital lease-vehicles	5 years

Repairs and maintenance, including website maintenance and administration, are charged to operations as incurred.

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ITRONICS INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 DECEMBER 31, 2004 AND 2003

## Intangible Assets:

Intangible assets are amortized by the straight-line method over the following lives:

	YEARS
Patents	17
Deferred loan fees	3-5

Estimated aggregate amortization expense for the succeeding five years is:

2005	\$ 14,244
2006	3,949
2007	3,255
2008	3,255
2009	3,255

## Research and Development:

Wages, benefits, rent, and other costs, including costs to plan and populate databases and content on our web site are expensed as incurred as research and development in accordance with SFAS 7 *Accounting for Research and Development Costs*, and EITF 00-2.

## Advertising:

The Company advertises its products in various trade publications and general newspaper supplements. It also promotes the Company in various business publications, television, and internet media. Such advertising costs include the creative process, costs of production, and placement costs of the ads themselves. All advertising costs are expensed as incurred. Total advertising expense was \$157,986 and \$32,960 for the years ended December 31, 2004 and 2003, respectively.

## Income Taxes:

The Company has accounted for income taxes to conform to the requirements of Statements of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. Under the provisions of SFAS 109, an entity recognizes deferred tax assets and liabilities for future tax consequences of events that have already been recognized in the Company's financial statements or tax returns. The measurement of deferred tax assets and liabilities is based on provisions of the enacted tax law. The effects of future changes in tax laws or rates are not anticipated. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

## Loss per Common Share:

Loss per common share is calculated based on the consolidated net loss for the period divided by the weighted average number of common shares outstanding during 2004 and 2003. Common stock equivalents are not included, as their effect would be antidilutive.



ITRONICS INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2004 AND 2003

Common Stock:

The Company's common shares have, subject to the provisions of any series of Preferred Stock, certain rights including one vote per share on a non-cumulative basis and a ratable portion of any dividends that may be declared by the Board of Directors. The Company may from time to time issue common shares that are restricted under Rule 144 of the Securities and Exchange Commission. Such restrictions require the shareholder to hold the shares for a minimum of one year before sale. In addition, officers, directors and more than 10% shareholders are further restricted in their ability to sell such shares.

Stock Based Compensation:

The Company issues stock to its employees, directors and consultants pursuant to various Stock Option and Purchase Plans. The Company accounts for options granted to employees and directors under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations. Accordingly, no compensation expense is recognized. In accordance with Statement of Financial Accounting Standard (SFAS) 123, *Accounting for Stock Based Compensation* and SFAS 148, *Accounting for Stock Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123*, the Company discloses the additional compensation expense that would have been recorded had the Company elected to account for stock options under SFAS 123. The Company accounts for options granted to people other than employees and directors under SFAS 123 and EITF 98-16, *Accounting for Equity Investments That Are Issued to Other Than Employees for Acquiring or in Conjunction with Selling Goods and Services*. As such, the value of such options is periodically remeasured and income or expense is recognized during their vesting term.

On December 16, 2004 the FASB issued SFAS No. 123R, "Share-Based Payment," which is an amendment to SFAS No. 123, "Accounting for Stock-Based Compensation." This new standard eliminates the ability to account for share-based compensation transactions using Accounting Principles Board, or APB, Opinion No. 25, "Accounting for Stock Issued to Employees," and generally requires such transactions be accounted for using a fair-value-based method and the resulting cost recognized in our financial statements. This new standard is effective for awards that are granted, modified or settled in cash in interim and annual periods beginning after June 15, 2005, December 15, 2005 for small business issuers. In addition, this statement will apply to unvested options granted prior to the effective date. The Company will adopt this new standard effective for the first fiscal quarter of 2006 and it has not yet determined what impact this standard will have on its financial position or results of operations.

Asset Impairment:

The Company monitors conditions that may affect the carrying value of its long-lived and intangible assets when events and circumstances indicate that the carrying value of the assets may be impaired. The Company determines impairment based on the asset's ability to generate cash flow greater than the carrying value of the asset. If projected undiscounted cash flows are less than the carrying value of the asset, the asset is adjusted to its fair value.

Non-monetary Transactions:

The Company periodically enters into non-monetary transactions. These transactions are recorded based on the fair value of the asset, goods or services received or surrendered, whichever is more clearly evident and at such time as the earnings process is complete. When material non-monetary transactions occur, the Company discloses the transaction and basis for valuing the transaction in the period the transaction occurs. Additionally, pursuant to SFAS No. 95, "Statement of Cash Flows," the Company discloses non-cash investing and financing activities.

## Contingencies:

From time to time, the Company may become party to claims against it. Management evaluates these claims as they arise as probable, reasonably possible and remote. A liability is recorded when management estimates a loss is probable. Potential costs that arise are disclosed when management believes a loss is reasonably possible and that amount can be estimated

## NOTE 2 - Reclassification:

The prior year's financial statements have been reclassified, where necessary, to conform with the current year presentation.

## NOTE 3 - Long-Term Debt:

Long-term debt at December 31, 2004 and 2003 is comprised of the following (all debt payments are applied to outstanding interest owed at date of payment prior to being applied to the principal balance). The carrying amount approximates fair value. The fair value of long-term debt is based on current rates at which the Company could borrow funds with similar remaining maturities.

	DECEMBER 31,	
	2004	2003
Notes due to unrelated parties:		
Notes payable secured by vehicles due at varying dates through 2006. The monthly payments total \$1,345, including interest at 10.5% to 11.0% per annum.	\$ 17,440	\$ 33,584
Note payable secured by real property due May 2016. Monthly payment is \$6,601, including interest at 12% per annum.	492,881	510,218
Financing contract secured by equipment due May 2006. Monthly payment is \$806, including interest at 17.99%	14,589	18,585
City of Reno Special Assessment District for road and access improvements. Payable in 40 equal semi-annual payments plus interest at 6% percent per annum.	94,957	97,703
Less current portion due within one year	(522,845)	(537,031)
Total long-term liabilities due to unrelated parties	\$ 97,022	\$ 123,059



## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

	DECEMBER 31,	
	2004	2003
<b>Convertible Promissory Notes:</b>		
Three year convertible promissory notes due November 2005 through February 2006, including interest at 12% per annum. The notes and accrued interest are convertible into the Company's restricted common stock at \$0.15 per share at any time through November 18, 2005 and February 16, 2006.	\$ 47,000	\$ 47,000
Three year convertible promissory notes due at varying dates through February 2006, including interest at 9% to 12% per annum. The notes and accrued interest are convertible into the Company's restricted common stock at prices ranging from \$0.125 to \$1.18 per share at any time through February 2006.	1,570,000	1,645,000
Three year convertible promissory notes due at varying dates through December 2004, including interest at 12% per annum. The notes and accrued interest are convertible into the Company's restricted common stock at prices ranging from \$0.10 to \$0.15 per share at any time through dates ranging from March to December 2004.	20,000	1,185,000
Three year convertible promissory notes due at varying dates through September 2005, including interest at 12% per annum. The notes and accrued interest are convertible into the Company's restricted common stock at prices ranging from \$0.10 to \$0.25 per share at any time through dates ranging from January to September 2005.	606,100	774,100
Accrued interest on convertible promissory notes	1,220,062	1,290,412
Less current portion due within one year	(1,020,946)	(1,686,286)
<b>Total Long Term Convertible Promissory Notes and Accrued Interest</b>	<b>\$ 2,442,216</b>	<b>\$ 3,255,226</b>



## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

	DECEMBER 31,	
	2004	2003
Loans from Stockholders/Related Transactions:		
Advances from officer/stockholder. Due on demand, with interest accruing at 12% per annum.	\$ 161,525	\$ 248,168
	161,525	248,168
Less current portion due within one year	(161,525)	(248,168)
Total long-term liabilities due to stockholders	\$ -	\$ -

Long-term debt matures as follows:

YEAR	UNRELATED PARTIES	CONVERTIBLE NOTES	STOCKHOLDERS
2005	\$ 522,845	\$ 1,020,946	\$ 161,525
2006	8,023	2,442,216	-
2007	3,276	-	-
2008	3,475	-	-
2009	3,687	-	-
2010-2023	78,561	-	-
	\$ 619,867	\$ 3,463,162	\$ 161,525

As discussed in Note 15, property taxes on the Company's manufacturing facility are delinquent as of December 31, 2004 in the amount of \$7,336 plus penalties and interest. Such delinquency in property tax payments is a default under terms of the deed of trust securing the mortgage on the property and the lender can demand payment in full and institute foreclosure proceedings. As required by U.S. Generally Accepted Accounting Principles, the entire principal balance of the note, amounting to \$492,881 as of December 31, 2004, is included in current liabilities. The lender is aware of the situation and has not made a demand or taken any other action. In addition a financing contract on equipment, with a balance of \$14,589, is in default and is included in current liabilities. The lender has referred the loan to an attorney, but no further action has been taken.

During 2003 the holders of the 2000 Series Convertible Promissory Notes were offered to extend the notes for three years in exchange for an increased interest rate to 12% and a reduction in conversion price to \$0.125 per share, an amount above the trading price of our stock. As of December 31, 2004 all but \$80,000 of the notes and \$44,475 of the accrued interest were extended. The un-extended notes and accrued interest are in default, but no action has been taken by the note holders.

ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

NOTE 4 - Major Customers:

Fertilizer sales for the years ended December 31, 2004 and 2003 include \$989,084 and \$518,202, respectively, from one major customer, which represents 97% and 93%, respectively, of fertilizer sales for the years ended December 31, 2004 and 2003. Receivables from this major customer as of December 31, 2004 amounted to \$58,094, which represents 77% of photochemical fertilizer accounts receivable. The customer is one of the largest fertilizer distribution companies in the country.

Photochemical recycling revenues for the year ended December 31, 2004 and 2003, respectively, include \$-0- and \$80,900 from one major customer under a Department of Defense contract. Photochemical recycling and silver refining revenues for the years ended December 31, 2004 and 2003 also include \$201,291 and \$116,693, respectively, from one major customer in the digital imaging and processing industry. The combined revenues from the one major customer represents 59% of 2004 photochemical recycling and silver refining revenues and the combined revenues for the two major customers was 60% of photochemical recycling and silver refining revenues for 2003.

Sales of silver bars, film, and processed bullion for the year ended December 31, 2004 includes \$47,456 to three customers, which is 75% of such sales. Comparable sales for the year ended December 31, 2003 include \$15,726 to two customers, which is 57% of such sales.

Technical services revenue (including pass through funds described in Note 1) for the year ended December 31, 2004 includes \$224,039 and \$32,816 from two major customers which represents 86% of technical services revenues. Technical services revenue (including pass through funds described in Note 1) for the year ended December 31, 2003 includes \$146,893, \$131,600, and \$45,830 from three major customers which represents 98% of technical services revenues. Receivables from these major customers as of December 31, 2004 and 2003 amount to \$101,281 and \$21,210, which represents 85% and 73%, respectively, of consulting accounts receivable.

The Company's major technical services customers operate within the mining industry, both nationally and internationally. Due to the nature of the Company's operations, the major sources of revenues may change from year to year.

NOTE 5 - Income Taxes:

The following is a reconciliation of the federal statutory tax and tax rate to the Company's provision for taxes and its effective tax rate.

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## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

	2004		2003	
	AMOUNT	PERCENT OF PRE-TAX INCOME	AMOUNT	PERCENT OF PRE-TAX INCOME
Federal tax at statutory rate	\$ -	-%	\$ -	-%
Temporary differences, primarily bad debt and compensation related expenses	-	-%	-	-%
Non-deductible expenses	-	-%	-	-%
Utilization of NOL	-	-%	-	-%
Total Income Tax Expense	\$ -	0.0%	\$ -	0.0%

The Company's consolidated net operating loss available for carry-forward to offset future taxable income and tax liabilities for income tax reporting purposes expire as follows:

Year Ending December 31:	Net Operating Loss
2005	\$ 65,113
2006	430,403
2007	188,146
2008	113,253
2012	322,525
2018	377,944
2019	1,605,954
2020	3,254,375
2021	2,933,607
2022	2,496,744
2023	2,286,436
2024	2,208,740
	\$ 16,283,240

The Company's total deferred tax assets, and deferred tax asset valuation allowances at December 31, 2004 and 2003 are as follows:

	2004	2003
Total deferred tax assets	\$ 5,682,993	\$ 4,776,751
Less valuation allowance	(5,682,993)	(4,776,751)

Net deferred tax asset	\$	-	\$	-
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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

NOTE 6 - Stock Option and Purchase Plans:

In January 2000 the Company began a private placement of three year convertible notes to raise \$2.5 million. The placement was completed in February 2000 and raised a total of \$2,668,000. The notes and accrued interest are convertible to restricted Common Shares at varying dates through February 2006, with conversion prices ranging from \$0.125 to \$1.18. During 2003 the holders of these notes were offered to extend the notes for three years in exchange for an increased interest rate from 9% to 12% and a reduction in conversion price to \$0.125 per share. All but \$90,000 of the notes were extended. \$75,000 in principal and \$34,434 in accrued interest were converted to restricted common stock during 2004. \$928,000 in principal and \$340,450 in accrued interest were converted to restricted common stock during 2003.

In October 2000 the Company completed the registration of 10,000,000 common shares in connection with its agreement with Swartz Private Equity, LLC. (Swartz) to raise \$15 million over three years. As part of the agreement, Swartz received a five year warrant for 2,400,000 shares at \$0.55 per share and it received five year warrants for 331,033 shares based on the exercise of the Company's put rights during 2001. The exercise price of these warrants range from \$0.0825 to \$0.308, but are subject to downward reset provisions. In February 2002 the agreement with Swartz was renegotiated and as part of the new agreement, Swartz was granted a five year warrant for 360,000 shares at an exercise price of \$0.238.

In March 2001 the Company began a private placement of three year convertible notes. A total of \$1,242,029 was raised in 2001. The notes and accrued interest at 12% compounded annually are convertible to restricted common shares at varying dates through December 2004, with conversion prices ranging from \$0.10 to \$0.15. \$1,165,000 in principal and \$471,492 in accrued interest were converted to restricted common stock during 2004. \$57,029 in principal and \$14,551 in accrued interest were converted to restricted common stock during 2003.

In January 2002 the Company began a private placement of three year convertible notes. A total of \$844,100 was raised in 2002. The notes and accrued interest at 12% compounded annually are convertible to restricted common shares at varying dates through September 2005, with conversion prices ranging from \$0.10 to \$0.25. \$168,000 in principal and \$48,294 in accrued interest were converted to restricted common stock during 2004. \$70,000 in principal and \$10,442 in accrued interest were converted to restricted common stock during 2003.

In November 2002 the Company began a private placement of restricted common stock with an equal number of attached warrants. A total of \$117,500 at \$0.08 per share was raised in 2002. The warrants are for three years and are convertible into restricted common stock at \$0.08 for the first year, \$0.16 for the second year, and \$0.24 for the third year.

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

During 2003 the Company continued the private placement of restricted common stock with an equal number of attached warrants. A total of \$703,500 at \$0.08 per share was raised in 2003. The warrants are for three years and are convertible into restricted common stock at \$0.08 during the first year, \$0.16 during the second year, and \$0.24 during the third year.

During 2003 three officer/employee/stockholders converted salary in arrears totaling \$480,000, or a total of 6,000,000 restricted common shares, into the \$0.08 per share private placement described above under the same terms and conditions, including an equal number of attached warrants, as described above. Of this amount, \$317,500 was for salary previously converted to restricted common stock, but not issued to conserve the cash required to pay payroll taxes, and \$162,500 was additional salary in arrears converted into restricted common stock. The shares remain un-issued as of the date of this report to conserve cash. Also during 2003 an officer/stockholder converted a total of \$12,037 in short term debt and accrued interest into the private placement with the same terms and conditions as described above.

During 2004 the Company continued the private placement of restricted common stock with an equal number of attached warrants. Through May 2004 a total of \$646,000 at prices ranging from \$0.08 to \$0.125 per share was raised. The warrants, totaling 3,924,500 shares, are for three years and are convertible into restricted common stock at prices ranging from \$0.08 to \$0.125 during the first year of the warrant period, double the respective amounts during the second year, and triple the respective amounts during the third year. In December 2004 a new private placement of restricted common shares was begun with an attached three year warrant for one half the number of shares acquired in the private placement. A total of \$197,500 was raised in 2004 at \$0.05 per share, which resulted in the issuance of warrants to acquire 1,975,000 restricted common shares. The exercise price of these warrants is \$0.085 during the first year of the warrant period, double that amount during the second year, and triple that amount during the third year. In addition, an officer/stockholder converted \$120,000 in loans to the Company into the private placement and received warrants to acquire 1,200,000 restricted common shares under the same terms and conditions as the other investors in the private placement.

The Company periodically grants compensatory options and warrants to acquire common shares to certain officers, directors, employees, and consultants of the Company. The options are exercisable at varying dates through 2014, except for 5,600,000 options granted to various officers and employees, which expire one year after the end of their employment. The number of outstanding compensatory options and warrants was 5,996,626 and 4,409,591 shares at December 31, 2004 and 2003, respectively, at prices ranging from \$0.15 to \$0.90.

Following is a summary of all warrant and option activity for the years ended December 31, 2004 and 2003.

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ITRONICS INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

	NUMBER OF SHARES	
	2004	2003
Under option, beginning of year	60,907,607	35,618,794
Granted	12,558,586	39,125,973
Exercised	(21,484,760)	(13,483,260)
Expired	(87,965)	(353,900)
Under option, end of year	51,893,468	60,907,607
Average price for all options granted and exercised	\$ 0.11	\$ 0.12

Compensatory Stock Options:

Included in the above options and warrants are compensatory options granted to various employees and consultants during 2004 and 2003 to acquire 1,675,000 and 14,000 common shares, respectively. Of the options for 2004, 1,600,000 shares are exercisable any time up to twelve months after the end of the respective employee's employment, 60,000 shares are exercisable at any time over three years from the date of grant, and 15,000 shares are exercisable at any time over ten years from the date of grant. All 2004 options are exercisable at \$0.15 per share. Of the options for 2003, 12,000 shares are exercisable at any time over three years from the date of grant and 2,000 shares are exercisable at any time over ten years from the date of grant. The exercise prices are 2,000 shares at \$0.50 and 12,000 shares at \$0.90. The Company applies APB Opinion 25 in accounting for these stock options. Total option compensation expense, based on the fair market values of the stock on the grant dates, is \$536 for December 31, 2004. For 2004, options for 87,965 shares from prior years expired. For 2003, options for 353,900 shares from prior years expired during the year, resulting in option compensation expense of \$(108,955) and deferred compensation of \$123.

If the Company were to apply the provisions of FASB Statement No. 123 to these options, using the fair value method, compensation expense would have been \$61,575 and \$96 for December 31, 2004 and 2003, respectively. Net loss and loss per share would have been impacted as follows:

	2004	2003
Net Income (Loss):		
As reported	\$ (2,839,872)	\$ (2,752,291)
Adjustment for additional expense for fair value of options	(61,039)	(109,051)
Pro forma	\$ (2,900,911)	\$ (2,861,342)
Earnings (Loss) per share, basic and diluted		
As reported	\$ (0.020)	\$ (0.026)
Pro forma, basic and diluted	\$ (0.020)	\$ (0.028)

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## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

The pro forma amounts were estimated for each quarter using the Black-Scholes option pricing model with the following assumptions for 2004 and 2003:

	2004	2003
Dividend yield	0%	0%
Risk-free interest rate	2.75% to 4.75%	3.38%
Expected life	3-10 years	3-10 years
Expected volatility	16.65% to 66.75%	42.71%

## NOTE 7 - Common Stock to be Issued:

The following summarizes stock transactions commencing prior to December 31, with stock issued or to be issued subsequent to that date:

	2004	2003
Payment of salaries	\$ 540,900	\$ 526,375
Payment of consulting and operating fees	4,800	5,600
Payment of director fees	525	1,125
Payment of interest, employees	37,701	67,118
Payment of debt, officer/stockholder	170,000	12,037
Private placement for cash	32,500	60,000
	\$ 786,426	\$ 672,255

Of the above salary amounts for December 31, 2004 and 2003, \$519,200 and \$488,000, respectively, is for compensation to three officer/stockholders that they have agreed to accept in our common stock. The related shares, totaling 6,000,000 common shares at December 31, 2004, remain unissued to preserve cash that would otherwise go to pay payroll taxes. Of the \$488,000 as of December 31, 2003, \$133,200 was expensed in 2003 and included in Expenses Paid with Issuance of Common Stock on the Statement of Cash Flows for that year, \$162,250 was a conversion of prior year salaries and is included in Settlement of Accruals by Issuance of Common Stock in the supplemental disclosures of cash flow information in 2003, and \$192,550 was salary accepted in stock in years prior to 2003 and is not reflected in the Statements of Cash Flows for 2003 or 2004. All of the remainder of the expense items listed above were expensed in the period indicated and are included in the appropriate category under Expenses Paid with Common Stock in the Statements of Cash Flows for the respective periods.

The Payment of debt amounts listed above, \$170,000 and \$12,037 for December 31, 2004 and 2003, respectively, reflect the conversion into common stock of loans made to the Company by an officer/stockholder. These amounts are included in the Supplemental Disclosure of Cash Flow Information under the heading Settlement of debt/accruals by issuance of common stock. The Private placement for cash amounts, \$32,500 and \$60,000 for December 31, 2004 and 2003, respectively, were cash received shortly before year end, with the stock issued in the following period. These amounts are included in Cash flows from financing activities under Proceeds from sale of stock in the year received.

## NOTE 8 - Accrued Expenses:

The following is the composition of accrued expenses as of December 31:

	2004	2003
Accrued vacation	\$ 85,587	\$ 70,339
Federal and state payroll taxes	219,899	33,366
Sales tax	245	16,590
Audit and annual meeting costs	93,000	93,000
	\$ 398,731	\$ 213,295

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ITRONICS INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2004 AND 2003

## NOTE 9 - Other Comprehensive Income

The Company holds marketable securities that are available for sale, which consist solely of equity securities. The carrying amount on the balance sheets of these securities is adjusted to fair value at each balance sheet date. The adjustment to fair value is an unrealized holding gain or loss that is reported in Other Comprehensive Income. At present, these unrealized gains or losses are the only component of Accumulated and Other Comprehensive Income. The Company had an Accumulated Unrealized Holding Loss of \$9,568 at December 31, 2004, and an Unrealized Holding Gain of \$374,346 at December 31, 2003. The Company realized gross gains of \$172,116 and gross losses of \$3,179 on gross proceeds of \$356,107 during the twelve months ended December 31, 2004. No losses were reclassified out of accumulated other comprehensive income into earnings during 2004. The Company realized gross gains of \$468,735 and gross losses of \$19,131 on gross proceeds of \$786,381 during the twelve months ended December 31, 2003. Gains of \$256,387 and losses of \$28,791 were reclassified out of accumulated other comprehensive income into earnings during 2003. The table below illustrates the amount of unrealized holding gains and losses included in other comprehensive income, net of tax effects of \$0. The reclassification adjustment listed in the below table represents unrealized holding gains and losses transferred into earnings as securities are sold.

Following are the components of Other Comprehensive Income:

	Year Ended December 31,	
	2004	2003
Unrealized holding gains (losses) arising during the period	\$ 9,109	\$ 360,289
Reclassification adjustment	(393,023)	(227,596)
Other Comprehensive Income	\$ (383,914)	\$ 132,693

## NOTE 10 - Related Party Transactions:

Promissory notes are held by stockholders at December 31, 2004 and 2003 (see Note 3 for terms). \$389,127 and \$218,185 of the accrued management salaries as of December 31, 2004 and 2003, respectively, is for salary in arrears due to several officer/stockholders and employee/stockholders. In addition, salary in arrears of \$523,800 and \$515,100 for 2004 and 2003, respectively, are included in stock to be issued at the respective year ends. These amounts represent the portion of salaries earned but unpaid that the officers/employees/stockholders have agreed to accept in the Company's common stock. The number of shares to be issued are 6,488,021 and 6,220,624 for 2004 and 2003, respectively. Issuance of the stock is pending sufficient cash available to pay the related federal withholding taxes. Interest accrued at 12% per annum on salaries due officer and employee/stockholders amounted to \$97,869 and \$113,233, respectively, in 2004 and 2003. Of these amounts, \$94,299 and \$109,290 for 2004 and 2003, respectively, were paid (or will be paid) by issuance of 990,187 and 808,092 shares of restricted common stock.

Interest expense on related party loans amounted to \$31,041 and \$33,706 for the years ended December 31, 2004 and 2003, respectively. Accrued interest on related party loans totaled \$6,307 and \$42,876 at December 31, 2004 and 2003, respectively.

After approval from the Company's Board of Directors, in March 1999 the Company's subsidiary, WWI, agreed to provide technical services to Golden Phoenix Minerals, Inc. (GPXM), a junior mine exploration and development company whose common shares trade on the OTC Bulletin Board. Services were billed monthly and WWI received a

combination of GPXM common stock, SEC Rule 144 restricted common stock, and cash. Separately, Dr. Whitney personally agreed to acquire up to 10,000,000 common shares of GPXM at \$0.10 per share, making him beneficial owner of more than ten percent of GPXM. Any unexercised options under this arrangement can be assigned to WWI. Dr. Whitney is a principal in a group that controls the mining claims underlying one of GPXM's principal exploration and development properties. At December 31, 2004 WWI owned 123,198 restricted GPXM shares. At December 31,

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ITRONICS INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2004 AND 2003

2003 WWI owned 736,442 restricted GPXM shares. The initial Rule 144 one year period for resale began in April 2000, and continues monthly thereafter. Total revenue from GPXM for 2004 and 2003 was \$224,039 and \$146,893, respectively. A total of \$101,281 and \$13,707 is included in accounts receivable at December 31, 2004 and 2003, respectively. At December 31, 2004, the average bid/asked price for GPXM common was \$0.213, resulting in a value of shares held on that date of \$26,180. Included in the GPXM shares held at December 31, 2003 and 2002 are 300,000 and 1,050,000 restricted common shares, respectively, that were acquired by WWI purchasing \$0.10 options from Dr. Whitney and subsequently exercising the options by offsetting accounts receivable due it from GPXM. The purchase price of the options was \$109,275, which was determined at 85% of fair market value of the then current trading price of GPXM, less the \$0.10 option price. This valuation method is under the same terms that WWI uses to accept GPXM restricted common shares for its monthly services. Dr. Whitney accepted Company restricted common shares in the 2002 Equity Private Placement as payment for the options, which amounted to 1,365,938 shares plus an equal number of warrants with conversion prices ranging from \$0.08 to \$0.24 per share. The total cost to WWI of these GPXM shares was \$214,275 and the market value at December 31, 2002 was \$241,500. The 300,000 shares held at December 31, 2003 were valued at \$135,750 and had a cost of \$70,650.

During 2004 Dr. Whitney loaned WWI 103,765 shares of GPXM stock at a value of \$28,276. The loaned shares were sold by WWI for \$25,097, for a realized loss of \$3,179. The loan was repaid in 2004 by conversion into the Company's restricted common stock when Dr. Whitney exercised warrants he acquired in 2003. During the first quarter of 2002 Dr. Whitney loaned WWI 600,000 shares of GPXM stock at a value of \$105,000. The loaned shares were sold by WWI for \$83,045, for a realized loss of \$21,955. In 2002, WWI repaid 416,463 of the GPXM shares out of shares owned by it at a value of \$72,881 and a realized gain of \$35,587. During 2003 the remaining balance of the loan and accrued interest was paid by a combination of 87,283 GPXM shares, 250,000 shares of other marketable securities, and 150,461 Company restricted common shares. The portion of the loan paid in Company shares was converted into the \$0.08 per share Private Placement under the same terms and conditions as other investors, including an equal number of three year warrants. WWI realized a net gain of \$19,369 on the transaction.

During 2003 WWI's lease of a vehicle utilized by Dr. Whitney was completed. Dr. Whitney purchased the vehicle by financing it through a commercial lender. The purchase price was \$21,741 and the monthly payment for four years is \$531. WWI is leasing the vehicle from Dr. Whitney by making the monthly payments to the commercial lender and will acquire ownership of the vehicle when the loan is paid in full.

For related party transactions subsequent to December 31, 2004, see Note 16.

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## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

## NOTE 11 - Lease Commitments and Rent Expense:

Operating Leases:

The Company leases its corporate office facility under a non-cancelable agreement which expires June 30, 2005. Monthly payments are \$4,912.

A wholly owned subsidiary of the Company, IMI, leases storage facilities on a month-to-month basis and, therefore, no long-term binding contractual obligation exists with regards to minimum lease payments. The monthly rent payment is \$1,000.

A wholly owned subsidiary of the Company, WWI, is committed under a non-cancelable agreement for the use of office space which expires July 31, 2006. The monthly lease payment totals \$2,430.

Future minimum rental commitments at December 31, 2004, under these operating lease agreements are due as follows:

2005	\$ 58,632
2006	17,010
2007	-
2008	-
	\$ 75,642

Total rental expense included in the statements of operations for the years ended December 31, 2004 and 2003 is \$99,981 and \$105,867, respectively.

Capital Leases:

At varying dates in 1999 the Company's subsidiaries, WWI and IMI, entered into leases to finance the equipment for the manufacturing facility in Reno/Stead, Nevada and for computer equipment. The leases totaled \$987,315. Of this amount \$408,788 was received in cash, of which \$65,033 was in connection with two sale/leaseback transactions of computer and office equipment. The lease periods range from three to five years, and the total monthly lease payments are \$24,192. With the exception of two leases, all have buyout options for \$1 at the end of the lease. The remaining two leases have buyout provisions totaling \$9,667.

At varying dates in 2000 the Company and its subsidiaries entered into leases primarily for financing purposes. The leases totaled \$543,832, of which \$437,636 was received in cash. The lease periods range from three to five years, and the total monthly lease payments are \$13,737. All the leases have buyout options for \$1 at the end of the lease.

At varying dates in 2001 the Company and its subsidiaries entered into leases both for new plant equipment and for financing purposes. The leases totaled \$288,881, of which \$192,282 was received in cash. The lease periods

## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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range from four to five years, and the total monthly lease payments are \$7,413. All the leases have buyout options for \$1 at the end of the lease, with the exception of one lease which has a fair market value purchase option at the end of the lease, which is anticipated to be a nominal amount.

At varying dates in 2002 the Company and its subsidiaries entered into leases for new plant and office equipment. The leases totaled \$209,502. The lease periods range from three to five years, and the total monthly lease payments are \$2,914. All the leases have buyout options for \$1 at the end of the lease.

At varying dates in 2003 the Company and its subsidiaries entered into leases for automotive and office equipment. The leases totaled \$31,008. The lease periods are for four years, and the total monthly lease payments are \$807. All the leases have buyout options for \$1 at the end of the lease.

In January 2004 the Company and its subsidiaries entered into a lease for office equipment. The lease totaled \$2,236, with a lease period of four years, and total monthly lease payments of \$66. The lease has a buyout option for \$1 at the end of the lease.

As of December 31, 2004 lease payments totaling \$741,597 were in arrears. As required by U.S. Generally Accepted Accounting Principles, the principal balance of the leases that are in default are classified as a current liability. Some of the lessors have filed suit to recover the amounts due under the leases. The present status of these actions is discussed in Note 15. The Company is making ongoing payment arrangements with these and the other lessors to avoid action that may be adverse to the Company.

All of the above described leases are secured by the equipment acquired or financed under the lease.

Future minimum lease commitments at December 31, 2004 are due as follows:

	Unrelated Parties	Related Party
2005	\$ 974,123	\$ 6,370
2006	-	6,370
2007	-	2,655
2008	-	-
2009	-	-
	974,123	15,395
Less: amounts representing interest	(166,377)	(831)
	\$ 807,746	\$ 14,564



ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

NOTE 12 - Business Segments:

The Company and its subsidiaries operate primarily in two business segments as identified in Note 1. The following defines business segment activities:

Photochemical Fertilizer: Photochemical recycling,

Silver recovery,

Fertilizer production and

Sales

Mining Technical Services: Mining industry services

The photochemical fertilizer segment operates principally in Northern Nevada and Southern California and, to a lesser extent, Northern California. The primary source of revenue for this segment is from the pick-up and processing of photochemicals, recovery of silver therefrom, and sales of GOLD'n GRO fertilizer products. The customer base is diverse and includes organizations in the photo-processing, printing, x-ray and medical fields. Fertilizer sales are concentrated in the same geographic markets and the customer base is principally in commercial markets, including golf courses, turf farms, and specialty agriculture which includes vegetables, fruit and nut trees, and wine and table grapes.

The mining technical services segment performs its services primarily out of the Company's Reno, Nevada offices, but its source of clients is not limited to organizations based locally. It has served both national and international clients in the past. As discussed in Note 4, at present the segment is serving primarily two clients in the gold mining industry, who have several operations in different areas of the United States.

The Company measures segment performance based on net income or loss. At present there are no intercompany revenues. Costs benefiting both segments are incurred by both the Company and by Whitney & Whitney, Inc. Such costs are allocated to each segment based on the estimated benefits to the segment. General and administrative costs incurred by the Company that have no other rational basis for allocation are divided evenly between the segments. Cost allocation percentages are reviewed annually and are adjusted based on expected business conditions for the year.

Reconciliation of segment revenues, cost of sales, gross profit (loss), operating income (loss), other income (loss) and net income (loss) to the respective consolidated amounts follows:

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## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

	2004	2003
Revenues		
Photochemical Fertilizer	\$ 1,422,929	\$ 936,913
Mining Technical Services	297,120	331,874
Consolidated Revenues	\$ 1,720,049	\$ 1,268,787
Cost of Revenues		
Photochemical Fertilizer	\$ 1,457,616	\$ 1,119,831
Mining Technical Services	230,137	308,809
Consolidated Cost of Revenues	\$ 1,687,753	\$ 1,428,640
Gross Profit (Loss)		
Photochemical Fertilizer	\$ (34,687)	\$ (182,918)
Mining Technical Services	66,983	23,065
Consolidated Gross Profit (Loss)	\$ 32,296	\$ (159,853)
Operating Income (Loss)		
Photochemical Fertilizer	\$ (2,024,481)	\$ (1,834,621)
Mining Technical Services	(382,145)	(359,324)
Consolidated Operating Income (Loss)	\$ (2,406,626)	\$ (2,193,945)
Other Income (Expense)		
Photochemical Fertilizer	\$ (602,213)	\$ (1,014,821)
Mining Technical Services	168,967	456,475
Consolidated Other Income (Expense)	\$ (433,246)	\$ (558,346)
Net Income (Loss)		
Photochemical Fertilizer	\$ (2,626,694)	\$ (2,849,442)
Mining Technical Services	(213,178)	97,151
Consolidated Net Income (Loss) before taxes	\$ (2,839,872)	\$ (2,752,291)

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ITRONICS INC. AND SUBSIDIARIES  
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Other segment information:	2004	2003
Capital expenditures by business segment:		
Photochemical Fertilizer	\$ 243,989	\$ 46,419
Mining Technical Services	4,477	32,426
Consolidated Capital Expenditures	\$ 248,466	\$ 78,845
Depreciation and amortization expense by business segment:		
Photochemical Fertilizer		
Depreciation	\$ 173,555	\$ 175,568
Amortization	119,324	120,952
	292,879	296,520
Mining Technical Services		
Depreciation	16,462	19,188
Amortization	16,064	21,030
	32,525	40,218
Consolidated Depreciation and Amortization	\$ 325,404	\$ 336,738

General and administrative expenses of \$153,887 and \$179,761 incurred by Itronics Inc. were equally divided between the two segments for 2004 and 2003, respectively.

ITRONICS INC. AND SUBSIDIARIES  
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Identifiable assets by business segment (net of accumulated depreciation, accumulated amortization, and allowance for doubtful accounts):

ASSET DESCRIPTION	2004		2003	
	PHOTO- CHEMICAL FERTILIZER	MINING TECHNICAL SERVICES	PHOTO- CHEMICAL FERTILIZER	MINING TECHNICAL SERVICES
<b>Current Assets</b>				
Cash	\$ 4,370	\$ 420	\$ 6,249	\$ 25,753
Accounts receivable, net	73,339	115,466	71,197	25,187
Marketable securities	-	26,180	-	413,240
Inventories	569,878	1,826	423,699	1,826
Prepaid expenses	23,015	13,711	39,371	3,049
	670,602	157,603	540,516	469,055
<b>Property and Equipment, net</b>				
Land	215,000	-	215,000	-
Building and improvements	1,026,356	-	1,058,798	-
Construction in progress, manufacturing facility	121,171	-	102,203	-
Equipment and furniture	1,116,920	25,601	1,021,596	54,054
Vehicles	7,136	-	21,501	-
Equipment under capital lease- equipment and furniture	503,772	81,522	542,133	105,603
Equipment under capital lease-vehicles	20,394	15,219	29,816	19,567
	3,010,749	122,342	2,991,047	179,224
<b>Other Assets, net</b>				
Patents, trademarks, and other	8,435	-	8,483	-
Marketable securities	-	-	-	120,000
Inter-company investments/loans	-	1,234,257	-	1,782,550
Deposits	9,760	12,567	11,180	15,197
Deferred loan fees	48,654	-	85,347	4,539
	66,849	1,246,824	105,010	1,922,286
	\$ 3,748,200	\$ 1,526,769	\$ 3,636,573	\$ 2,570,565

Reconciliation of segment assets to consolidated assets:

	2004	2003
Total Assets:		
Photochemical Fertilizer	\$ 3,748,200	\$ 3,636,573
Mining Technical Services	1,526,769	2,570,565

Total Segment Assets	5,274,969	6,207,138
Ironics Inc. assets	22,504,867	20,587,504
Less: inter-company elimination	(23,631,896)	(22,354,134)
Consolidated Assets	\$ 4,147,940	\$ 4,440,508

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

NOTE 13 - Going Concern:

The Company's consolidated financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company and its subsidiaries have reported recurring losses from operations, including a net loss of \$2,839,872 during the year ended December 31, 2004, a negative working capital of \$3,215,298, and a stockholders' deficit balance of \$2,564,270 as of December 31, 2004. These factors indicate the Company and its subsidiaries' ability to continue in existence is dependent upon their ability to obtain additional long-term debt and/or equity financing and achieve profitable operations. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company and its subsidiaries be unable to continue in existence.

Prior to acquiring Whitney & Whitney, Inc. in 1988, the Company registered 1,777,000 common shares for public offering. Due to security law changes immediately subsequent to the offering, the offering did not raise sufficient equity capital to complete the Company's business plan. In order to solve the Company's liquidity problems, management implemented a plan of obtaining equity through private placements of common shares, convertible debt, conversion of debt to common shares, and payment of consulting and other labor services with common shares.

In addition to continuing the above described efforts, development of the technology necessary to manufacture fertilizer from photochemicals has been completed. In March 1998 the Company's subsidiary, Itronics Metallurgical, Inc., signed a definitive manufacturing and distribution agreement with Western Farm Services, Inc. (WFS). The agreement gives WFS the exclusive license and right to manufacture and market the GOLD'n GRO line of fertilizer products in the states of Arizona, California, Hawaii, Idaho, Oregon and Washington. The agreement is for five years, with five year renewal options. In March 2003 the companies entered the second five year term of the agreement.

A summary of the results of efforts to raise funds through various private placements over the last several years is presented in Note 6.

NOTE 14 - Off-Balance Sheet Risks and Concentration of Credit Risk:

The Company occasionally maintains bank deposits in excess of federally insured limits. The Company's risk is managed by maintaining its accounts in one of the top five largest banks in the country.

As of December 31, 2004, a significant portion of the Company's accounts receivable is concentrated with one fertilizer distribution company. This concentration of credit risk is somewhat mitigated due to the fact that the distribution company is one of the largest fertilizer distribution companies in the country.

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Increase or decrease in photochemical recycling service and silver extraction revenues has a direct relationship with federal, state, and local regulations and enforcement of said regulations. Fertilizer revenues could be impacted by crop cycles, seasonal variations, and weather patterns.

The ability to recognize a net profit from silver recovery sales is based on the fair market value of silver (Handy & Harmon five day average) at the time the photochemicals are obtained versus the fair market value of silver when recovered silver is sold. Most customers are given an 80% silver credit against recycling services based on the content of silver in the photochemicals. If the fair market value of silver declines, the possibility exists that the 80% credit, plus operating costs associated with the silver extraction, could exceed the revenues generated at the time the silver is sold.

Management's long term plan to reduce the market risk of silver is to increase the volume of photochemicals and the resultant silver recovery, and then to implement a hedging program in which silver will be sold forward, thereby matching the price to be received to the price paid to the Company's customers.

As a handler of photochemical materials, and a seller of liquid fertilizers, the Company is subject to various federal, state, and local environmental, safety, and hazardous waste regulations and state fertilizer registration requirements. The Company believes that its policies and procedures for handling hazardous wastes are in compliance with the applicable laws and regulations and are consistent with industry standards. Costs for these compliance activities are expensed as incurred. As the Company's photochemical fertilizer business expands, the various laws and regulations that are applicable to the Company's activities will change. During 1996, the Company received concurrence from the State of Nevada environmental officials that the Company's photochemical fertilizer process meets the existing requirements for exemption from all environmental regulations, except toxic metal content standards, and with the exception that certain presently conducted lab analyses of the photochemicals will continue to be required. Certain of the Company's large scale customers presently meet the exemption requirements. Now that all the photochemicals are utilized in the fertilizer or other commercial products, all the Company's customers are arguably exempt.

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 15 - Legal Proceedings

The Company may become involved in a lawsuit or legal proceeding at any time in the ordinary course of business. Litigation is subject to inherent uncertainties, and an unexpected adverse result may arise that may adversely affect our business. Certain lawsuits have been filed against us for collection of funds due that are delinquent, as described below. The Company is currently not aware of any litigation pending or threatened for any reason other than collection of funds due and already recorded. The Company is not aware of any additional legal proceeding or claims that the Company believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

As of December 31, 2004 total recorded liabilities of \$786,471 including accrued interest to December 31, 2004, were subject to a total of 15 separate lawsuits for the collection of the funds due. These include 12 leases totaling \$626,372 (reflected in Current Maturities of Capital Lease Obligations) plus \$20,260 in additional interest (reflected in Accrued Interest) and three trade payables totaling \$131,286 (reflected in Accounts Payable) plus \$8,553 in additional interest (reflected in Accrued Interest). The leases are individually secured by specified equipment.

The accrued interest noted above was recorded based on our assessment of additional amounts the Company believes is probable and is related to three cases originally seeking \$251,522; the creditors have received judgments in these cases. The Company will continue to accrue interest until these cases are settled or paid in full.

The Company estimates an additional \$58,500 interest may be reasonably possible on other cases; however, the Company has not accrued this amount because it does not believe it is probable to be incurred. This estimate is related to six cases. In one case, there is a negotiated payment agreement with a remaining balance of approximately \$19,500. Our last payment was made in December 2004 and no contact or other collection action has been taken since then. A second case, claiming \$35,210, was filed in March 2003. No contact or other collection action has taken place since then. A third case, seeking \$171,853, is being actively negotiated by legal counsel and a settlement offer to pay the balance over approximately 46 months has been received. The remaining three cases, seeking a total of \$181,672, are being actively negotiated with a local law firm. It has been our experience that if the Company is able to pay an account in full, the creditor will accept a discount, in some cases a substantial discount, to get the case settled. In the event the Company has not been able to fully pay a claim, creditors have been willing to accept extended payment terms.

The Company has a total of six cases, that originally sought \$325,345, that it deems to have a remote possibility of incurring an additional unrecorded loss. The Company has negotiated payment agreements on these cases and, as of December 31, 2004, the recorded liability for these cases was \$122,313. Three of the cases are paid current under the settlements agreements and three are delinquent, but no further collection action has been taken by the lenders.

As of December 31, 2004 our subsidiaries were delinquent on approximately \$206,200 in federal payroll taxes. These amounts are included Accrued expenses in the Balance Sheet. The Company engaged a consultant to assist in working with the IRS to formulate a payment plan. A plan was negotiated to pay specified portions of the liability on or before January 31, 2005 and on the fifteenth of each month beginning March 15, 2005 until paid off on May 15, 2005. The Company made the required payments in January and March 2005, and paid a total of \$115,586, but did not make the subsequent payments as they became due. The Company received notice of intent to levy on the subsidiaries IMI and ICI for a total amount due of \$93,273. The notices were dated May 12, 2005. The IRS also filed federal tax liens for the amounts due.



Successful settlement of the above claims is dependent on future financing.

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ITRONICS INC. AND SUBSIDIARIES  
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NOTE 16 - Subsequent Events:

The following summarizes common stock issued from January 1, 2005 through May 19, 2005 and common stock to be issued as of March 31, 2005 :

	ISSUED		TO BE ISSUED	
	SHARES	AMOUNT	SHARES	AMOUNT
Labor and consulting services				