HOME BANCSHARES INC
Form 10-Q
November 03, 2008

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# UNITED STATES <br> SECURITIES AND EXCHANGE COMMISSION <br> Washington, DC 20549 <br> FORM 10-Q 

(Mark One)
p Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarterly Period Ended September 30, 2008
or


719 Harkrider, Suite 100, Conway, Arkansas
(Address of principal executive offices)

72032
(Zip Code)
(501) 328-4770
(Registrant stelephone number, including area code) Not Applicable

Former name, former address and former fiscal year, if changed since last report
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes p No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

| Large | Accelerated filer | Non-accelerated filer o | Smaller reporting company o |
| :---: | :---: | :---: | :---: |
| accelerated filer <br> o | p |  |  |
|  |  |  |  |

(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No p
Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practical date.
Common Stock Issued and Outstanding: 19,836,615 shares as of October 29, 2008.

## HOME BANCSHARES, INC. <br> FORM 10-Q <br> September 30, 2008 <br> INDEX

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15 Awareness of Independent Registered Public Accounting Firm
31.1 CEO Certification Pursuant to 13a-14(a)/15d-14(a)
31.2 CFO Certification Pursuant to 13a-14(a)/15d-14(a)
32.1 CEO Certification Pursuant to 18 U.S.C. Section 1350
32.2 CFO Certification Pursuant to 18 U.S.C. Section 1350

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## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of our statements contained in this document, including matters discussed under the caption Management s Discussion and Analysis of Financial Condition and Results of Operation are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements relate to future events or our future financial performance and include statements about the competitiveness of the banking industry, potential regulatory obligations, our entrance and expansion into other markets, our other business strategies and other statements that are not historical facts. Forward-looking statements are not guarantees of performance or results. When we use words like may, plan, contemplate, anticipate, believe, intend, continue, expect, project, predict, estimate, could, expressions, you should consider them as identifying forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions, and on the information available to us at the time that these disclosures were prepared. These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to, the following:
the effects of future economic conditions, including inflation or a decrease in residential housing values;
governmental monetary and fiscal policies, as well as legislative and regulatory changes;
the risks of changes in interest rates or the level and composition of deposits, loan demand and the values of loan collateral, securities and interest sensitive assets and liabilities;
the effects of terrorism and efforts to combat it;
credit risks;
the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally and internationally, together with competitors offering banking products and services by mail, telephone and the Internet;
the effect of any mergers, acquisitions or other transactions to which we or our subsidiaries may from time to time be a party, including our ability to successfully integrate any businesses that we acquire; and
the failure of assumptions underlying the establishment of our allowance for loan losses.
All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, see the Risk Factors section of our Form 10-K filed with the Securities and Exchange Commission on March 5, 2008.

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PART I: FINANCIAL INFORMATION
Item 1: Financial Statements

Home BancShares, Inc.<br>Consolidated Balance Sheets



## Liabilities and Stockholders Equity

Deposits:
Demand and non-interest-bearing $\quad \$ \quad 263,410 \quad \$ \quad 211,993$
$\begin{array}{lll}\text { Savings and interest-bearing transaction accounts } & 680,217 & 582,477\end{array}$
Time deposits
\$ 2,650,590 \$ 2,291,630

| Total deposits | $1,913,071$ | $1,592,206$ |
| :--- | ---: | ---: |
| Federal funds purchased | 16,407 |  |
| Securities sold under agreements to repurchase | 108,350 | 120,572 |
| FHLB borrowed funds | 278,182 | 251,750 |
| Accrued interest payable and other liabilities | 12,350 | 13,067 |
| Subordinated debentures | 47,598 | 44,572 |
| Total liabilities | $2,359,551$ | $2,038,574$ |


| Stockholders equity: |  |  |
| :--- | ---: | ---: |
| Common stock, par value $\$ 0.01$ in 2008 and 2007; shares authorized |  |  |
| $50,000,000$ in 2008 and 2007; shares issued and outstanding 19,823,360 in |  | 173 |
| 2008 and 18,630,038 (stock dividend adjusted) in 2007 | 252,836 | 195,649 |
| Capital surplus | 43,310 | 59,489 |
| Retained earnings | $(5,305)$ | $(2,255)$ |
| Accumulated other comprehensive loss | 291,039 | 253,056 |
| Total stockholders equity |  |  |
|  | $\$ 2,650,590$ | $\$$ |
| Total liabilities and stockholders equity | $2,291,630$ |  |

See Condensed Notes to Consolidated Financial Statements.

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| (In thousands, except per share data(1)) | 2008 | 2007 | 2008 | 2007 |
| :---: | :---: | :---: | :---: | :---: |
|  | (Unaudited) |  |  |  |
| Interest income: |  |  |  |  |
| Loans | \$ 31,831 | \$ 31,116 | \$ 97,285 | \$ 89,180 |
| Investment securities |  |  |  |  |
| Taxable | 2,982 | 4,133 | 9,740 | 12,992 |
| Tax-exempt | 1,216 | 1,043 | 3,583 | 3,094 |
| Deposits other banks | 35 | 53 | 127 | 132 |
| Federal funds sold | 24 | 36 | 289 | 311 |
| Total interest income | 36,088 | 36,381 | 111,024 | 105,709 |
| Interest expense: |  |  |  |  |
| Interest on deposits | 10,752 | 14,416 | 35,893 | 42,640 |
| Federal funds purchased | 79 | 194 | 168 | 646 |
| FHLB borrowed funds | 2,239 | 2,426 | 6,873 | 6,270 |
| Securities sold under agreements to repurchase | 394 | 1,267 | 1,349 | 3,772 |
| Subordinated debentures | 769 | 758 | 2,314 | 2,254 |
| Total interest expense | 14,233 | 19,061 | 46,597 | 55,582 |
| Net interest income | 21,855 | 17,320 | 64,427 | 50,127 |
| Provision for loan losses | 1,439 | 547 | 6,952 | 2,047 |
| Net interest income after provision for loan losses | 20,416 | 16,773 | 57,475 | 48,080 |
| Non-interest income: |  |  |  |  |
| Service charges on deposit accounts | 3,557 | 2,816 | 10,006 | 8,073 |
| Other service charges and fees | 1,698 | 1,342 | 5,051 | 4,176 |
| Data processing fees | 239 | 192 | 674 | 619 |
| Mortgage lending income | 695 | 451 | 2,142 | 1,277 |
| Mortgage servicing income | 206 |  | 654 |  |
| Insurance commissions | 164 | 153 | 620 | 613 |
| Income from title services | 141 | 181 | 498 | 575 |
| Increase in cash value of life insurance | 544 | 607 | 1,642 | 1,822 |
| Dividends from FHLB, FRB \& bankers bank | 194 | 218 | 702 | 652 |
| Equity in earnings (loss) of unconsolidated affiliates |  | 47 | 102 | (123) |
| Gain on sale of equity investment |  |  | 6,102 |  |
| Gain on sale of SBA loans | 26 |  | 127 | 170 |
| Gain (loss) on sale of premises and equipment, net |  | (31) | (2) | 150 |
| Gain (loss) on OREO, net | (28) | 87 | (458) | 197 |
| Gain (loss) on securities, net |  |  | $(2,067)$ |  |
| Other income | 348 | 249 | 1,192 | 899 |


| Total non-interest income | 7,784 | 6,312 | 26,985 | 19,100 |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
|  |  |  |  |  |  |
| Non-interest expense: | 8,739 | 7,739 | 26,948 | 22,936 |  |
| Salaries and employee benefits | 2,825 | 2,446 | 8,253 | 6,998 |  |
| Occupancy and equipment | 815 | 644 | 2,434 | 1,958 |  |
| Data processing expense | 6,099 | 4,770 | 18,023 | 13,965 |  |
| Other operating expenses | 18,478 | 15,599 | 55,658 | 45,857 |  |
| Total non-interest expense | 9,722 | 7,486 | 28,802 | 21,323 |  |
| Income before income taxes | 3,158 | 2,258 | 9,306 | 6,273 |  |
| Income tax expense | $\$ 6,564$ | $\$ 5,228$ | $\$ 19,496$ | $\$ 15,050$ |  |
| Net income | $\$ 0.32$ | $\$$ | 0.28 | $\$$ | 0.98 |
| Basic earnings per share | $\$ 0.32$ | $\$$ | 0.28 | $\$$ | 0.96 |
| Diluted earnings per share |  |  |  | $\$$ | 0.81 |

(1) All per share amounts have been restated to reflect the effect of the $8 \%$ stock dividend.
See Condensed Notes to Consolidated Financial Statements.

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| (In thousands, except share data (1)) | Home BancShares, Inc. <br> d Statements of Stockholders Equity <br> Ended September 30, 2008 and 2007 |  |  |  |  |  | Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | mmon | Capital <br> Surplus | Retained <br> Earnings |  | ulated her hhensive ome oss) |  |
| Balance at January 1, 2007 | \$ |  | \$ 194,595 | \$ 41,544 | \$ | $(4,892)$ | \$ 231,419 |
| Comprehensive income (loss): |  |  |  |  |  |  |  |
| Net income |  |  |  | 15,050 |  |  | 15,050 |
| Other comprehensive income (loss): |  |  |  |  |  |  |  |
| Unrealized loss on investment securities available for sale, net of tax effect of \$623 |  |  |  |  |  | 966 | 966 |
| Unconsolidated affiliates unrecognized loss on investment securities available for sale, net of taxes recorded by the unconsolidated |  |  |  |  |  |  |  |
| Comprehensive income |  |  |  |  |  |  | 16,047 |
| Net issuance of 40,378 shares of common |  |  |  |  |  |  |  |
| Tax benefit from stock options exercised |  |  | 218 |  |  |  | 218 |
| Share-based compensation |  |  | 340 |  |  |  | 340 |
| Cash dividends Common Stock, $\$ 0.093$ per share |  |  |  | $(1,723)$ |  |  | $(1,723)$ |
| Balances at September 30, 2007 (unaudited) |  | 172 | 195,429 | 54,871 |  | $(3,895)$ | 246,577 |
| Comprehensive income (loss): |  |  |  |  |  |  |  |
| Net income |  |  |  | 5,395 |  |  | 5,395 |
| Other comprehensive income (loss): |  |  |  |  |  |  |  |
| Unrealized gain on investment securities |  |  |  |  |  |  |  |
| Unconsolidated affiliates unrecognized gain on investment securities available for sale, net of taxes recorded by the unconsolidated affiliate |  |  |  |  |  | 65 | 65 |
| Comprehensive income |  |  |  |  |  |  | 7,035 |
| Net issuance of 7,559 shares of common stock from exercise of stock options |  | 1 | 78 |  |  |  | 79 |
| Tax benefit from stock options exercised |  |  | 26 |  |  |  | 26 |
| Share-based compensation |  |  | 116 |  |  |  | 116 |
| Cash dividends Common Stock, $\$ 0.042$ per share |  |  |  | (777) |  |  | (777) |


| Balances at December 31, 2007 | 173 | 195,649 | 59,489 | $(2,255)$ | 253,056 |
| :--- | :--- | :--- | :--- | :--- | :--- |

See Condensed Notes to Consolidated Financial Statements.
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| Home BancShares, Inc. <br> Consolidated Statements of Stockholders Equity Continued Nine Months Ended September 30, 2008 and 2007 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| (In thousands, except share data (1)) | Common <br> Stock | Capital <br> Surplus | Retained <br> Earnings | Accumulated <br> Other <br> Comprehensive Income (Loss) | Total |
| Cumulative effect of adoption of EITF 06-4 |  |  | (276) |  | (276) |
| Comprehensive income (loss): <br> Net income |  |  | 19,496 |  | 19,496 |
| Other comprehensive income (loss): Unrealized loss on investment securities available for sale, net of tax effect of (\$1,907) |  |  |  | $(3,142)$ | $(3,142)$ |
| Unconsolidated affiliates unrecognized gain on investment securities available for sale, net of taxes recorded by the unconsolidated affiliate |  |  |  | 92 | 92 |
| Comprehensive income Issuance of $1,170,506$ common shares pursuant to acquisition of Centennial |  |  |  |  | 16,446 |
| Bancshares, Inc. | 10 | 24,245 |  |  | 24,255 |
| Net issuance of 23,381 shares of common stock from exercise of stock options |  | 196 |  |  | 196 |
| Tax benefit from stock options exercised |  | 134 |  |  | 134 |
| Share-based compensation |  | 354 |  |  | 354 |
| Cash dividends Common Stock, \$0.157 per share |  |  | $(3,113)$ |  | $(3,113)$ |
| 8\% Stock dividend Common Stock | 15 | 32,258 | $(32,286)$ |  | (13) |
| Balances at September 30, 2008 (unaudited) | \$198 | \$252,836 | \$ 43,310 | \$ $(5,305)$ | \$291,039 |
| (1) All share and per share amounts have been restated to reflect the effect of the $8 \%$ stock dividend. |  |  |  |  |  |
| See Condensed Notes to Consolidated Financial Statements. 7 |  |  |  |  |  |

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## Home BancShares, Inc. Consolidated Statements of Cash Flows



| Net increase (decrease) in FHLB and other borrowed funds | $(9,113)$ | 74,260 |
| :--- | ---: | ---: |
| Proceeds from exercise of stock options | 196 | 276 |
| Tax benefits from stock options exercised | $(3,126)$ | $(1,723)$ |
| Dividends paid | 101,190 | 60,010 |
| Net cash provided by financing activities | 5,714 | $(10,656)$ |
| Net change in cash and cash equivalents | 55,021 | 59,700 |
| Cash and cash equivalents beginning of year | $\$ 60,735$ | $\$ 49,044$ |

See Condensed Notes to Consolidated Financial Statements.

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## Home BancShares, Inc. <br> Condensed Notes to Consolidated Financial Statements <br> (Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies Nature of Operations

Home BancShares, Inc. (the Company or HBI) is a bank holding company headquartered in Conway, Arkansas. The Company is primarily engaged in providing a full range of banking services to individual and corporate customers through its six wholly owned community bank subsidiaries. Three of our bank subsidiaries are located in the central Arkansas market area, a fourth serves central and southern Arkansas, a fifth serves Stone County in north central Arkansas, and a sixth serves the Florida Keys and southwestern Florida. The Company is subject to competition from other financial institutions. The Company also is subject to the regulation of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

A summary of the significant accounting policies of the Company follows:

## Operating Segments

The Company is organized on a subsidiary bank-by-bank basis upon which management makes decisions regarding how to allocate resources and assess performance. Each of the subsidiary banks provides a group of similar community banking services, including such products and services as loans, time deposits, checking and savings accounts. The individual bank segments have similar operating and economic characteristics and have been reported as one aggregated operating segment.

## Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the valuation of foreclosed assets. In connection with the determination of the allowance for loan losses and the valuation of foreclosed assets, management obtains independent appraisals for significant properties.

## Principles of Consolidation

The consolidated financial statements include the accounts of HBI and its subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

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## Investments in Unconsolidated Affiliates

The Company had a $20.4 \%$ investment in White River Bancshares, Inc. (WRBI) at December 31, 2007. The Company s investment in WRBI at December 31, 2007 totaled $\$ 13.8$ million. On March 3, 2008, WRBI repurchased the Company s interest in WRBI which resulted in a one-time gain of $\$ 6.1$ million. Prior to this date, the investment in WRBI was accounted for on the equity method. The Company s share of WRBI operating income included in non-interest income during 2008 totaled $\$ 102,000$. See the Acquisitions footnote related to the Company s acquisition and disposal of WRBI.

The Company has invested funds representing 100\% ownership in five statutory trusts which issue trust preferred securities. The Company s investment in these trusts was $\$ 1.4$ million and $\$ 1.3$ million at September 30, 2008 and December 31, 2007, respectively. Under accounting principles generally accepted in the United States of America, these trusts are not consolidated.

The summarized financial information below represents an aggregation of the Company s unconsolidated affiliates as of September 30, 2008 and 2007, and for the three-month and nine-month periods then ended:

|  | Three Months Ended |  | Nine Months Ended |  |
| :--- | :---: | :---: | :---: | ---: |
|  | September 30, |  | September 30, |  |
|  | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ |  | $\mathbf{2 0 0 8}$ |
|  |  | (In thousands) | $\mathbf{2 0 0 7}$ |  |
| Assets | $\$ 47,424$ | $\$ 552,126$ | $\$ 47,424$ | $\$ 552,126$ |
| Liabilities | 46,000 | 485,220 | 46,000 | 485,220 |
| Equity | 1,424 | 66,906 | 1,424 | 66,906 |
| Net income (loss) |  | 233 | 163 | $(462)$ |

## Interim financial information

The accompanying unaudited consolidated financial statements as of September 30, 2008 and 2007 have been prepared in condensed format, and therefore do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

The information furnished in these interim statements reflects all adjustments, which are, in the opinion of management, necessary for a fair statement of the results for each respective period presented. Such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter or for the full year. The interim financial information should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s 2007 Form 10-K, filed with the Securities and Exchange Commission.

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## Earnings per Share

Basic earnings per share are computed based on the weighted average number of shares outstanding during each year. Diluted earnings per share are computed using the weighted average common shares and all potential dilutive common shares outstanding during the period. Prior year and end of period per share amounts have been adjusted for the stock dividend which occurred in August of 2008. The following table sets forth the computation of basic and diluted earnings per share (EPS) for the three-month and nine-month periods ended September 30:

|  | Three Months Ended September 30, |  |  |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2008 |  | 2007 | 2008 | 2007 |
|  | (In thousands) |  |  |  |  |  |
| Net income |  | 6,564 | \$ | 5,228 | \$ 19,496 | \$ 15,050 |
| Average shares outstanding |  | 19,814 |  | 18,618 | 19,808 | 18,609 |
| Effect of potential share issuance for acquisition earn out |  | 195 |  |  | 195 |  |
| Effect of common stock options |  | 314 |  | 322 | 306 | 314 |
| Diluted shares outstanding |  | 20,323 |  | 18,940 | 20,309 | 18,923 |
| Basic earnings per share |  | \$.32 | \$ | 0.28 | \$ 0.98 | \$ 0.81 |
| Diluted earnings per share |  | 0.32 | \$ | 0.28 | \$ 0.96 | \$ 0.80 |

## 2. Acquisitions

On January 1, 2008, HBI acquired Centennial Bancshares, Inc., an Arkansas bank holding company. Centennial Bancshares, Inc. owned Centennial Bank, located in Little Rock, Arkansas which had total assets of $\$ 234.1$ million, loans of $\$ 192.8$ million and total deposits of $\$ 178.8$ million on the date of acquisition. The consideration for the merger was $\$ 25.4$ million, which was paid approximately $4.6 \%$, or $\$ 1.2$ million in cash and $95.4 \%$, or $\$ 24.2$ million, in shares of the Company s common stock. In connection with the acquisition, $\$ 3.0$ million of the purchase price, consisting of $\$ 139,000$ in cash and 140,456 shares (stock dividend adjusted) of the Company s common stock, was placed in escrow related to possible losses from identified loans and an IRS examination. In the first quarter of 2008, the IRS examination was completed which resulted in $\$ 1.0$ million of the escrow proceeds being released. The merger further provides for an earn out based upon 2008 earnings of up to a maximum of $\$ 4,000,000$ which can be paid in cash or the Company s stock at the election of the accredited shareholders. As a result of this transaction, the Company recorded goodwill of $\$ 12.3$ million and a core deposit intangible of $\$ 694,000$.

In January 2005, HBI purchased $20 \%$ of the common stock during the formation of White River Bancshares, Inc. of Fayetteville, Arkansas for $\$ 9.1$ million. White River Bancshares owns all of the stock of Signature Bank of Arkansas, with branch locations in the northwest Arkansas area. In January 2006, White River Bancshares issued an additional $\$ 15.0$ million of their common stock. To maintain a $20 \%$ ownership, the Company made an additional investment in White River Bancshares of $\$ 3.0$ million in January 2006. During April 2007, White River Bancshares acquired $100 \%$ of the stock of Brinkley Bancshares, Inc. in Brinkley, Arkansas. As a result, HBI made a $\$ 2.6$ million additional investment in White River Bancshares on June 29, 2007 to maintain its 20\% ownership. On March 3, 2008, White River BancShares repurchased HBI s $20 \%$ investment in White River Bancshares resulting in a one-time gain for HBI of $\$ 6.1$ million.

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## 3. Investment Securities

The amortized cost and estimated market value of investment securities were as follows:
September 30, 2008
Available for Sale

| Available for Sale |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Amortized <br> Cost | Gross Unrealized Gains |  | Gross |  |  |
|  |  | Unrealized (Losses) |  | Estimated <br> Fair Value |  |
|  | (In thousands) |  |  |  |  |
| \$ 76,588 | \$ 277 | \$ | (526) | \$ | 76,339 |
| 185,325 | 971 |  | $(4,381)$ |  | 181,915 |
| 118,288 | 729 |  | $(4,939)$ |  | 114,078 |
| 10,089 |  |  | (857) |  | 9,232 |
| \$ 390,290 | \$ 1,977 |  | $(10,703)$ |  | 381,56 |

December 31, 2007
Available for Sale
Gross Gross
Amortized Unrealized Unrealized Estimated
Cost Gains (Losses) Fair Value
(In thousands)
U.S. government-sponsored enterprises

Mortgage-backed securities
State and political subdivisions
Other securities
Total
\$ 434,272 \$ 1,552 \$ $\quad(5,425) \quad \$ \quad 430,399$
Assets, principally investment securities, having a carrying value of approximately $\$ 189.0$ million and $\$ 210.6$ million at September 30, 2008 and December 31, 2007, respectively, were pledged to secure public deposits and for other purposes required or permitted by law. Also, investment securities pledged as collateral for repurchase agreements totaled approximately $\$ 108.4$ million and $\$ 120.6$ million at September 30, 2008 and December 31, 2007, respectively.

During the three-month and nine-month periods ended September 30, 2008 and 2007, no available for sale securities were sold.

The Company evaluates all securities quarterly to determine if any unrealized losses are deemed to be other than temporary. In completing these evaluations the Company follows the requirements of paragraph 16 of SFAS No. 115, Staff Accounting Bulletin 59 and FASB Staff Position No. 115-1. Certain investment securities are valued less than their historical cost. These declines are primarily the result of the rate for these investments yielding less than current market rates. Based on evaluation of available evidence, management believes the declines in fair value for these securities are temporary. It is management s intent to hold these securities to maturity. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary, impairment is identified.

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During the second quarter of 2008, the Company became aware that one of its investment securities in the other securities category had become other than temporarily impaired. As a result of this impairment the security was written-down by $\$ 2.1$ million or $\$ 0.06$ diluted earnings per share (stock dividend adjusted) for the second quarter of 2008. This investment security is a pool of 60 other financial holding companies subordinated debentures throughout the country. The Company has only two securities of this nature with a remaining balance of $\$ 3.9$ million which was put on non-accrual at June 30, 2008. The Company will continue to monitor its investments in these subordinated debentures and make additional write-downs if appropriate.

## 4: Loans Receivable and Allowance for Loan Losses

The various categories of loans are summarized as follows:

|  | $\begin{gathered} \text { September } \\ 30, \\ 2008 \end{gathered}$ | $\begin{gathered} \text { December } \\ 31, \\ 2007 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: |
|  | (In thousands) |  |  |
| Real estate: |  |  |  |
| Commercial real estate loans |  |  |  |
| Non-farm/non-residential | \$ 798,447 | \$ | 607,638 |
| Construction/land development | 339,691 |  | 367,422 |
| Agricultural | 25,097 |  | 22,605 |
| Residential real estate loans |  |  |  |
| Residential 1-4 family | 376,722 |  | 259,975 |
| Multifamily residential | 61,341 |  | 45,428 |
| Total real estate | 1,601,298 |  | 1,303,068 |
| Consumer | 49,600 |  | 46,275 |
| Commercial and industrial | 255,933 |  | 219,062 |
| Agricultural | 38,431 |  | 20,429 |
| Other | 22,661 |  | 18,160 |
| Total loans receivable before allowance for loan losses | 1,967,923 |  | 1,606,994 |
| Allowance for loan losses | 36,372 |  | 29,406 |
| Total loans receivable, net | \$ 1,931,551 | \$ | 1,577,588 |

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The following is a summary of activity within the allowance for loan losses:

|  | 2008 | (In thousands) |
| :---: | :---: | :---: |
| Balance, beginning of year | \$ 29,406 | \$ 26,111 |
| Additions |  |  |
| Provision charged to expense | 6,952 | 2,047 |
| Allowance for loan loss of Centennial Bancshares, Inc. | 3,382 |  |
| Net (recoveries) loans charged off |  |  |
| Losses charged to allowance, net of recoveries of $\$ 1,411$ and $\$ 818$ for the first nine months of 2008 and 2007, respectively | 3,368 | (478) |
| Balance, September 30 | \$ 36,372 | 28,636 |
| Additions |  |  |
| Provision charged to expense |  | 1,195 |
| Net (recoveries) loans charged off |  |  |
| Losses charged to allowance, net of recoveries of \$61 for the last three months of 2007 |  | 425 |
| Balance, end of year |  | \$ 29,406 |

At September 30, 2008 and December 31, 2007, accruing loans delinquent 90 days or more totaled $\$ 490,000$ and $\$ 301,000$, respectively. Non-accruing loans at September 30, 2008 and December 31, 2007 were $\$ 15.6$ million and $\$ 3.0$ million, respectively.

During the three-month period ended September 30, 2008, the Company sold $\$ 821,000$ of the guaranteed portion of certain SBA loans, which resulted in a gain of $\$ 26,000$. During the three-month period ended September 30, 2007, the Company did not sell any of the guaranteed portions of SBA loans. During the nine month period ended September 30, 2008 and 2007, the Company sold $\$ 2.6$ million and $\$ 2.8$ million of the guaranteed portion of certain SBA loans, which resulted in a gain of $\$ 127,000$ and $\$ 170,000$, respectively.

Mortgage loans held for sale of approximately $\$ 6.2$ million and $\$ 4.8$ million at September 30, 2008 and December 31, 2007, respectively, are included in residential 1-4 family loans. Mortgage loans held for sale are carried at the lower of cost or fair value, determined using an aggregate basis.

At September 30, 2008 and December 31, 2007, impaired loans totaled $\$ 42.0$ million and $\$ 11.9$ million, respectively. As of September 30, 2008 and 2007, average impaired loans were $\$ 28.8$ million and $\$ 11.8$ million, respectively. All impaired loans had designated reserves for possible loan losses. Reserves relative to impaired loans were $\$ 6.4$ million and $\$ 2.6$ million at September 30, 2008 and December 31, 2007, respectively. Interest recognized on impaired loans during 2008 and 2007 was $\$ 1.0$ million and $\$ 509,000$, respectively.

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## 5: Goodwill and Core Deposits and Other Intangibles

Changes in the carrying amount of the Company s goodwill and core deposits and other intangibles for the nine-month period ended September 30, 2008 and for the year ended December 31, 2007, were as follows:

|  | $\begin{aligned} & \text { September } \\ & \text { 30, } \\ & 2008 \\ & \text { (In thous } \end{aligned}$ | $\begin{aligned} & \text { December } \\ & 31, \\ & 2007 \\ & \text { usands) } \end{aligned}$ |
| :---: | :---: | :---: |
| Goodwill |  |  |
| Balance, beginning of period | \$ 37,527 \$ | \$ 37,527 |
| Acquisition of Centennial Bancshares, Inc. | 12,322 |  |
| Prior Acquisition (deferred taxes) | 189 |  |
| Balance, end of period | \$ 50,038 \$ | \$ 37,527 |
|  | 2008 <br> (In th | $\begin{gathered} 2007 \\ \text { housands) } \end{gathered}$ |
| Core Deposit and Other Intangibles |  |  |
| Balance, beginning of period | \$ 7,702 | \$ 9,458 |
| Acquisition of Centennial Bancshares, Inc. | 694 |  |
| Amortization expense | $(1,387)$ | $(1,317)$ |
| Balance, September 30 | \$ 7,009 | 8,141 |
| Amortization expense |  | (439) |
| Balance, end of year |  | \$ 7,702 |

The carrying basis and accumulated amortization of core deposits and other intangibles at September 30, 2008 and December 31, 2007 were:

|  | September | December |  |
| :--- | :---: | :---: | :---: |
|  | $\mathbf{3 0 ,}$ | $\mathbf{3 1 ,}$ |  |
|  | $\mathbf{2 0 0 8}$ |  | $\mathbf{2 0 0 7}$ |
| Gross carrying amount | (In thousands) |  |  |
| Accumulated amortization | $\$ 14,151$ | $\$$ | 13,457 |
|  | 7,142 |  | 5,755 |
| Net carrying amount | $\$ 7,009$ | $\$$ | 7,702 |

Core deposit and other intangible amortization for the three months ended September 30, 2008 and 2007 was approximately $\$ 462,000$ and $\$ 439,000$, respectively. Core deposit and other intangible amortization for the nine months ended September 30, 2008 and 2007 was approximately $\$ 1.4$ million and $\$ 1.3$ million, respectively. Including all of the mergers completed, HBI s estimated amortization expense of core deposits and other intangibles for each of the years 2008 through 2012 is: $2008 \quad \$ 1.8$ million; $2009 \quad \$ 1.8$ million; $2010 \quad \$ 1.8$ million; $2011 \quad \$ 1.1$ million; and 2012 \$619,000.

Goodwill is tested annually for impairment. If the implied fair value of goodwill is lower than its carrying amount, goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in
goodwill value are not recognized in the financial statements.

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## 6: Deposits

The aggregate amount of time deposits with a minimum denomination of $\$ 100,000$ was $\$ 535.6$ million and $\$ 435.5$ million at September 30, 2008 and December 31, 2007, respectively. Interest expense applicable to certificates in excess of $\$ 100,000$ totaled $\$ 4.4$ million and $\$ 5.9$ million for the three months ended September 30, 2008 and 2007, respectively. Interest expense applicable to certificates in excess of $\$ 100,000$ totaled $\$ 15.1$ million and $\$ 17.2$ million for the nine months ended September 30, 2008 and 2007, respectively.

Deposits totaling approximately $\$ 276.5$ million and $\$ 185.6$ million at September 30, 2008 and December 31, 2007, respectively, were public funds obtained primarily from state and political subdivisions in the United States.

## 7: FHLB Borrowed Funds

The Company s FHLB borrowed funds were $\$ 278.2$ million and $\$ 251.8$ million at September 30, 2008 and December 31, 2007, respectively. The outstanding balance for September 30, 2008 includes $\$ 25.0$ million of short-term advances and $\$ 253.2$ million of long-term advances. The outstanding balance for December 31, 2007 includes $\$ 116.0$ million of short-term advances and $\$ 135.8$ million of long-term advances. The long-term FHLB advances mature from the current year to 2025 with interest rates ranging from $2.495 \%$ to $5.416 \%$ and are secured by loans and investments securities. Expected maturities will differ from contractual maturities, because FHLB may have the right to call or prepay certain obligations.

## 8: Subordinated Debentures

Subordinated Debentures at September 30, 2008 and December 31, 2007 consisted of guaranteed payments on trust preferred securities with the following components:

| September | December |
| :---: | :---: |
| 30, | 31, |
| 2008 | 2007 |
| (In thousands) |  |

Subordinated debentures, issued in 2003, due 2033, fixed at $6.40 \%$, during the first five years and at a floating rate of $3.15 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, currently callable without penalty \$ 20,619 $\quad \$ \quad 20,619$ Subordinated debentures, issued in 2000, due 2030, fixed at $10.60 \%$, callable in 2010 with a penalty ranging from $5.30 \%$ to $0.53 \%$ depending on the year of prepayment, callable in 2020 without penalty Subordinated debentures, issued in 2003, due 2033, floating rate of 3.15\% above the three-month LIBOR rate, reset quarterly, currently callable without penalty Subordinated debentures, issued in 2005, due 2035, fixed rate of $6.81 \%$ during the first ten years and at a floating rate of $1.38 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, callable in 2010 without penalty Subordinated debentures, issued in 2006, due 2036, fixed rate of $6.75 \%$ during the first five years and at a floating rate of $1.85 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, callable in 2011 without penalty

Total subordinated debt
\$47,598 \$
3,333
3,266
\$
15,465

$$
15,465
$$

5,155
5,155

Total subor

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The trust preferred securities are tax-advantaged issues that qualify for Tier 1 capital treatment subject to certain limitations. Distributions on these securities are included in interest expense. Each of the trusts is a statutory business trust organized for the sole purpose of issuing trust securities and investing the proceeds thereof in junior subordinated debentures of the Company, the sole asset of each trust. The preferred trust securities of each trust represent preferred beneficial interests in the assets of the respective trusts and are subject to mandatory redemption upon payment of the junior subordinated debentures held by the trust. The Company wholly owns the common securities of each trust. Each trust s ability to pay amounts due on the trust preferred securities is solely dependent upon the Company making payment on the related junior subordinated debentures. The Company s obligations under the junior subordinated securities and other relevant trust agreements, in aggregate, constitute a full and unconditional guarantee by the Company of each respective trust s obligations under the trust securities issued by each respective trust.

## 9: Income Taxes

The following is a summary of the components of the provision for income taxes for the three-month and nine-month periods ended September 30:

|  | Three Months Ended September 30, |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
|  | (In thousands) |  |  |  |
| Current: |  |  |  |  |
| Federal | \$ 3,116 | \$ 2,568 | \$ 9,290 | \$ 7,086 |
| State | 552 | 363 | 1,643 | 970 |
| Total current | 3,668 | 2,931 | 10,933 | 8,056 |
| Deferred: |  |  |  |  |
| Federal | (407) | (567) | $(1,337)$ | $(1,499)$ |
| State | (103) | (106) | (290) | (284) |
| Total deferred | (510) | (673) | $(1,627)$ | $(1,783)$ |
| Provision for income taxes | \$ 3,158 | \$ 2,258 | \$ 9,306 | \$ 6,273 |

The reconciliation between the statutory federal income tax rate and effective income tax rate is as follows for the three-month and nine-month periods ended September 30:

|  | Three Months Ended <br> September 30, |  | Nine Months Ended <br> September 30, |  |
| :--- | :---: | :---: | :---: | :---: |
|  | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ |
| Statutory federal income tax rate | $35.00 \%$ | $35.00 \%$ | $35.00 \%$ | $35.00 \%$ |
| Effect of nontaxable interest income | $(5.26)$ | $(4.60)$ | $(4.54)$ | $(4.75)$ |
| Cash value of life insurance | $(1.95)$ | $(2.83)$ | $(2.00)$ | $(2.99)$ |
| State income taxes, net of federal benefit | 3.00 | 2.23 | 3.06 | 2.09 |
| Other | 1.69 | 0.36 | 0.79 | 0.07 |
|  |  |  |  |  |
| Effective income tax rate | $32.48 \%$ | $30.16 \%$ | $32.31 \%$ | $29.42 \%$ |

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The types of temporary differences between the tax basis of assets and liabilities and their financial reporting amounts that give rise to deferred income tax assets and liabilities, and their approximate tax effects, are as follows:


## 10: Common Stock and Stock Compensation Plans

On July 16, 2008, our Board of Directors declared an 8\% stock dividend which was paid August 27, 2008 to shareholders of record as of August 13, 2008. Except for fractional shares, the holders of our common stock received $8 \%$ additional common stock on August 27, 2008. The common shareholders did not receive fractional shares; instead they received cash at a rate equal to the closing price of a share on August 28, 2008 times the fraction of a share they otherwise would have been entitled to.

All share and per share amounts have been restated to reflect the retroactive effect of the stock dividend. After issuance, this stock dividend lowered our total capital position by approximately $\$ 13,000$ as a result of the cash paid in lieu of fractional shares. Our financial statements reflect an increase in the number of outstanding shares of common stock, an increase in surplus and reduction of retained earnings.

The Company has a stock option and performance incentive plan. The purpose of the plan is to attract and retain highly qualified officers, directors, key employees, and other persons, and to motivate those persons to improve our business results. This plan provides for the granting of incentive nonqualified options to purchase up to $1,620,000$ (stock dividend adjusted) of common stock in the Company.

Total unrecognized compensation cost, net of income tax benefit, related to non-vested awards, which are expected to be recognized over the vesting periods, is approximately $\$ 431,000$ as of September 30, 2008. The intrinsic value of the stock options outstanding and stock options vested at September 30, 2008 was $\$ 15.9$ million and $\$ 10.1$ million, respectively. The intrinsic value of the stock options exercised during the three-month and nine-month periods ended September 30, 2008 was $\$ 212,000$ and $\$ 342,000$, respectively.

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The table below summarized the transactions under the Company s stock option plans at September 30, 2008 and December 31, 2007 and changes during the nine-month period and year then ended, respectively (stock dividend adjusted):

|  | For the Nine Months Ended September 30, 2008 |  | For the Decem | ar Ended <br> 31, 2007 <br> Weighted <br> Average <br> Exercisable |
| :---: | :---: | :---: | :---: | :---: |
|  | Shares (000) | Price | Shares (000) | Price |
| Outstanding, beginning of year | 1,096 | \$ 11.12 | 1,115 | \$ 10.55 |
| Granted | 46 | 18.86 | 44 | 21.31 |
| Forfeited | (16) | 11.57 | (15) | 11.36 |
| Exercised | (23) | 8.40 | (48) | 7.40 |
| Outstanding, end of period | 1,103 | 11.49 | 1,096 | 11.12 |
| Exercisable, end of period | 625 | \$ 9.68 | 603 | \$ 9.07 |

For stock option awards, the fair value is estimated at the date of grant using the Black-Scholes option-pricing model. This model requires the input of highly subjective assumptions, changes to which can materially affect the fair value estimate. Additionally, there may be other factors that would otherwise have a significant effect on the value of employee stock options granted but are not considered by the model. Accordingly, while management believes that the Black-Scholes option-pricing model provides a reasonable estimate of fair value, the model does not necessarily provide the best single measure of fair value for the Company s employee stock options. The weighted-average fair value of options granted during the nine-months ended September 30, 2008 and year-ended December 31, 2007, was $\$ 2.49$ and $\$ 4.94$ (stock dividend adjusted), respectively. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

|  | For the Nine Months <br> Ended | For the Year <br> Ended <br> December 31, |
| :--- | :---: | :---: |
| Expected dividend yield | September 30, 2008 | $\mathbf{2 0 0 7}$ |
| Expected stock price volatility | $0.98 \%$ | $0.46 \%$ |
| Risk-free interest rate | $2.70 \%$ | $9.44 \%$ |
| Expected life of options | $3.36 \%$ | $4.65 \%$ |
|  | 6.4 years | 6.1 years |

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The following is a summary of currently outstanding and exercisable options (stock dividend adjusted) at September 30, 2008:


## 11. Non-Interest Expense

The table below shows the components of non-interest expense for three and nine months ended September 30, 2008 and 2007:

|  | Three Months Ended September 30, |  |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 |  | 2007 | 2008 | 2007 |
|  | (In thousands) |  |  |  |  |
| Salaries and employee benefits | \$ 8,739 | \$ | 7,739 | \$ 26,948 | \$ 22,936 |
| Occupancy and equipment | 2,825 |  | 2,446 | 8,253 | 6,998 |
| Data processing expense | 815 |  | 644 | 2,434 | 1,958 |
| Other operating expenses: |  |  |  |  |  |
| Advertising | 670 |  | 646 | 1,975 | 1,855 |
| Amortization of intangibles | 462 |  | 439 | 1,387 | 1,317 |
| Amortization of mortgage servicing rights | 148 |  |  | 442 |  |
| Electronic banking expense | 740 |  | 618 | 2,315 | 1,803 |
| Directors fees | 254 |  | 225 | 716 | 617 |
| Due from bank service charges | 73 |  | 55 | 217 | 162 |
| FDIC and state assessment | 524 |  | 341 | 1,325 | 926 |
| Insurance | 244 |  | 211 | 707 | 683 |
| Legal and accounting | 382 |  | 308 | 978 | 930 |
| Mortgage servicing expense | 59 |  |  | 220 |  |
| Other professional fees | 184 |  | 201 | 1,461 | 585 |
| Operating supplies | 234 |  | 241 | 723 | 694 |
| Postage | 189 |  | 163 | 557 | 498 |
| Telephone | 238 |  | 227 | 702 | 688 |

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| Other expense | 1,698 | 1,095 | 4,298 | 3,207 |
| :--- | ---: | ---: | ---: | ---: |
| Total other operating expenses | 6,099 | 4,770 | 18,023 | 13,965 |
| Total non-interest expense | $\$ 18,478$ | $\$ 15,599$ | $\$ 55,658$ | $\$ 45,857$ |
|  | 20 |  |  |  |

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At its April 20, 2007 meeting, our Board of Directors approved a Chairman s Retirement Plan for John Allison our Chairman and CEO. Beginning on Mr. Allison s 65th birthday, he will receive a $\$ 250,000$ annual benefit to be paid for 10 consecutive years or until his death, whichever shall occur later. This will result in an annual expense of approximately $\$ 535,000$ and $\$ 388,000$ for 2008 and 2007, respectively. An expense of $\$ 138,000$ and $\$ 397,000$ was accrued for the three and nine months ended September 30, 2008, respectively. An expense of $\$ 130,000$ and $\$ 258,000$ was accrued for the three and nine months ended September 30, 2007. This expense was accrued using an 8 percent discount factor.

## 12: Concentration of Credit Risks

The Company s primary market area is in central Arkansas, north central Arkansas, northwest Arkansas, southern Arkansas, southwest Florida and the Florida Keys (Monroe County). The Company primarily grants loans to customers located within these geographical areas unless the borrower has an established relationship with the Company.

The diversity of the Company s economic base tends to provide a stable lending environment. Although the Company has a loan portfolio that is diversified in both industry and geographic area, a substantial portion of its debtors ability to honor their contracts is dependent upon real estate values, tourism demand and the economic conditions prevailing in its market areas.

## 13: Significant Estimates and Concentrations

Accounting principles generally accepted in the United Sates of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Estimates related to the allowance for loan losses and certain concentrations of credit risk are reflected in Note 4, while deposit concentrations are reflected in Note 6.

## 14: Commitments and Contingencies

In the ordinary course of business, the Company makes various commitments and incurs certain contingent liabilities to fulfill the financing needs of their customers. These commitments and contingent liabilities include lines of credit and commitments to extend credit and issue standby letters of credit. The Company applies the same credit policies and standards as they do in the lending process when making these commitments. The collateral obtained is based on the assessed creditworthiness of the borrower.

At September 30, 2008 and December 31, 2007, commitments to extend credit of $\$ 385.5$ million and $\$ 315.4$ million, respectively, were outstanding. A percentage of these balances are participated out to other banks; therefore, the Company can call on the participating banks to fund future draws. Since some of these commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

Outstanding standby letters of credit are contingent commitments issued by the Company, generally to guarantee the performance of a customer in third-party borrowing arrangements. The term of the guarantee is dependent upon the credit worthiness of the borrower some of which are long-term. The maximum amount of future payments the Company could be required to make under these guarantees at September 30, 2008 and December 31, 2007, is $\$ 15.2$ million and $\$ 15.8$ million, respectively.

The Company and/or its subsidiary banks have various unrelated legal proceedings, most of which involve loan foreclosure activity pending, which, in the aggregate, are not expected to have a material adverse effect on the financial position of the Company and its subsidiaries.

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## 15: Regulatory Matters

The Company s subsidiaries are subject to a legal limitation on dividends that can be paid to the parent company without prior approval of the applicable regulatory agencies. Arkansas bank regulators have specified that the maximum dividend limit state banks may pay to the parent company without prior approval is $75 \%$ of the current year earnings plus $75 \%$ of the retained net earnings of the preceding year. Since, the Company s Arkansas bank subsidiaries are also under supervision of the Federal Reserve, they are further limited if the total of all dividends declared in any calendar year by the Bank exceeds the Bank s net profits to date for that year combined with its retained net profits for the preceding two years. Under Florida state banking law, regulatory approval will be required if the total of all dividends declared in any calendar year by the Bank exceeds the Bank s net profits to date for that year combined with its retained net profits for the preceding two years. As the result of leveraged capital positions, the Company s subsidiary banks do not have a significant amount of undivided profits available for payment of dividends to the Company as of September 30, 2008.

The Federal Reserve Board s risk-based capital guidelines include the definitions for (1) a well-capitalized institution, (2) an adequately-capitalized institution, and (3) and undercapitalized institution. The criteria for a well-capitalized institution are: a 5\% Tier 1 leverage capital ratio, a $6 \%$ Tier 1 risk-based capital ratio, and a $10 \%$ total risk-based capital ratio. As of September 30, 2008, each of the six subsidiary banks met the capital standards for a well-capitalized institution. The Company s Tier 1 leverage capital ratio, Tier 1 risk-based capital ratio, and total risk-based capital ratio was $11.29 \%, 13.02 \%$, and $14.27 \%$, respectively, as of September 30, 2008.

## 16: Additional Cash Flow Information

In connection with the Centennial Bancshares, Inc. acquisition accounting for using the purchase method, the Company acquired approximately $\$ 241.5$ million in assets, assumed $\$ 218.9$ million in liabilities, issued $\$ 24.3$ million of equity and received net funds of $\$ 1.7$ million during 2008.

The Company paid interest and taxes during the three and nine months ended as follows:

|  | Three Months Ended | Nine Months Ended <br> September 30, |  |  |
| :--- | :---: | :---: | :---: | :---: |
|  | September 30, | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ |  |
|  | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ | (In thousands) |  |
| Interest paid |  | $\$ 18,587$ | $\$ 48,351$ | $\$ 55,531$ |
| Income taxes paid | $\$ 14,977$ | 1,620 | 12,877 | 7,320 |

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## 17: Adoption of Recent Accounting Pronouncements

FAS 157
Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 has been applied prospectively as of the beginning of the period.

FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities
Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities
Available-for-sale securities are the only material instruments valued on a recurring basis which are held by the Company at fair value. The Company does not have any Level 1 securities. Primarily all of the Company s securities are considered to be Level 2 securities. These Level 2 securities consist of U.S. government-sponsored enterprises, mortgage-backed securities plus state and political subdivisions. Level 3 securities were immaterial.

Impaired loans are the only material instruments valued on a non-recurring basis which are held by the Company at fair value. Loan impairment is reported when full payment under the loan terms is not expected. Impaired loans are carried at the present value of estimated future cash flows using the loan s existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to require increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when Management believes the uncollectability of a loan is confirmed. Impaired loans, net of specific allowance, were $\$ 35.6$ million as of September 30, 2008. This valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

Compared to prior years, the adoption of SFAS 157 did not have a material impact on our 2008 consolidated financial statements.

## FAS 159

Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159) became effective for the Company on January 1, 2008. FAS 159 allows companies an option to report selected financial assets and liabilities at fair value. Because we did not elect the fair value measurement provision for any of our financial assets or liabilities, the adoption of SFAS 159 did not have any impact on our 2008 consolidated financial statements. Presently, we have not determined whether we will elect the fair value measurement provisions for future transactions.

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## EITF 06-4 and 06-10

Effective January 1, 2008, the Company adopted EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements and EITF 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements. As a result of the adoption of EITF 06-4, the Company recognized the effect of applying the EITF with a change in accounting principle through a cumulative-effect adjustment to retained earnings for $\$ 276,000$. Additionally, this change will result in an increase of approximately $\$ 100,000$ in annual non-interest expense as a result of the mortality cost for 2008 and beyond. The adoption of EITF 06-10 did not have any impact on our 2008 consolidated financial statements.

## 18: Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 141(revised 2007), Business Combinations, ( SFAS 141(R) ). SFAS 141(R), which replaces SFAS 141, Business Combinations, establishes accounting standards for all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree) including mergers and combinations achieved without the transfer of consideration. SFAS $141(\mathrm{R})$ requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. Goodwill is measured as the excess of consideration transferred plus the fair value of any noncontrolling interest in the acquiree over the fair value of the identifiable net assets acquired. In the event that the fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any non-controlling interest (referred to as a bargain purchase ), SFAS $141(\mathrm{R})$ requires the acquirer to recognize that excess in earnings as a gain attributable to the acquirer. In addition, SFAS $141(\mathrm{R})$ requires costs incurred to effect an acquisition to be recognized separately from the acquisition and requires the recognition of assets or liabilities arising from noncontractual contingencies as of the acquisition date only if it is more likely than not that they meet the definition of an asset or liability in FASB Concepts Statement No. 6, Elements of Financial Statements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for us is the fiscal year beginning January 1, 2009. The Company is currently evaluating the impact of the adoption of this standard, but does not expect it to have a material effect on the Company sfinancial position or results of operation.

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## Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Stockholders
Home BancShares, Inc.
Conway, Arkansas
We have reviewed the accompanying condensed consolidated balance sheet of Home BancShares, Inc. as of September 30, 2008 and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2008 and 2007 and statements of stockholders equity and cash flows for the nine-month periods September 30, 2008 and 2007. These interim financial statements are the responsibility of the Company s management.
We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.
We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2007 and the related consolidated statements of income, stockholders equity and cash flows for the year then ended (not presented herein); and in our report dated March 4, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2007 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.
/s/ BKD, LLP
Little Rock, Arkansas
November 3, 2008

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## Item 2: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our Form 10-K, filed with the Securities and Exchange Commission on March 5, 2008, which includes the audited financial statements for the year ended December 31, 2007. Unless the context requires otherwise, the terms Company, us, we, and our refer to Home BancShares, Inc. on a consolidated basis.

## General

We are a bank holding company headquartered in Conway, Arkansas, offering a broad array of financial services through our six wholly owned bank subsidiaries. As of September 30, 2008, we had, on a consolidated basis, total assets of $\$ 2.65$ billion, loans receivable of $\$ 1.97$ billion, total deposits of $\$ 1.91$ billion, and shareholders equity of $\$ 291.0$ million.

We generate most of our revenue from interest on loans and investments, service charges, and mortgage banking income. Deposits are our primary source of funding. Our largest expenses are interest on these deposits and salaries and related employee benefits. We measure our performance by calculating our return on average equity, return on average assets, and net interest margin. We also measure our performance by our efficiency ratio, which is calculated by dividing non-interest expense less amortization of core deposit intangibles by the sum of net interest income on a tax equivalent basis and non-interest income. Per share amounts have been adjusted for the $8 \%$ stock dividend which occurred in August of 2008.

## Key Financial Measures

| As of or for the Three Months | As of or for the Nine Months |
| :---: | :---: |
| Ended September 30, | Ended September 30, |
| 2008 | 2007 |

(Dollars in thousands, except per share data)

| Total assets | $\$ 2,650,590$ | $\$ 2,267,672$ | $\$ 2,650,590$ | $\$ 2,267,672$ |
| :--- | :---: | :---: | :---: | ---: |
| Loans receivable | $1,967,923$ | $1,560,374$ | $1,967,923$ | $1,560,374$ |
| Total deposits | $1,91,071$ | $1,598,571$ | $1,913,071$ | $1,598,571$ |
| Net income | 6,564 | 5,228 | 19,496 | 15,050 |
| Basic earnings per share | 0.32 | 0.28 | 0.98 | 0.81 |
| Diluted earnings per share | 0.32 | 0.28 | 0.96 | 0.80 |
| Diluted cash earnings per share (1) | 0.34 | 0.29 | 1.00 | 0.84 |
| Annualized net interest margin FTE | $3.82 \%$ | $3.55 \%$ | $3.83 \%$ | $3.49 \%$ |
| Efficiency ratio | 59.25 | 62.47 | 57.95 | 62.65 |
| Annualized return on average assets | 1.00 | 0.92 | 1.01 | 0.91 |
| Annualized return on average equity | 9.02 | 8.60 | 9.09 | 8.48 |

(1) See Table 16

Diluted Cash
Earnings Per
Share for a
reconciliation to
GAAP for
diluted cash
earnings per
share.

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## Overview

Our net income increased $25.6 \%$ to $\$ 6.6$ million for the three-month period ended September 30, 2008, from $\$ 5.2$ million for the same period in 2007. Our net income increased $29.5 \%$ to $\$ 19.5$ million for the nine-month period ended September 30, 2008, from $\$ 15.1$ million for the same period in 2007. On a diluted earnings per share basis, our net earnings increased $14.3 \%$ to $\$ 0.32$ for the three-month period ended September 30, 2008, as compared to $\$ 0.28$ (stock dividend adjusted) for the same period in 2007. On a diluted earnings per share basis, our net earnings increased $20.0 \%$ to $\$ 0.96$ for the nine-month period ended September 30, 2008, as compared to $\$ 0.80$ (stock dividend adjusted) for the same period in 2007. The third quarter increase in earnings is associated with our acquisition of Centennial Bancshares, Inc., and organic growth of our bank subsidiaries. The year to date increase in earnings is associated with our acquisition of Centennial Bancshares, Inc., a $\$ 6.1$ million gain on the sale of our investment in White River Bancshares, Inc. and organic growth of our bank subsidiaries offset by the additional provision for loan loss associated with the unfavorable economic conditions, particularly in the Florida market and $\$ 458,000$ of losses on a foreclosed property of which $\$ 380,000$ was a owner occupied strip center in Florida, a $\$ 2.1$ million impairment write down of an investment security and $\$ 860,000$ of costs associated with an efficiency study.

Our annualized return on average assets was $1.00 \%$ and $1.01 \%$ for the three and nine months ended September 30, 2008, compared to $0.92 \%$ and $0.91 \%$ for the same periods in 2007, respectively. Our annualized return on average equity was $9.02 \%$ and $9.09 \%$ for the three and nine months ended September 30, 2008, compared to $8.60 \%$ and $8.48 \%$ for the same periods in 2007, respectively. The changes were primarily due to the previously discussed changes in net income for the three and nine months ended September 30, 2008, compared to the same periods in 2007.

Our annualized net interest margin, on a fully taxable equivalent basis, was $3.82 \%$ and $3.83 \%$ for the three and nine months ended September 30, 2008, compared to $3.55 \%$ and $3.49 \%$ for the same periods in 2007, respectively. Our strong loan growth which was funded by run off in the investment portfolio and deposit growth combined with our acquisition of Centennial Bancshares, Inc. and improved pricing on our deposits allowed the Company to improve net interest margin.

Our efficiency ratio (calculated by dividing non-interest expense less amortization of core deposit intangibles by the sum of net interest income on a tax equivalent basis and non-interest income) was $59.25 \%$ and $57.95 \%$ for three and nine months ended September 30, 2008, compared to $62.47 \%$ and $62.65 \%$ for the same periods in 2007, respectively. These improvements in our efficiency ratio are primarily due to continued improvement of our operations combined with previously discussed changes in net income for the three and nine months ended September 30, 2008, compared to the same periods in 2007.

Our total assets increased $\$ 359.0$ million, a growth of $15.7 \%$, to $\$ 2.65$ billion as of September 30, 2008, from $\$ 2.29$ billion as of December 31, 2007. Our loan portfolio increased $\$ 360.9$ million, a growth of $22.5 \%$, to $\$ 1.97$ billion as of September 30, 2008, from $\$ 1.61$ billion as of December 31, 2007. Shareholders equity increased $\$ 38.0$ million, a growth of $15.0 \%$, to $\$ 291.0$ million as of September 30, 2008, compared to $\$ 253.1$ million as of December 31, 2007. Asset and loan increases are primarily associated with our acquisition of Centennial Bancshares and organic growth of our bank subsidiaries. During the nine months of 2008 we experienced $\$ 214.7$ million of organic loan growth. The increase in stockholders equity was primarily the result of the $\$ 24.3$ million in additional capital that was issued upon our acquisition of Centennial Bancshares combined with the retained earnings for the nine months.

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As of September 30, 2008, our non-performing loans increased to $\$ 16.1$ million, or $0.82 \%$, of total loans from $\$ 3.3$ million, or $0.20 \%$, of total loans as of December 31, 2007. The allowance for loan losses as a percent of non-performing loans decreased to $226 \%$ as of September 30, 2008, compared to $904 \%$ from December 31, 2007. Unfavorable economic conditions in the Florida market increased our non-performing loans by $\$ 9.2$ million. The remaining increase in non-performing loans is associated with our Arkansas market which includes an increase of $\$ 620,000$ from our acquisition of Centennial Bancshares, Inc.

As of September 30, 2008, our non-performing assets increased to $\$ 29.3$ million, or $1.11 \%$, of total assets from $\$ 8.4$ million, or $0.36 \%$, of total assets as of December 31, 2007. The increase in non-performing assets is primarily the result of the $\$ 12.8$ million increase in non-performing loans combined with two investment securities with a remaining balance of $\$ 3.9$ million which were put on non-accrual in the second quarter of 2008 and a $\$ 4.3$ million increase in foreclosed assets held for sale.

## Critical Accounting Policies

Overview. We prepare our consolidated financial statements based on the selection of certain accounting policies, generally accepted accounting principles and customary practices in the banking industry. These policies, in certain areas, require us to make significant estimates and assumptions. Our accounting policies are described in detail in the notes to our consolidated financial statements in Note 1 of the audited consolidated financial statements included in our Form 10-K, filed with the Securities and Exchange Commission.

We consider a policy critical if (i) the accounting estimate requires assumptions about matters that are highly uncertain at the time of the accounting estimate; and (ii) different estimates that could reasonably 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 our financial statements. Using these criteria, we believe that the accounting policies most critical to us are those associated with our lending practices, including the accounting for the allowance for loan losses, investments, intangible assets, income taxes and stock options.

Investments. Securities available for sale are reported at fair value with unrealized holding gains and losses reported as a separate component of shareholders equity and other comprehensive income (loss). Securities that are held as available for sale are used as a part of our asset/liability management strategy. Securities that may be sold in response to interest rate changes, changes in prepayment risk, the need to increase regulatory capital, and other similar factors are classified as available for sale.

Loans Receivable and Allowance for Loan Losses. Substantially all of our loans receivable are reported at their outstanding principal balance adjusted for any charge-offs, as it is management s intent to hold them for the foreseeable future or until maturity or payoff, except for mortgage loans held for sale. Interest income on loans is accrued over the term of the loans based on the principal balance outstanding.

The allowance for loan losses is established through a provision for loan losses charged against income. The allowance represents an amount that, in management s judgment, will be adequate to absorb probable credit losses on identifiable loans that may become uncollectible and probable credit losses inherent in the remainder of the loan portfolio. The amounts of provisions for loan losses are based on management s analysis and evaluation of the loan portfolio for identification of problem credits, internal and external factors that may affect collectability, relevant credit exposure, particular risks inherent in different kinds of lending, current collateral values and other relevant factors.

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We consider a loan to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms thereof. We apply this policy even if delays or shortfalls in payments are expected to be insignificant. All non-accrual loans and all loans that have been restructured from their original contractual terms are considered impaired loans. The aggregate amount of impaired loans is used in evaluating the adequacy of the allowance for loan losses and amount of provisions thereto. Losses on impaired loans are charged against the allowance for loan losses when in the process of collection it appears likely that losses will be realized. The accrual of interest on impaired loans is discontinued when, in management s opinion, the borrower may be unable to meet payments as they become due. When accrual of interest is discontinued, all unpaid accrued interest is reversed.

Loans are placed on non-accrual status when management believes that the borrower s financial condition, after giving consideration to economic and business conditions and collection efforts, is such that collection of interest is doubtful, or generally when loans are 90 days or more past due. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely. Accrued interest related to non-accrual loans is generally charged against the allowance for loan losses when accrued in prior years and reversed from interest income if accrued in the current year. Interest income on non-accrual loans may be recognized to the extent cash payments are received, although the majority of payments received are usually applied to principal. Non-accrual loans are generally returned to accrual status when principal and interest payments are less than 90 days past due, the customer has made required payments for at least six months, and we reasonably expect to collect all principal and interest.

Intangible Assets. Intangible assets consist of goodwill and core deposit intangibles. Goodwill represents the excess purchase price over the fair value of net assets acquired in business acquisitions. The core deposit intangible represents the excess intangible value of acquired deposit customer relationships as determined by valuation specialists. The core deposit intangibles are being amortized over 84 to 114 months on a straight-line basis. Goodwill is not amortized but rather is evaluated for impairment on at least an annual basis. We perform an annual impairment test of goodwill and core deposit intangibles as required by SFAS No. 142, Goodwill and Other Intangible Assets, in the fourth quarter.

Income Taxes. We use the liability method in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based upon the difference between the values of the assets and liabilities as reflected in the financial statements and their related tax basis using enacted tax rates in effect for the year in which the differences are expected to be recovered or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Any estimated tax exposure items identified would be considered in a tax contingency reserve. Changes in any tax contingency reserve would be based on specific development, events, or transactions.

We and our subsidiaries file consolidated tax returns. Our subsidiaries provide for income taxes on a separate return basis, and remit to us amounts determined to be currently payable.

Stock Options. Prior to 2006, we elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations in accounting for employee stock options using the fair value method. Under APB 25, because the exercise price of the options equals the estimated market price of the stock on the issuance date, no compensation expense is recorded. On January 1, 2006, we adopted SFAS No. 123, Share-Based Payment (Revised 2004) which establishes standards for the accounting for transactions in which an entity (i) exchanges its equity instruments for goods and services, or (ii) incurs liabilities in exchange for goods and services that are based on the fair value of the entity s equity instruments or that may be settled by the issuance of the equity instruments. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which is generally the date of the grant.

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## Acquisitions and Equity Investments

On January 1, 2008, we acquired Centennial Bancshares, Inc., an Arkansas bank holding company. Centennial Bancshares, Inc. owned Centennial Bank, located in Little Rock, Arkansas which had total assets of $\$ 234.1$ million, loans of $\$ 192.8$ million and total deposits of $\$ 178.8$ million on the date of acquisition. The consideration for the merger was $\$ 25.4$ million, which was paid approximately $4.6 \%$, or $\$ 1.2$ million in cash and $95.4 \%$, or $\$ 24.3$ million, in shares of our common stock. In connection with the acquisition, $\$ 3.0$ million of the purchase price, consisting of $\$ 139,000$ in cash and 140,456 shares (stock dividend adjusted) of our common stock, was placed in escrow related to possible losses from identified loans and an IRS examination. In the first quarter of 2008, the IRS examination was completed which resulted in $\$ 1.0$ million of the escrow proceeds being released. The merger further provides for an earn out based upon 2008 earnings of up to a maximum of $\$ 4,000,000$ which can be paid in cash or our stock at the election of the accredited shareholders. As a result of this transaction, we recorded goodwill of $\$ 12.3$ million and a core deposit intangible of $\$ 694,000$.

In January 2005, we purchased 20\% of the common stock during the formation of White River Bancshares, Inc. of Fayetteville, Arkansas for $\$ 9.1$ million. White River Bancshares owns all of the stock of Signature Bank of Arkansas, with branch locations in northwest Arkansas. In January 2006, White River Bancshares issued an additional $\$ 15.0$ million of common stock. To maintain our $20 \%$ ownership, we made an additional investment of $\$ 3.0$ million in January 2006. During April 2007, White River Bancshares acquired 100\% of the stock of Brinkley Bancshares, Inc. in Brinkley, Arkansas. As a result, we made a $\$ 2.6$ million additional investment in White River Bancshares on June 29, 2007 to maintain our 20\% ownership. On March 3, 2008, White River Bancshares repurchased our 20\% investment in their company which resulted in a one-time gain of $\$ 6.1$ million.

In our continuing evaluation of our growth plans for the Company, we believe properly priced bank acquisitions can complement our organic growth and de novo branching growth strategies. The Company sacquisition focus will be to expand in its primary market areas of Arkansas and Florida. We are continually evaluating potential bank acquisitions to determine what is in the best interest of our Company. Our goal in making these decisions is to maximize the return to our investors.

## De Novo Branching

We intend to continue to open new (commonly referred to de novo) branches in our current markets and in other attractive market areas if opportunities arise. During 2008, we opened branch locations in the Arkansas communities of Morrilton and Cabot. Presently, we are evaluating additional opportunities but have no firm commitments for any additional de novo branch locations.

## Charter Consolidation

In July 2008, management of Home BancShares, Inc. approved the combining of all six of the Company s individually charted banks into one charter. The six banks will adopt Centennial Bank as their common name.

Assuming regulatory approvals are received; we are projecting name changes to Centennial Bank and charter consolidations will be phased in beginning in late 2008 when First State Bank and Marine Bank will be the first to consolidate and adopt the new name. Community Bank and Bank of Mountain View will follow suit in the first quarter of 2009, and Twin City Bank and the current Centennial Bank will complete the process in the summer of 2009. All of the banks will, at that time, have the same name, logo and charter allowing for a more customer-friendly banking experience and seamless transactions across all of our banks.

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This decision is based in part on our continuing efforts to improve efficiency and the results of a study conducted for us by a third party. This structure will improve product and service offerings by the combined banks, plus provide a greater value to customers in pricing and delivery systems across the company. We remain committed to our community banking philosophy and will continue to rely on local management and boards of directors.

## Holding Company Status

During the second quarter of 2008, we changed from a financial holding company to a bank holding company. Since, we were not utilizing any of the additional permitted activities allowed to our financial holding company status; this will not change any of our current business practices.

## Results of Operations

Our net income increased $25.6 \%$ to $\$ 6.6$ million for the three-month period ended September 30, 2008, from $\$ 5.2$ million for the same period in 2007. Our net income increased $29.5 \%$ to $\$ 19.5$ million for the nine-month period ended September 30, 2008, from $\$ 15.1$ million for the same period in 2007. On a diluted earnings per share basis, our net earnings increased $14.3 \%$ to $\$ 0.32$ for the three-month period ended September 30, 2008, as compared to $\$ 0.28$ (stock dividend adjusted) for the same period in 2007. On a diluted earnings per share basis, our net earnings increased $20.0 \%$ to $\$ 0.96$ for the nine-month period ended September 30, 2008, as compared to $\$ 0.80$ (stock dividend adjusted) for the same period in 2007. The third quarter increase in earnings is associated with our acquisition of Centennial Bancshares, Inc., and organic growth of our bank subsidiaries. The year to date increase in earnings is associated with our acquisition of Centennial Bancshares, Inc., a $\$ 6.1$ million gain on the sale of our investment in White River Bancshares, Inc. and organic growth of our bank subsidiaries offset by the additional provision for loan loss associated with the unfavorable economic conditions, particularly in the Florida market and $\$ 458,000$ of losses on a foreclosed property of which $\$ 380,000$ was a owner occupied strip center in Florida, a $\$ 2.1$ million impairment write down of an investment security and $\$ 860,000$ of costs associated with an efficiency study.

## Net Interest Income

Net interest income, our principal source of earnings, is the difference between the interest income generated by earning assets and the total interest cost of the deposits and borrowings obtained to fund those assets. Factors affecting the level of net interest income include the volume of earning assets and interest-bearing liabilities, yields earned on loans and investments and rates paid on deposits and other borrowings, the level of non-performing loans and the amount of non-interest-bearing liabilities supporting earning assets. Net interest income is analyzed in the discussion and tables below on a fully taxable equivalent basis. The adjustment to convert certain income to a fully taxable equivalent basis consists of dividing tax-exempt income by one minus the combined federal and state income tax rate.

The Federal Reserve Board sets various benchmark rates, including the Federal Funds rate, and thereby influences the general market rates of interest, including the deposit and loan rates offered by financial institutions. During 2007, the federal funds rate remained constant $5.25 \%$ until September 18, 2007, when the Federal Funds rate was lowered by 50 basis points to $4.75 \%$. The Federal Funds rate decreased another 25 basis points on October 31, 2007 and December 11, 2007. Due to these reductions occurring late in 2007, the impact for the year was minimal. Average interest rates for 2007 reflect the higher interest rate environment that existed until September 18, 2007 when the Federal Funds rate was lowered. Going forward, we will begin to see more of an impact of the decrease in the Federal Funds rate as our earning assets and interest-bearing liabilities begin to reprice. During 2008, the rate decreased by 75 basis points on January 22, 2008, 50 basis points on January 30, 2008, 75 basis points on March 18, 2008, 25 basis points on April 30, 2008 and 50 basis points to a rate of $1.50 \%$ as of October 8, 2008.

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Net interest income on a fully taxable equivalent basis increased $\$ 4.7$ million, or $26.0 \%$, to $\$ 22.6$ million for the three-month period ended September 30, 2008, from $\$ 18.0$ million for the same period in 2007. This increase in net interest income was the result of a $\$ 159,000$ decrease in interest income combined with a $\$ 4.8$ million decrease in interest expense. The $\$ 159,000$ decrease in interest income was primarily the result of our acquisition of Centennial Bancshares, Inc. and organic growth of our bank subsidiaries offset by the repricing of our earning assets in the declining interest rate environment. The higher level of earning assets resulted in an improvement in interest income of $\$ 6.8$ million, and our earning assets repricing in the declining interest rate environment resulted in a $\$ 7.0$ million decrease in interest income for the three-month period ended September 30, 2008. The $\$ 4.8$ million decrease in interest expense for the three-month period ended September 30, 2008, is primarily the result of our acquisition of Centennial Bancshares, Inc. and organic growth of our bank subsidiaries offset by our interest bearing liabilities repricing in the declining interest rate environment. The higher level of interest-bearing liabilities resulted in additional interest expense of $\$ 2.7$ million. The repricing of our interest bearing liabilities in the declining interest rate environment resulted in a $\$ 7.5$ million decrease in interest expense for the three-month period ended September 30, 2008.

Net interest income on a fully taxable equivalent basis increased $\$ 14.7$ million, or $28.2 \%$, to $\$ 66.7$ million for the nine-month period ended September 30, 2008, from $\$ 52.0$ million for the same period in 2007. This increase in net interest income was the result of a $\$ 5.7$ million increase in interest income combined with a $\$ 9.0$ million decrease in interest expense. The $\$ 5.7$ million increase in interest income was primarily the result of our acquisition of Centennial Bancshares, Inc. and organic growth of our bank subsidiaries offset by the repricing of our earning assets in the declining interest rate environment. The higher level of earning assets resulted in an improvement in interest income of $\$ 19.7$ million, and our earning assets repricing in the declining interest rate environment resulted in a $\$ 14.0$ million decrease in interest income for the nine-month period ended September 30, 2008. The $\$ 9.0$ million decrease in interest expense for the nine-month period ended September 30, 2008, is primarily the result of our acquisition of Centennial Bancshares, Inc. and organic growth of our bank subsidiaries offset by our interest bearing liabilities repricing in the declining interest rate environment. The higher level of interest-bearing liabilities resulted in additional interest expense of $\$ 8.1$ million. The repricing of our interest bearing liabilities in the declining interest rate environment resulted in a $\$ 17.1$ million decrease in interest expense for the nine-month period ended September 30, 2008.

Net interest margin, on a fully taxable equivalent basis, was $3.82 \%$ and $3.83 \%$ for the three and nine months ended September 30, 2008 compared to $3.55 \%$ and $3.49 \%$ for the same periods in 2007, respectively. Our strong loan growth which was funded by run off in the investment portfolio and deposit growth combined with improved pricing on deposits allowed the Company to improve net interest margin.

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Tables 1 and 2 reflect an analysis of net interest income on a fully taxable equivalent basis for the three-month and nine-month periods ended September 30, 2008 and 2007, as well as changes in fully taxable equivalent net interest margin for the three-month and nine-month periods ended September 30, 2008, compared to the same periods in 2007.

## Table 1: Analysis of Net Interest Income

|  | Three Months Ended September 30, |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
|  | (Dollars in thousands) |  |  |  |
| Interest income | \$ 36,088 | \$ 36,381 | \$ 111,024 | \$ 105,709 |
| Fully taxable equivalent adjustment | 768 | 634 | 2,236 | 1,867 |
| Interest income fully taxable equivalent | 36,856 | 37,015 | 113,260 | 107,576 |
| Interest expense | 14,233 | 19,061 | 46,597 | 55,582 |
| Net interest income fully taxable equivalent | \$ 22,623 | \$ 17,954 | \$ 66,663 | \$ 51,994 |
| Yield on earning assets fully taxable equivalent | 6.22\% | 7.31\% | 6.51\% | 7.23\% |
| Cost of interest-bearing liabilities | 2.75 | 4.26 | 3.06 | 4.24 |
| Net interest spread fully taxable equivalent | 3.47 | 3.05 | 3.45 | 2.99 |
| Net interest margin fully taxable equivalent | 3.82 | 3.55 | 3.83 | 3.49 |

Table 2: Changes in Fully Taxable Equivalent Net Interest Margin

|  | Three Months Ended September 30, 2008 vs. 2007 |  | nths d r 30, $2007$ |
| :---: | :---: | :---: | :---: |
| Increase in interest income due to change in earning assets | \$ 6,802 | \$ | 19,681 |
| Decrease in interest income due to change in earning asset yields | 6,961 |  | 13,997 |
| Increase in interest expense due to change in interest-bearing liabilities | 2,685 |  | 8,125 |
| Decrease in interest expense due to change in interest rates paid on interest-bearing liabilities | 7,513 |  | 17,110 |
| Increase in net interest income | \$ 4,669 | \$ | 14,669 |

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Table 3 shows, for each major category of earning assets and interest-bearing liabilities, the average amount outstanding, the interest income or expense on that amount and the average rate earned or expensed for the three-month and nine-month periods ended September 30, 2008 and 2007. The table also shows the average rate earned on all earning assets, the average rate expensed on all interest-bearing liabilities, the net interest spread and the net interest margin for the same periods. The analysis is presented on a fully taxable equivalent basis. Non-accrual loans were included in average loans for the purpose of calculating the rate earned on total loans.

Table 3: Average Balance Sheets and Net Interest Income Analysis

|  | Three Months Ended September 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2008 |  |  | 2007 |  |  |
|  | Average Balance | Income / <br> Expense | Yield / Rate (Dollars in | Average Balance ousands) | Income / Expense | Yield <br> / Rate |
| ASSETS |  |  |  |  |  |  |
| Earnings assets |  |  |  |  |  |  |
| Interest-bearing balances due from banks | \$ 6,882 | \$ 35 | 2.02\% | \$ 3,894 | \$ 53 | 5.40\% |
| Federal funds sold | 5,196 | 24 | 1.84 | 2,995 | 36 | 4.77 |
| Investment securities taxable | 266,400 | 2,982 | 4.45 | 366,530 | 4,133 | 4.47 |
| Investment securities non-taxable | 113,222 | 1,925 | 6.76 | 87,953 | 1,614 | 7.28 |
| Loans receivable | 1,964,267 | 31,890 | 6.46 | 1,547,858 | 31,179 | 7.99 |
| Total interest-earning assets | 2,355,967 | 36,856 | 6.22 | 2,009,230 | 37,015 | 7.31 |
| Non-earning assets | 247,510 |  |  | 234,003 |  |  |
| Total assets | \$ 2,603,477 |  |  | \$ 2,243,233 |  |  |
| LIABILITIES AND |  |  |  |  |  |  |
| SHAREHOLDERS |  |  |  |  |  |  |
| EQUITY |  |  |  |  |  |  |
| Liabilities |  |  |  |  |  |  |
| Interest-bearing liabilities |  |  |  |  |  |  |
| Savings and interest-bearing transaction accounts | \$ 690,564 | \$ 2,651 | 1.53\% | \$ 586,710 | \$ 4,375 | 2.96\% |
| Time deposits | 940,558 | 8,101 | 3.43 | 813,676 | 10,041 | 4.90 |
| Total interest-bearing deposits | 1,631,122 | 10,752 | 2.62 | 1,400,386 | 14,416 | 4.08 |
| Federal funds purchased | 16,044 | 79 | 1.96 | 14,446 | 194 | 5.33 |
| Securities sold under agreement to repurchase | 111,829 | 394 | 1.40 | 125,877 | 1,267 | 3.99 |
| FHLB borrowed funds | 254,230 | 2,239 | 3.50 | 191,887 | 2,426 | 5.02 |
| Subordinated debentures | 47,611 | 769 | 6.43 | 44,609 | 758 | 6.74 |


| Total interest-bearing liabilities | 2,060,836 | 14,233 | 2.75 | 1,777,205 | 19,061 | 4.26 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Non-interest bearing |  |  |  |  |  |  |
| liabilities |  |  |  |  |  |  |
| Non-interest bearing deposits | 242,155 |  |  | 212,298 |  |  |
| Other liabilities | 10,961 |  |  | 12,577 |  |  |
| Total liabilities | 2,313,952 |  |  | 2,002,080 |  |  |
| Shareholders equity | 289,525 |  |  | 241,153 |  |  |
| Total liabilities and shareholders equity | \$ 2,603,477 |  |  | \$ 2,243,233 |  |  |
| Net interest spread |  |  | 3.47\% |  |  | 3.05\% |
| Net interest income and margin |  | \$ 22,623 | 3.82\% |  | \$ 17,954 | 3.55\% |
|  |  | 34 |  |  |  |  |

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## LIABILITIES AND <br> SHAREHOLDERS <br> EQUITY

Liabilities
Interest-bearing liabilities Savings and interest-bearing transaction accounts
Time deposits
Total interest-bearing deposits
Federal funds purchase
Securities sold under
agreement to repurcha
FHLB borrowed funds
Subordinated debentur
Total interest-bearing liabilities

$$
2,033,972
$$

46,597
3.06

1,752,394 55,582
4.24

Non-interest bearing
liabilities
Non-interest bearing deposits

| Other liabilities | 13,527 |  |  | 12,422 |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total liabilities | 2,287,948 |  |  | 1,980,532 |  |  |  |  |
| Shareholders equity | 286,619 |  |  | 237,391 |  |  |  |  |
| Total liabilities and shareholders equity | \$ 2,574,567 |  |  | \$ 2,217,923 |  |  |  |  |
| Net interest spread |  |  |  | 3.45\% |  |  |  | 2.99\% |
| Net interest income and margin |  | \$ | 66,663 | 3.83\% |  | \$ | 51,994 | 3.49\% |
| 35 |  |  |  |  |  |  |  |  |

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Table 4 shows changes in interest income and interest expense resulting from changes in volume and changes in interest rates for the three-month and nine-month periods ended September 30, 2008 compared to the same periods in 2007, on a fully taxable basis. The changes in interest rate and volume have been allocated to changes in average volume and changes in average rates, in proportion to the relationship of absolute dollar amounts of the changes in rates and volume.

## Table 4: Volume/Rate Analysis

Three Months Ended September

30,
2008 over 2007
Volume Yield/Rate Total Volume Yield/Rate Total (In thousands)

Increase (decrease) in:
Interest income:
Interest-bearing balances due from banks
Federal funds sold
Investment securities taxable
Investment securities non-taxable
Loans receivable

Total interest income

Interest expense:
Interest-bearing transaction and savings deposits
Time deposits
Federal funds purchased
Securities sold under agreement to repurchase
FHLB borrowed funds
Subordinated debentures
Total interest expense
2,685
$(7,513)$
$(4,828)$
8,125
$(17,110)$
$(4,535)$

| 675 | $(2,399)$ | $(1,724)$ | 1,635 | $(6,170)$ |
| ---: | ---: | ---: | :---: | ---: |
| 1,405 | $(3,345)$ | $(1,940)$ | 4,071 | $(6,283)$ |
| 20 | $(135)$ | $(115)$ | $(224)$ | $(254)$ |

$(2,423)$
(128)
(745)
(873)
(23
$(2,192)$
664
(851)
(187)

2,726
$(2,123)$
603
(88)

60
$(8,985)$

Increase (decrease) in net
interest income
internal net loss experience, as well as management s review of trends within the portfolio and related industries.
Generally, commercial, commercial real estate, and residential real estate loans are assigned a level of risk at origination. Thereafter, these loans are reviewed on a regular basis. The periodic reviews generally include loan payment and collateral status, the borrowers financial data, and key ratios such as cash flows, operating income, liquidity, and leverage. A material change in the borrower s credit analysis can result in an increase or decrease in the loan s assigned risk grade. Aggregate dollar volume by risk grade is monitored on an ongoing basis.

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Our management reviews certain key loan quality indicators on a monthly basis, including current economic conditions, delinquency trends and ratios, portfolio mix changes, and other information management deems necessary. This review process provides a degree of objective measurement that is used in conjunction with periodic internal evaluations. To the extent that this review process yields differences between estimated and actual observed losses, adjustments are made to the loss factors used to determine the appropriate level of the allowance for loan losses.

The provision for loan losses represents management s determination of the amount necessary to be charged against the current period s earnings, to maintain the allowance for loan losses at a level that is considered adequate in relation to the estimated risk inherent in the loan portfolio. Our provision for loan losses increased $\$ 892,000$, or $163.1 \%$, to $\$ 1.4$ million for the three-month period ended September 30, 2008, from $\$ 547,000$ for the same period in 2007. Our provision for loan losses increased $\$ 4.9$ million, or $239.6 \%$, to $\$ 7.0$ million for the nine-month period ended September 30, 2008, from $\$ 2.0$ million for the same period in 2007. The increase in the provision is primarily associated with a decline in asset quality in 2008, particularly in our Florida market combined with growth in the loan portfolio. The decrease in our asset quality is primarily related to the unfavorable economic conditions that are impacting our Florida market. The provision for loan losses in our Florida subsidiary was $\$ 750,000$ and $\$ 4.1$ million for the three and nine months ended September 30, 2008.

## Non-Interest Income

Total non-interest income was $\$ 7.8$ million for the three-month period ended September 30, 2008 compared to $\$ 6.3$ million for the same period in 2007. Total non-interest income was $\$ 27.0$ million for the nine-month period ended September 30, 2008 compared to $\$ 19.1$ million for the same period in 2007. Our recurring non-interest income includes service charges on deposit accounts, other service charges and fees, data processing fees, mortgage banking income, insurance commissions, income from title services, increases in cash value of life insurance, dividends, and other income.

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Table 5 measures the various components of our non-interest income for the three-month and nine-month periods ended September 30, 2008 and 2007, respectively, as well as changes for the three-month and nine-month periods ended September 30, 2008 compared to the same periods in 2007.

Table 5: Non-Interest Income

| Three Months |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
| Ended |  | Nine Months |  |  |
| September 30, | 2008 Change | Ended |  |  |
| 2008 2007 | from 2007 | 2008 | 2007 |  |

Service charges on deposit accounts
Other service charges and fees
Data processing fees
Mortgage lending income
Mortgage servicing income
Insurance commissions Income from title services

| \$ 3,557 | \$ 2,816 | \$ | 741 | 26.3\% | \$ 10,006 | \$ | 8,073 | \$ 1,933 | 23.9\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 1,698 | 1,342 |  | 356 | 26.5 | 5,051 |  | 4,176 | 875 | 21.0 |
| 239 | 192 |  | 47 | 24.5 | 674 |  | 619 | 55 | 8.9 |
| 695 | 451 |  | 244 | 54.1 | 2,142 |  | 1,277 | 865 | 67.7 |
| 206 |  |  | 206 | 100.0 | 654 |  |  | 654 | 100.0 |
| 164 | 153 |  | 11 | 7.2 | 620 |  | 613 | 7 | 1.1 |
| 141 | 181 |  | (40) | (22.1) | 498 |  | 575 | (77) | (13.4) |
| 544 | 607 |  | (63) | (10.4) | 1,642 |  | 1,822 | (180) | (9.9) |
| 194 | 218 |  | (24) | (11.0) | 702 |  | 652 | 50 | 7.7 |
|  | 47 |  | (47) | (100.0) | 102 |  | (123) | 225 | (182.9) |
|  |  |  |  | 0.0 | 6,102 |  |  | 6,102 | 100.0 |
| 26 |  |  | 26 | 100.0 | 127 |  | 170 | (43) | (25.3) |
|  | (31) |  | 31 | (100.0) | (2) |  | 150 | (152) | (101.3) |
| (28) | 87 |  | (115) | (132.2) | (458) |  | 197 | (655) | (332.5) |
|  |  |  |  | 0.0 | $(2,067)$ |  |  | $(2,067)$ | 100.0 |
| 348 | 249 |  | 99 | 39.8 | 1,192 |  | 899 | 293 | 32.6 |
| \$7,784 | \$ 6,312 |  | 1,472 | 23.3\% | \$ 26,985 |  | 19,100 | \$ 7,885 | 41.3\% |

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Non-interest income increased $\$ 1.5$ million, or $23.3 \%$, to $\$ 7.8$ million for the three-month period ended September 30, 2008 from $\$ 6.3$ million for the same period in 2007. Non-interest income increased $\$ 7.9$ million, or $41.3 \%$, to $\$ 27.0$ million for the nine-month period ended September 30, 2008 from $\$ 19.1$ million for the same period in 2007. The primary factors that resulted in the increase include:

Of the aggregate increase in service charges on deposit accounts, our acquisition of Centennial Bancshares, Inc. accounted for $\$ 156,000$ and $\$ 422,000$ of the increase for the three and nine month periods ended September 30, 2008. The remaining increase is related to organic growth of our bank subsidiaries and an improved fee process.

Of the aggregate increase in other service charges and fees, our acquisition of Centennial Bancshares, Inc. accounted for $\$ 33,000$ and $\$ 103,000$ of the increase for the three and nine month periods ended September 30, 2008. The remaining increases are a result of increased retention of interchange fees and organic growth of our bank subsidiaries.

Of the aggregate increase in mortgage lending income, our acquisition of Centennial Bancshares, Inc. accounted for $\$ 173,000$ and $\$ 527,000$ of the increase for the three and nine month periods ended September 30, 2008. The remaining increase is related to organic growth of our bank subsidiaries.

The new revenue source mortgage servicing income was related to our acquisition of Centennial Bancshares, Inc. As a result of this acquisition, we now have a mortgage loan servicing portfolio of approximately $\$ 270.0$ million and purchased mortgage servicing rights of $\$ 2.0$ million.

The equity in earnings of unconsolidated affiliate is related to the $20 \%$ interest in White River Bancshares that we purchased during 2005. Because the investment in White River Bancshares is accounted for on the equity method, we recorded our share of White River Bancshares operating earnings. White River Bancshares had been operating at a loss as a result of their status as a start up company until late in 2007. White River Bancshares repurchased our interest in them on March 3, 2008. This resulted in a one time gain on the sale of the equity investment of $\$ 6.1$ million.

The $\$ 458,000$ loss on OREO is primarily the result of a $\$ 380,000$ write down on OREO related to a foreclosure on an owner occupied strip center in the Florida market. Due to the unfavorable economic conditions in the Florida market, the current fair market value estimate required for this write down be taken on the property.

During the second quarter of 2008, the Company became aware that one of its investment securities had become other than temporarily impaired. As a result of this impairment the security was written-down by $\$ 2.1$ million or $\$ 0.06$ diluted earnings per share (stock dividend adjusted) during the second quarter of 2008.

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## Non-Interest Expense

Non-interest expense consists of salary and employee benefits, occupancy and equipment, data processing, and other expenses such as advertising, amortization of intangibles, electronic banking expense, FDIC and state assessment, and legal and accounting fees.

Table 6 below sets forth a summary of non-interest expense for the three-month and nine-month periods ended September 30, 2008 and 2007, as well as changes for the three-month and nine-month periods ended September 30, 2008 compared to the same periods in 2007.

Table 6: Non-Interest Expense

$\left.\begin{array}{lrrrrrrrr}\text { Salaries and employee } & & 8,739 & \$ 7,739 & \$ 1,000 & 12.9 \% & \$ 26,948 & \$ 22,936 & \$ 4,012\end{array}\right) 17.5 \%$

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Non-interest expense increased $\$ 2.9$ million, or $18.5 \%$, to $\$ 18.5$ million for the three-month period ended September 30, 2008, from $\$ 15.6$ million for the same period in 2007. Non-interest expense increased $\$ 9.8$ million, or $21.4 \%$, to $\$ 55.7$ million for the nine-month period ended September 30, 2008, from $\$ 45.9$ million for the same period in 2007. The increase is the result of our acquisition of Centennial Bancshares, Inc. during the first quarter of 2008, the continued expansion of the Company and additional costs associated with an efficiency study performed by a third party during 2008 combined with the normal increased cost of doing business. The most significant component of the increase was related to our acquisition of Centennial Bancshares. During 2008 and 2007, we have opened two de novo branch locations in Florida and six in Arkansas.

At its April 20, 2007 meeting, our Board of Directors approved a Chairman s Retirement Plan for John Allison our Chairman and CEO. Beginning on Mr. Allison s 65th birthday, he will receive a $\$ 250,000$ annual benefit to be paid for 10 consecutive years or until his death, whichever shall occur later. This will result in an annual expense of approximately $\$ 535,000$ and $\$ 388,000$ for 2008 and 2007, respectively. An expense of $\$ 138,000$ and $\$ 397,000$ was accrued for the three and nine months ended September 30, 2008, respectively. An expense of $\$ 130,000$ and $\$ 258,000$ was accrued for the three and nine months ended September 30, 2007, respectively. During April 2007, we purchased $\$ 3.5$ million of additional bank-owned life insurance to help offset a portion of the costs related to this retirement benefit.

At its October 17, 2008 meeting, the Board of Directors of Home BancShares, Inc., pursuant to a recommendation by the Compensation Committee, granted John W. Allison, Chairman and CEO, an annual base salary of \$275,000 beginning on November 1, 2008. Also, they made him eligible for an annual discretionary cash bonus. Any cash bonus will be based upon the goals of the Company including shareholder return, earnings per share and other criteria. Mr. Allison has never received a salary prior to this time. The committee felt as a result of the leadership Mr. Allison has provided for the past 10 years, he should be compensated for his services.

Late in the second quarter an internal investigation uncovered an apparent fraud by a senior officer at one of our subsidiary banks estimated at this time to be approximately $\$ 2.1$ million. This apparent fraud did not originate from the lending area but the operational area of the subsidiary bank. The apparent fraud did not result in any losses to our customers. As a result, we accrued $\$ 150,000$ in other expense for the insurance deductible for this issue in 2008. This senior officer has been terminated.

## Income Taxes

The provision for income taxes increased $\$ 900,000$, or $39.9 \%$, to $\$ 3.2$ million for the three-month period ended September 30, 2008, from $\$ 2.3$ million as of September 30, 2007. The provision for income taxes increased $\$ 3.0$ million, or $48.4 \%$, to $\$ 9.3$ million for the nine-month period ended September 30, 2008, from $\$ 6.3$ million as of September 30, 2007. The effective income tax rate was $32.5 \%$ and $32.3 \%$ for the three-month and nine-month periods ended September 30, 2008, compared to $30.2 \%$ and $29.4 \%$ for the same periods in 2007, respectively. The primary cause of this increase is the result of our increased earnings which is tax-effected at a marginal tax rate of $39.225 \%$.
Financial Condition as of and for the Quarter Ended September 30, 2008 and 2007
Our total assets increased $\$ 359.0$ million, a growth of $15.7 \%$, to $\$ 2.65$ billion as of September 30, 2008, from $\$ 2.29$ billion as of December 31, 2007. Our loan portfolio increased $\$ 360.9$ million, a growth of $22.5 \%$, to $\$ 1.97$ billion as of September 30, 2008, from $\$ 1.61$ billion as of December 31, 2007. Shareholders equity increased $\$ 38.0$ million, a growth of $15.0 \%$, to $\$ 291.0$ million as of September 30, 2008, compared to $\$ 253.1$ million as of December 31, 2007. Asset and loan increases are primarily associated with our acquisition of Centennial Bancshares and organic growth of our bank subsidiaries. During the nine months of 2008 we experienced $\$ 214.7$ million of organic loan growth. The increase in stockholders equity was primarily the result of the $\$ 24.3$ million in additional capital that was issued upon our acquisition of Centennial Bancshares combined with the retained earnings for the nine months.

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## Loan Portfolio

Our loan portfolio averaged $\$ 1.96$ billion and $\$ 1.90$ billion during the three-month and nine-month periods ended September 30, 2008. Loans were $\$ 1.97$ billion as of September 30, 2008, compared to $\$ 1.61$ billion as of December 31, 2007. The most significant components of the loan portfolio were commercial real estate, residential real estate, consumer, and commercial and industrial loans. These loans are primarily originated within our market areas of central Arkansas, north central Arkansas, southern Arkansas, southwest Florida and the Florida Keys and are generally secured by residential or commercial real estate or business or personal property within our market areas.

Certain credit markets have experienced difficult conditions and volatility during 2007 and 2008, particularly Florida. These markets continue to experience pressure including the well publicized sub-prime mortgage market. The Company does not actively market or originate subprime mortgage loans.

Table 7 presents our loan balances by category as of the dates indicated.

## Table 7: Loan Portfolio



Commercial Real Estate Loans. We originate non-farm and non-residential loans (primarily secured by commercial real estate), construction/land development loans, and agricultural loans, which are generally secured by real estate located in our market areas. Our commercial mortgage loans are generally collateralized by first liens on real estate and amortized over a 10 to 20 year period with balloon payments due at the end of one to five years. These loans are generally underwritten by addressing cash flow (debt service coverage), primary and secondary source of repayment, the financial strength of any guarantor, the strength of the tenant (if any), the borrower s liquidity and leverage, management experience, ownership structure, economic conditions and industry specific trends and collateral. Generally, we will loan up to $85 \%$ of the value of improved property, $65 \%$ of the value of raw land and $75 \%$ of the value of land to be acquired and developed. A first lien on the property and assignment of lease is required if the collateral is rental property, with second lien positions considered on a case-by-case basis.

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As of September 30, 2008, commercial real estate loans totaled $\$ 1.16$ billion, or $59.1 \%$ of our loan portfolio, compared to $\$ 997.7$ million, or $62.1 \%$ of our loan portfolio, as of December 31, 2007. Our acquisition of Centennial Bancshares resulted in an increase of $\$ 91.5$ million of commercial real estate. The remaining increase is primarily the result of solid demand for this type of loan product which resulted in organic growth of our loan portfolio.

Residential Real Estate Loans. We originate one to four family, owner occupied residential mortgage loans generally secured by property located in our primary market area. The majority of our residential mortgage loans consist of loans secured by owner occupied, single family residences. Residential real estate loans generally have a loan-to-value ratio of up to $90 \%$. These loans are underwritten by giving consideration to the borrower s ability to pay, stability of employment or source of income, debt-to-income ratio, credit history and loan-to-value ratio.

As of September 30, 2008, we had $\$ 438.1$ million, or $22.3 \%$ of our loan portfolio, in residential real estate loans, compared to the $\$ 305.4$ million, or $19.0 \%$ of our loan portfolio, as of December 31, 2007. Our acquisition of Centennial Bancshares resulted in an increase of $\$ 65.4$ million of residential real estate loans. The changing market conditions have given our community banks the opportunity to retain more residential real estate loans. These loans normally have maturities of less than five years.

Consumer Loans. Our consumer loan portfolio is composed of secured and unsecured loans originated by our banks. The performance of consumer loans will be affected by the local and regional economy as well as the rates of personal bankruptcies, job loss, divorce and other individual-specific characteristics.

As of September 30, 2008, our installment consumer loan portfolio totaled $\$ 49.6$ million, or $2.5 \%$ of our total loan portfolio, compared to the $\$ 46.3$ million, or $2.9 \%$ of our loan portfolio as of December 31, 2007. The primary cause for the increase is related to our acquisition of Centennial Bancshares which resulted in an increase of $\$ 8.3$ million to consumer loans.

Commercial and Industrial Loans. Commercial and industrial loans are made for a variety of business purposes, including working capital, inventory, equipment and capital expansion. The terms for commercial loans are generally one to five years. Commercial loan applications must be supported by current financial information on the borrower and, where appropriate, by adequate collateral. Commercial loans are generally underwritten by addressing cash flow (debt service coverage), primary and secondary sources of repayment, the financial strength of any guarantor, the borrower s liquidity and leverage, management experience, ownership structure, economic conditions and industry specific trends and collateral. The loan to value ratio depends on the type of collateral. Generally speaking, accounts receivable are financed at between $50 \%$ to $80 \%$ of accounts receivable less than 90 days past due. Inventory financing will range between $50 \%$ and $60 \%$ depending on the borrower and nature of inventory. We require a first lien position for those loans.

As of September 30, 2008, commercial and industrial loans outstanding totaled $\$ 255.9$ million, or $13.0 \%$ of our loan portfolio, compared to $\$ 219.1$ million, or $13.6 \%$ of our loan portfolio, as of December 31, 2007. Our acquisition of Centennial Bancshares resulted in an increase of $\$ 31.5$ million of commercial and industrial loans.

## Non-Performing Assets

We classify our problem loans into three categories: past due loans, special mention loans and classified loans (accruing and non-accruing).

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When management determines that a loan is no longer performing, and that collection of interest appears doubtful, the loan is placed on non-accrual status. Loans that are 90 days past due are placed on non-accrual status unless they are adequately secured and there is reasonable assurance of full collection of both principal and interest. Our management closely monitors all loans that are contractually 90 days past due, treated as special mention or otherwise classified or on non-accrual status. Generally, non-accrual loans that are 120 days past due without assurance of repayment are charged off against the allowance for loan losses.

Table 8 sets forth information with respect to our non-performing assets as of September 30, 2008 and December 31, 2007. As of these dates, we did not have any restructured loans within the meaning of Statement of Financial Accounting Standards No. 15.

## Table 8: Non-performing Assets

|  | As of September 30, 2008 (Dollar | D | of mber 1, 07 ds) |
| :---: | :---: | :---: | :---: |
| Non-accrual loans | \$ 15,571 | \$ | 2,952 |
| Loans past due 90 days or more (principal or interest payments) | 490 |  | 301 |
| Total non-performing loans | 16,061 |  | 3,253 |
| Other non-performing assets |  |  |  |
| Foreclosed assets held for sale | 9,392 |  | 5,083 |
| Non-accrual investments | 3,860 |  |  |
| Other non-performing assets | 13 |  | 15 |
| Total other non-performing assets | 13,265 |  | 5,098 |
| Total non-performing assets | \$ 29,326 | \$ | 8,351 |
| Allowance for loan losses to non-performing loans | 226.46\% |  | 903.97\% |
| Non-performing loans to total loans | 0.82 |  | 0.20 |
| Non-performing assets to total assets | 1.11 |  | 0.36 |

Our non-performing loans are comprised of non-accrual loans and loans that are contractually past due 90 days. Our bank subsidiaries recognize income principally on the accrual basis of accounting. When loans are classified as non-accrual, the accrued interest is charged off and no further interest is accrued, unless the credit characteristics of the loan improves. If a loan is determined by management to be uncollectible, the portion of the loan determined to be uncollectible is then charged to the allowance for loan losses.

Total non-performing loans were $\$ 16.1$ million as of September 30, 2008, compared to $\$ 3.3$ million as of December 31, 2007 for an increase of $\$ 12.8$ million. Unfavorable economic conditions, particularly the slowdown in housing sales in the Florida market resulted in an increase in our non-performing loans by $\$ 9.2$ million during 2008. The remaining 2008 increase in non-performing loans is associated with our Arkansas market which includes an increase of $\$ 620,000$ from our acquisition of Centennial Bancshares, Inc. The weakening real estate market has and may continue to raise our level of non-performing loans going forward. When we reported our year-end results, we provided a projection for non-performing loans to total loans in the range of $0.60 \%$ to $2.0 \%$. This continues to be our expected range for non-performing loans to total loans. While we believe our allowance for loan losses is adequate at September 30, 2008, as additional facts become known about relevant internal and external factors that effect loan collectability and our assumptions, it may result in us making additions to the provision for loan loss during 2008.

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If the non-accrual loans had been accruing interest in accordance with the original terms of their respective agreements, interest income of approximately $\$ 222,000$ and $\$ 103,000$ for the three-month periods ended September 30, 2008 and 2007, respectively, and $\$ 474,000$ and $\$ 193,000$ for the nine-month periods ended September 30, 2008 and 2007, respectively, would have been recorded. The interest income recognized on the non-accrual loans for the three-month and nine-month periods ended September 30, 2008 and 2007 was considered immaterial.

A loan is considered impaired when it is probable that we will not receive all amounts due according to the contracted terms of the loans. Impaired loans may include non-performing loans (loans past due 90 days or more and non-accrual loans) and certain other loans identified by management that are still performing. As of September 30, 2008, average impaired loans were $\$ 28.8$ million compared to $\$ 11.8$ million as of September 30, 2007. As of September 30, 2008, impaired loans were $\$ 42.0$ million compared to $\$ 11.9$ million as of December 31, 2007 for an increase of $\$ 30.1$ million. The unfavorable economic conditions that are impacting our Florida market accounted for $\$ 27.4$ million of the increase, while the acquisition of Centennial Bancshares, increased our impaired loans by $\$ 1.8$ million.

The $\$ 9.4$ million in foreclosed assets held for sale is comprised of $\$ 6.9$ million of assets located in Florida with the remaining $\$ 2.5$ million of assets located in Arkansas. The Florida foreclosed assets includes one property for $\$ 4.0$ million. This foreclosure was an owner occupied strip center. In the first quarter of 2008, we took a $\$ 380,000$ write down of the property to reflect the current fair market value estimate. The property is listed for sale with a broker but is substantially vacant. As a result, it does not appear likely that the property will be disposed of before year end.

During the second quarter of 2008, the Company became aware that one of its investment securities had become other than temporarily impaired. This investment security is a pool of various other bank holding companies subordinated debentures throughout the country. The Company has only two securities of this nature with a remaining balance of $\$ 3.9$ million which was put on non-accrual during the second quarter of 2008.

## Allowance for Loan Losses

Overview. The allowance for loan losses is maintained at a level which our management believes is adequate to absorb all probable losses on loans in the loan portfolio. The amount of the allowance is affected by: (i) loan charge-offs, which decrease the allowance; (ii) recoveries on loans previously charged off, which increase the allowance; and (iii) the provision of possible loan losses charged to income, which increases the allowance. In determining the provision for possible loan losses, it is necessary for our management to monitor fluctuations in the allowance resulting from actual charge-offs and recoveries and to periodically review the size and composition of the loan portfolio in light of current and anticipated economic conditions. If actual losses exceed the amount of allowance for loan losses, our earnings could be adversely affected.

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As we evaluate the allowance for loan losses, we categorize it as follows: (i) specific allocations; (ii) allocations for classified assets with no specific allocation; (iii) general allocations for each major loan category; and (iv) miscellaneous allocations.

Specific Allocations. As a general rule, if a specific allocation is warranted, it is the result of an analysis of a previously classified credit or relationship. Our evaluation process in specific allocations includes a review of appraisals or other collateral analysis. These values are compared to the remaining outstanding principal balance. If a loss is determined to be reasonably possible, the possible loss is identified as a specific allocation. If the loan is not collateral dependent, the measurement of loss is based on the expected future cash flows of the loan.

Allocations for Classified Assets with No Specific Allocation. We establish allocations for loans rated special mention through loss in accordance with the guidelines established by the regulatory agencies. A percentage rate is applied to each loan category to determine the level of dollar allocation.

General Allocations. We establish general allocations for each major loan category. This section also includes allocations to loans, which are collectively evaluated for loss such as residential real estate, commercial real estate, consumer loans and commercial and industrial loans. The allocations in this section are based on a historical review of loan loss experience and past due accounts. We give consideration to trends, changes in loan mix, delinquencies, prior losses, and other related information.

Miscellaneous Allocations. Allowance allocations other than specific, classified, and general are included in our miscellaneous section.

Charge-offs and Recoveries. Total charge-offs increased to $\$ 1.7$ million for the three months ended September 30, 2008, compared to $\$ 172,000$ for the same period in 2007. Total charge-offs increased to $\$ 4.8$ million for the nine months ended September 30, 2008, compared to $\$ 340,000$ for the same period in 2007. Total recoveries increased to $\$ 43,000$ for the three months ended September 30, 2008, compared to $\$ 149,000$ for the same period in 2007. Total recoveries increased to $\$ 1.4$ million for the nine months ended September 30, 2008, compared to $\$ 818,000$ for the same period in 2007. The changes in net charge-offs are due to the unfavorable economic conditions in Florida and our proactive stance on asset quality offset by approximately a $\$ 900,000$ recovery of principal received from one borrower. The acquisition completed in the first quarter of 2008 had a $\$ 706,000$ and $\$ 1.3$ million impact on net charge-offs for the three and nine months period ended September 30, 2008.

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Table 9 shows the allowance for loan losses, charge-offs and recoveries as of and for the three-month and nine-month periods ended September 30, 2008 and 2007.

Table 9: Analysis of Allowance for Loan Losses

|  | Three Months Ended September 30, |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
|  | (Dollars in thousands) |  |  |  |
| Balance, beginning of period | \$ 36,563 | \$ 28,112 | \$ 29,406 | \$26,111 |
| Loans charged off |  |  |  |  |
| Real estate: |  |  |  |  |
| Commercial real estate loans: |  |  |  |  |
| Non-farm/non-residential | 33 |  | 49 |  |
| Construction/land development | 747 |  | 1,389 | 8 |
| Agricultural | 14 |  | 14 |  |
| Residential real estate loans: |  |  |  |  |
| Residential 1-4 family | 635 | 32 | 2,166 | 42 |
| Multifamily residential |  | 6 |  | 6 |
| Total real estate | 1,429 | 38 | 3,618 | 56 |
| Consumer | 105 | 70 | 271 | 179 |
| Commercial and industrial | 66 | 64 | 817 | 105 |
| Agricultural |  |  |  |  |
| Other | 73 |  | 73 |  |
| Total loans charged off | 1,673 | 172 | 4,779 | 340 |
| Recoveries of loans previously charged off |  |  |  |  |
| Real estate: |  |  |  |  |
| Commercial real estate loans: |  |  |  |  |
| Non-farm/non-residential | 5 | 13 | 1,165 | 431 |
| Construction/land development | 2 |  | 8 | 1 |
| Agricultural |  | 5 |  | 5 |
| Residential real estate loans: |  |  |  |  |
| Residential 1-4 family | 15 | 47 | 124 | 151 |
| Multifamily residential |  | 5 |  | 5 |
| Total real estate | 22 | 70 | 1,297 | 593 |
| Consumer | 14 | 18 | 70 | 94 |
| Commercial and industrial | 5 | 58 | 41 | 100 |
| Agricultural |  |  |  |  |
| Other | 2 | 3 | 3 | 31 |
| Total recoveries | 43 | 149 | 1,411 | 818 |
| Net (recoveries) loans charged off | 1,630 | 23 | 3,368 | (478) |
| Allowance for loan loss of Centennial Bancshares, |  |  |  |  |
| Inc. |  |  | 3,382 |  |
| Provision for loan losses | 1,439 | 547 | 6,952 | 2,047 |


| Balance, September 30 | $\$ 36,372$ | $\$ 28,636$ | $\$ 36,372$ | $\$ 28,636$ |
| :--- | :---: | :---: | :---: | :---: |
| Net (recoveries) charge-offs to average loans | $0.33 \%$ | $0.01 \%$ | $0.24 \%$ | $(0.04) \%$ |
| Allowance for loan losses to period end loans <br> Allowance for loan losses to net <br> (recoveries) charge-offs | 1.85 | 1.84 | 1.85 | 1.84 |
|  | 561 | 31,382 | 808 | $(4,481)$ |

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Allocated Allowance for Loan Losses. We use a risk rating and specific reserve methodology in the calculation and allocation of our allowance for loan losses. While the allowance is allocated to various loan categories in assessing and evaluating the level of the allowance, the allowance is available to cover charge-offs incurred in all loan categories. Because a portion of our portfolio has not matured to the degree necessary to obtain reliable loss data from which to calculate estimated future losses, the unallocated portion of the allowance is an integral component of the total allowance. Although unassigned to a particular credit relationship or product segment, this portion of the allowance is vital to safeguard against the imprecision inherent in estimating credit losses.

The changes for the period ended September 30, 2008 in the allocation of the allowance for loan losses for the individual types of loans are primarily associated with the decline in asset quality, particularly in our Florida market, our acquisition of Centennial Bancshares, Inc. on January 1, 2008, net charge-offs during 2008 and normal changes in the outstanding loan portfolio for those products from December 31, 2007.

Table 10 presents the allocation of allowance for loan losses as of September 30, 2008 and December 31, 2007.
Table 10: Allocation of Allowance for Loan Losses

|  | As of September 30, 2008 |  | As of <br> December 31, 2007 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Allowance Amount | $\begin{gathered} \% \text { of } \\ \operatorname{loans}(1) \end{gathered}$ | Allowance Amount | $\begin{gathered} \% \text { of } \\ \operatorname{loans}(1) \end{gathered}$ |
|  | (Dollars in thousands) |  |  |  |
| Real estate: |  |  |  |  |
| Commercial real estate loans: |  |  |  |  |
| Non-farm/non-residential | \$ 14,622 | 40.6\% | \$ 11,475 | 37.8\% |
| Construction/land development | 9,330 | 17.3 | 7,332 | 22.9 |
| Agricultural | 344 | 1.3 | 311 | 1.4 |
| Residential real estate loans: |  |  |  |  |
| Residential 1-4 family | 4,838 | 19.0 | 3,968 | 16.2 |
| Multifamily residential | 906 | 3.1 | 727 | 2.8 |
| Total real estate | 30,040 | 81.3 | 23,813 | 81.1 |
| Consumer | 858 | 2.5 | 905 | 2.9 |
| Commercial and industrial | 3,986 | 13.0 | 3,243 | 13.6 |
| Agricultural and other | 1,152 | 3.2 | 613 | 2.4 |
| Unallocated | 336 |  | 832 |  |
| Total | \$ 36,372 | 100.0\% | \$ 29,406 | 100.0\% |
| (1) Percentage of loans in each category to loans receivable. |  |  |  |  |
| Investments and Securities |  |  |  |  |
| Our securities portfolio is the revenue. Securities within the p intent and objective of the inves market prices where available. market prices of comparable se | of earning as d-to-maturity, to maturity ot available, 2008, we h | and provide ailable-for-s ir values of mated fair v o held-to-m | significant , or trading urities are bas ues are based rity or tradin | rce of d on the on quoted quoted ecurities. |

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Securities available-for-sale are reported at fair value with unrealized holding gains and losses reported as a separate component of shareholders equity as other comprehensive income. Securities that are held as available-for-sale are used as a part of our asset/liability management strategy. Securities may be sold in response to interest rate changes, changes in prepayment risk, the need to increase regulatory capital, and other similar factors are classified as available for sale. Available-for-sale securities were $\$ 381.6$ million as of September 30, 2008, compared to $\$ 430.4$ million as of December 31, 2007. The estimated duration of our securities portfolio was 3.4 as of September 30, 2008.

As of September 30, 2008, $\$ 181.9$ million, or $47.7 \%$, of our available-for-sale securities were invested in mortgage-backed securities, compared to $\$ 181.6$ million, or $42.2 \%$, of our available-for-sale securities as of December 31, 2007. To reduce our income tax burden, $\$ 114.1$ million, or $29.9 \%$, of our available-for-sale securities portfolio as of September 30, 2008, was primarily invested in tax-exempt obligations of state and political subdivisions, compared to $\$ 111.3$ million, or $25.9 \%$, of our available-for-sale securities as of December 31, 2007. Also, we had approximately $\$ 76.3$ million, or $20.0 \%$, invested in obligations of U.S. Government-sponsored enterprises as of September 30, 2008, compared to $\$ 126.3$ million, or $29.3 \%$, of our available-for-sale securities as of December 31, 2007. The Company does not have any preferred securities issued by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

Certain investment securities are valued at less than their historical cost. These declines are primarily the result of the rate for these investments yielding less than current market rates. Based on evaluation of available evidence, we believe the declines in fair value for these securities are temporary. It is our intent to hold these securities to recovery. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

During the second quarter of 2008, the Company became aware that one of its investment securities in the other securities category had become other than temporarily impaired. As a result of this impairment the security was written-down by $\$ 2.1$ million or $\$ 0.06$ diluted earnings per share (stock dividend adjusted) for the second quarter of 2008. This investment security is a pool of 60 other financial holding companies subordinated debentures throughout the country. As of September 30, 2008, none of these holding companies have defaulted but six are deferring their quarterly payments as a result of stressed capital levels. If the federal government were to seize a few of these institutions it could result in our investment becoming worthless. The Company has only two securities of this nature with a remaining balance of $\$ 3.9$ million which are on non-accrual at September 30, 2008. The Company will continue to monitor its investments in these subordinated debentures and make additional write-downs if appropriate.

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Table 11 presents the carrying value and fair value of investment securities as of September 30, 2008 and December 31, 2007.

Table 11: Investment Securities


## Deposits

Our deposits averaged $\$ 1.87$ billion and $\$ 1.85$ billion for the three-month and nine-month periods ended September 30, 2008. Total deposits increased $\$ 320.9$ million, or an increase of $20.2 \%$, to $\$ 1.91$ billion as of September 30, 2008, from $\$ 1.59$ billion as of December 31, 2007. On January 1, 2008, as a result of our acquisition of Centennial Bancshares, deposits increased by $\$ 178.8$ million. Deposits are our primary source of funds. We offer a variety of products designed to attract and retain deposit customers. Those products consist of checking accounts, regular savings deposits, NOW accounts, money market accounts and certificates of deposit. Deposits are gathered from individuals, partnerships and corporations in our market areas. In addition, we obtain deposits from state and local entities and, to a lesser extent, U.S. Government and other depository institutions. Our policy also permits the acceptance of deposits. As of September 30, 2008 and December 31, 2007 brokered deposits were $\$ 103.4$ million and $\$ 39.3$ million, respectively.

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The interest rates paid are competitively priced for each particular deposit product and structured to meet our funding requirements. We will continue to manage interest expense through deposit pricing and do not anticipate a significant change in total deposits unless our liquidity position changes. We believe that additional funds can be attracted and deposit growth can be accelerated through deposit pricing if we experience increased loan demand or other liquidity needs. During 2007, the federal funds rate remained constant until September 18, 2007, when the Federal Funds rate was lowered by 50 basis points to $4.75 \%$. The Federal Funds rate decreased another 25 basis points on October 31, 2007 and December 11, 2007. Due to these reductions occurring late in 2007, the impact for the year was minimal. Average interest rates for 2007 reflect the higher interest rate environment that existed until September 18, 2007 when the Federal Funds rate was lowered. Going forward, we will begin to see more of an impact of the decrease in the Federal Funds rate as our interest-bearing liabilities begin to reprice. During 2008, the rate decreased by 75 basis points on January 22, 2008, 50 basis points on January 30, 2008, 75 basis points on March 18, 2008 and 25 basis points on April 30, 2008 and 50 basis points to a rate of $1.50 \%$ as of October 8, 2008.

Table 12 reflects the classification of the average deposits and the average rate paid on each deposit category, which is in excess of 10 percent of average total deposits, for the three-month and nine-month periods ended September 30, 2008 and 2007.

Table 12: Average Deposit Balances and Rates

|  | Three Months Ended September 30, 20082007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Average | Average | Average | Average Rate |
|  | Amount | (Dollars in thousands) |  | Paid |
| Non-interest-bearing transaction accounts | \$ 242,155 | \% | \$ 212,298 |  |
| Interest-bearing transaction accounts | 631,802 | 1.57 | 531,292 | 3.12 |
| Savings deposits | 58,762 | 1.08 | 55,418 | 1.38 |
| Time deposits: |  |  |  |  |
| \$100,000 or more | 530,911 | 3.31 | 468,168 | 5.00 |
| Other time deposits | 409,647 | 3.57 | 345,508 | 4.76 |
| Total | \$ 1,873,277 | 2.28\% | \$ 1,612,684 | 3.55\% |


|  | Nine Months Ended September 30, 2008 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Average | Average <br> Rate | Average | Average <br> Rate |
|  | (Dollars in thousands) |  |  |  |
| Non-interest-bearing transaction accounts | \$ 240,449 | \% | \$ 215,716 | \% |
| Interest-bearing transaction accounts | 623,540 | 1.80 | 540,895 | 3.15 |
| Savings deposits | 56,127 | 1.04 | 57,175 | 1.40 |
| Time deposits: |  |  |  |  |
| \$100,000 or more | 529,334 | 3.82 | 461,570 | 4.98 |
| Other time deposits | 398,239 | 4.00 | 343,555 | 4.71 |
| Total | \$ 1,847,689 | 2.59\% | \$ 1,618,911 | 3.52\% |

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## FHLB Borrowed Funds

Our FHLB borrowed funds were $\$ 278.2$ million as of September 30, 2008. The outstanding balance for September 30, 2008 consists of $\$ 25.0$ million of short-term FHLB advances and $\$ 253.2$ million of FHLB long-term advances. Our FHLB borrowings were $\$ 251.8$ million as of December 31, 2007. The outstanding balance for December 31, 2007, includes $\$ 116.0$ million of short-term advances and $\$ 135.8$ million of long-term advances. Our remaining FHLB borrowing capacity was $\$ 255.8$ million and $\$ 186.6$ million as of September 30, 2008 and December 31, 2007, respectively. Expected maturities will differ from contractual maturities, because FHLB may have the right to call or prepay certain obligations.

## Subordinated Debentures

Subordinated debentures, which consist of guaranteed payments on trust preferred securities, were $\$ 47.6$ million and $\$ 44.6$ million as of September 30, 2008 and December 31, 2007, respectively. As a result of the acquisition of Centennial Bancshares we acquired $\$ 3.1$ million of additional trust preferred securities.

Table 13 reflects subordinated debentures as of September 30, 2008 and December 31, 2007, which consisted of guaranteed payments on trust preferred securities with the following components:

## Table 13: Subordinated Debentures

| As of | As of |
| :---: | :---: |
| September | December |
| 30, | 31, |
| 2008 | 2007 |
| (In thousands) |  |

Subordinated debentures, issued in 2003, due 2033, fixed at $6.40 \%$, during the first five years and at a floating rate of $3.15 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, currently callable without penalty
Subordinated debentures, issued in 2000, due 2030, fixed at $10.60 \%$, callable in 2010 with a penalty ranging from $5.30 \%$ to $0.53 \%$ depending on the year of prepayment, callable in 2020 without penalty Subordinated debentures, issued in 2003, due 2033, floating rate of $3.15 \%$ above the three-month LIBOR rate, reset quarterly, currently callable without penalty Subordinated debentures, issued in 2005, due 2035, fixed rate of $6.81 \%$ during the first ten years and at a floating rate of $1.38 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, callable in 2010 without penalty
Subordinated debentures, issued in 2006, due 2036, fixed rate of $6.75 \%$ during the first five years and at a floating rate of $1.85 \%$ above the three-month LIBOR rate, reset quarterly, thereafter, callable in 2011 without penalty
$\$ 20,619 \quad \$ \quad 20,619$

3,266
3,333 5,155 5,155
O-

Total
\$47,598 \$
44,572
The trust preferred securities are tax-advantaged issues that qualify for Tier 1 capital treatment subject to certain limitations. Distributions on these securities are included in interest expense. Each of the trusts is a statutory business trust organized for the sole purpose of issuing trust securities and investing the proceeds in our subordinated debentures, the sole asset of each trust. The trust preferred securities of each trust represent preferred beneficial interests in the assets of the respective trusts and are subject to mandatory redemption upon payment of the subordinated debentures held by the trust. We wholly own the common securities of each trust. Each trust s ability to pay amounts due on the trust preferred securities is solely dependent upon our making payment on the related subordinated debentures. Our obligations under the subordinated securities and other relevant trust agreements, in aggregate, constitute a full and unconditional guarantee by us of each respective trust $s$ obligations under the trust securities issued by each respective trust.

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Presently, the funds raised from the trust preferred offerings qualify as Tier 1 capital for regulatory purposes, subject to the applicable limit, with the balance qualifying as Tier 2 capital.

## Shareholders Equity

Stockholders equity was $\$ 291.0$ million at September 30, 2008 compared to $\$ 253.1$ million at December 31, 2007, an increase of $15.0 \%$. As of September 30, 2008 and December 31, 2007 our equity to asset ratio was $11.0 \%$. Book value per common share was $\$ 14.68$ at September 30, 2008 compared to $\$ 13.58$ at December 31, 2007, an $8.1 \%$ increase. The increases in stockholders equity and book value per share were primarily the result of our acquisition of Centennial Bancshares and retained earnings during the prior nine months.

Cash Dividends. We declared cash dividends on our common stock of $\$ 0.060$ and $\$ 0.037$ (stock dividend adjusted) per share for the three-month periods ended September 30, 2008 and 2007, respectively, and $\$ 0.157$ and $\$ 0.093$ per share (stock dividend adjusted) for the nine-month periods ended September 30, 2008 and 2007, respectively.

Stock Dividends. On July 16, 2008, our Board of Directors declared an $8 \%$ stock dividend which was paid August 27, 2008 to shareholders of record as of August 13, 2008. Except for fractional shares, the holders of our common stock received $8 \%$ additional common stock on August 27, 2008. The common shareholders did not receive fractional shares; instead they received cash at a rate equal to the closing price of a share on August 28, 2008 times the fraction of a share they otherwise would have been entitled to.

All share and per share amounts have been restated to reflect the retroactive effect of the stock dividend. After issuance, this stock dividend lowered our total capital position by approximately $\$ 13,000$ as a result of the cash paid in lieu of fractional shares. Our financial statements reflect an increase in the number of outstanding shares of common stock, an increase in surplus and reduction of retained earnings.

Repurchase Program. On January 18, 2008, we announced the adoption by our Board of Directors of a stock repurchase program. The program authorizes us to repurchase up to $1,080,000$ shares (stock dividend adjusted) of our common stock. Under the repurchase program, there is no time limit for the stock repurchases, nor is there a minimum number of shares that we intend to repurchase. The repurchase program may be suspended or discontinued at any time without prior notices. The timing and amount of any repurchases will be determined by management, based on its evaluation of current market conditions and other factors. The stock repurchase program will be funded using our cash balances, which we believe are adequate to support the stock repurchase program and our normal operations. As of September 30, 2008, we have not repurchased any shares in the program.

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## Troubled Asset Relief Program

The Troubled Asset Relief Program gives the U.S. Treasury purchasing power of $\$ 700$ billion in an attempt to restore liquidity and stability to the Unites States financial system. The fund was created by a bill that was made law on the 3rd of October 2008 with the passage of H.R. 1424 enacting the Emergency Economic Stabilization Act of 2008. The Treasury will be given $\$ 250$ billion immediately to inject as capital into financial institutions. The Treasury has agreed to buy a $\$ 125$ billion equity stake in several large American financial institutions.

The remaining $\$ 125$ billion will be offered directly to other qualifying financial institutions. The institutions that apply for these funds can request between $1 \%$ and $3 \%$ of their risk weighted assets, with a limit of $\$ 25$ billion. If approved, the institutions will issue preferred shares with a dividend rate of $5 \%$ for the first five years increasing to $9 \%$ dividend thereafter. These preferred shares will qualify as Tier 1 capital. The preferred shares will be callable at par after three years. Prior to the end of three years, the preferred shares may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock. The Treasury must approve any common stock dividend increase or share repurchases until three years from the date of the investment unless the shares are paid off in whole or transferred to a third party.

In addition, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to $15 \%$ of the preferred investment. The initial exercise price will be the trailing 20 day average price of the company s common stock.

In order to participate in the program, companies current benefit plans, arrangements, and agreements must be modified to be in compliance with the executive compensation and corporate governance requirements of Section 111 of the EESA and any guidance issued by the Treasury.

Institutions must submit their application to their primary regulator by November 14, 2008. We are currently evaluating the impact of this strategic opportunity to determine the effect on our financial position and results of operations. If we were to participate, it could result in approximately $\$ 22.1$ million to $\$ 66.3$ million of additional capital for the Company.

## Liquidity and Capital Adequacy Requirements

Risk-Based Capital. We as well as our bank subsidiaries are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and other discretionary actions by regulators that, if enforced, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classifications are also subject to qualitative judgments by the regulators as to components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes that, as of September 30, 2008 and December 31, 2007, we met all regulatory capital adequacy requirements to which we were subject.

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Table 14 presents our risk-based capital ratios as of September 30, 2008 and December 31, 2007.
Table 14: Risk-Based Capital

|  | As of September 30, 2008 (Dollars | D | As of December 31, 2007 usands) |
| :---: | :---: | :---: | :---: |
| Tier 1 capital |  |  |  |
| Shareholders equity | \$ 291,039 | \$ | 253,056 |
| Qualifying trust preferred securities | 46,000 |  | 43,000 |
| Goodwill and core deposit intangibles, net | $(54,396)$ |  | $(42,332)$ |
| Unrealized loss on available-for-sale securities | 5,305 |  | 2,255 |
| Servicing assets | (204) |  |  |
| Total Tier 1 capital | 287,744 |  | 255,979 |
| Tier 2 capital |  |  |  |
| Qualifying allowance for loan losses | 27,742 |  | 23,861 |
| Total Tier 2 capital | 27,742 |  | 23,861 |
| Total risk-based capital | \$ 315,486 | \$ | 279,840 |
| Average total assets for leverage ratio | \$ 2,548,877 | \$ | 2,236,776 |
| Risk weighted assets | \$2,210,740 | \$ | 1,903,364 |
| Ratios at end of period |  |  |  |
| Leverage ratio | 11.29\% |  | 11.44\% |
| Tier 1 risk-based capital | 13.02 |  | 13.45 |
| Total risk-based capital | 14.27 |  | 14.70 |
| Minimum guidelines |  |  |  |
| Leverage ratio | 4.00\% |  | 4.00\% |
| Tier 1 risk-based capital | 4.00 |  | 4.00 |
| Total risk-based capital | 8.00 |  | 8.00 |
| regulatory framework for prompt corrective action. To be categorized as well-capitalized, our banking subsidiaries and we must maintain minimum leverage, Tier 1 risk-based capital, and total risk-based capital ratios as set forth in the table. There are no conditions or events since that notification that we believe have changed the bank subsidiaries categories. |  |  |  |

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Table 15: Capital and Ratios

|  |  | To Be Well |  |
| :---: | :---: | :---: | :---: |
| Actual | For Capital | Capitalized Under <br> Prompt Corrective |  |
| Amount | Ratio | Adequacy Purposes <br> Amount <br> (Dollars in thousands) | Action Provision |
|  |  | Amount | Ratio |

As of September 30,
2008
Leverage ratios:

| Home BancShares | $\$ 287,744$ | $11.29 \%$ | $\$ 101,947$ | $4.00 \%$ | $\$$ N/A | N/A $\%$ |
| :--- | ---: | :---: | ---: | :--- | ---: | :--- |
| First State Bank | 60,856 | 9.65 | 25,225 | 4.00 | 31,532 | 5.00 |
| Community Bank | 37,105 | 9.31 | 15,942 | 4.00 | 19,927 | 5.00 |
| Twin City Bank | 67,210 | 9.24 | 29,095 | 4.00 | 36,369 | 5.00 |
| Marine Bank | 33,982 | 9.01 | 15,086 | 4.00 | 18,858 | 5.00 |
| Bank of Mountain View | 16,748 | 9.52 | 7,037 | 4.00 | 8,796 | 5.00 |
| Centennial Bank | 21,590 | 8.53 | 10,124 | 4.00 | 12,655 | 5.00 |
| Tier 1 capital ratios: |  |  |  |  |  |  |
| Home BancShares | $\$ 287,744$ | $13.02 \%$ | $\$ 88,401$ | $4.00 \%$ | $\$$ N/A | $6.00 \%$ |
| First State Bank | 60,856 | 10.79 | 22,560 | 4.00 | 33,840 | 6.00 |
| Community Bank | 37,105 | 10.84 | 13,692 | 4.00 | 20,538 | 6.00 |
| Twin City Bank | 67,210 | 10.43 | 25,776 | 4.00 | 38,663 | 6.00 |
| Marine Bank | 33,982 | 10.54 | 12,896 | 4.00 | 19,345 | 6.00 |
| Bank of Mountain View | 16,748 | 13.88 | 4,827 | 4.00 | 7,240 | 6.00 |
| Centennial Bank | 21,590 | 10.13 | 8,525 | 4.00 | 12,788 | 6.00 |
| Total risk-based capital |  |  |  |  |  |  |
| ratios: |  |  |  |  |  |  |
| Home BancShares | $\$ 315,486$ | $14.27 \%$ | $\$ 176,867$ | $8.00 \%$ | $\$$ | N/A |
| First State Bank | 67,926 | 12.05 | 45,096 | 8.00 | 56,370 | $10.00 \%$ |
| Community Bank | 41,431 | 12.10 | 27,392 | 8.00 | 34,240 | 10.00 |
| Twin City Bank | 75,275 | 11.68 | 51,558 | 8.00 | 64,448 | 10.00 |
| Marine Bank | 38,044 | 11.80 | 25,793 | 8.00 | 32,241 | 10.00 |
| Bank of Mountain View | 18,039 | 14.95 | 9,653 | 8.00 | 12,066 | 10.00 |
| Centennial Bank | 24,198 | 11.35 | 17,056 | 8.00 | 21,320 | 10.00 |

As of December 31,
2007
Leverage ratios:

| Home BancShares | $\$ 255,979$ | $11.44 \%$ | $\$ 89,503$ | $4.00 \%$ | $\$$ N/A | N/A\% |
| :--- | ---: | :---: | ---: | :--- | ---: | :--- |
| First State Bank | 54,537 | 9.18 | 23,763 | 4.00 | 29,704 | 5.00 |
| Community Bank | 34,189 | 8.90 | 15,366 | 4.00 | 19,207 | 5.00 |
| Twin City Bank | 61,178 | 8.87 | 27,589 | 4.00 | 34,486 | 5.00 |
| Marine Bank | 33,332 | 8.91 | 14,964 | 4.00 | 18,705 | 5.00 |
| Bank of Mountain View | 16,174 | 8.26 | 7,832 | 4.00 | 9,791 | 5.00 |
| Tier 1 capital ratios: |  |  |  |  |  |  |
| Home BancShares | $\$ 255,979$ | $13.45 \%$ | $\$ 76,128$ | $4.00 \%$ | $\$$ N/A | N/A\% |
| First State Bank | 54,537 | 10.29 | 21,200 | 4.00 | 31,800 | 6.00 |
| Community Bank | 34,189 | 11.21 | 12,199 | 4.00 | 18,299 | 6.00 |

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| Twin City Bank | 61,178 | 10.10 | 24,229 | 4.00 | 36,343 | 6.00 |
| :--- | ---: | :--- | ---: | :--- | ---: | ---: |
| Marine Bank | 33,332 | 10.20 | 13,071 | 4.00 | 19,607 | 6.00 |
| Bank of Mountain View | 16,174 | 13.84 | 4,675 | 4.00 | 7,012 | 6.00 |
| Total risk-based capital |  |  |  |  |  |  |
| ratios: |  |  |  |  |  |  |
| Home BancShares | $\$ 279,840$ | $14.70 \%$ | $\$ 152,294$ | $8.00 \%$ | $\$$ N/A | N/A $\%$ |
| First State Bank | 61,188 | 11.54 | 42,418 | 8.00 | 53,023 | 10.00 |
| Community Bank | 38,036 | 12.47 | 24,402 | 8.00 | 30,502 | 10.00 |
| Twin City Bank | 68,754 | 11.35 | 48,461 | 8.00 | 60,576 | 10.00 |
| Marine Bank | 37,429 | 11.45 | 26,151 | 8.00 | 32,689 | 10.00 |
| Bank of Mountain View | 17,442 | 14.92 |  | 9,352 | 8.00 | 11,690 |
|  |  |  | 56 |  |  |  |

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## Non-GAAP Financial Measurements

We had $\$ 57.0$ million, $\$ 45.2$ million, and $\$ 45.7$ million total goodwill, core deposit intangibles and other intangible assets as of September 30, 2008, December 31, 2007 and September 30, 2007, respectively. Because of our level of intangible assets and related amortization expenses, management believes diluted cash earnings per share, tangible book value per common share, cash return on average assets, cash return on average tangible equity and tangible equity to tangible assets are useful in evaluating our company. These calculations, which are similar to the GAAP calculation of diluted earnings per share, book value, return on average assets, return on average shareholders equity, and equity to assets, are presented in Tables 16 through 20, respectively. Per share amounts have been adjusted for the stock dividend which occurred in August of 2008.

Table 16: Diluted Cash Earnings Per Share

|  | Three Months Ended September 30, |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: |
| GAAP net income | \$ 6,564 | \$ 5,228 | \$ 19,496 | \$ 15,050 |
| Intangible amortization after-tax | 281 | 267 | 843 | 801 |
| Cash earnings | \$ 6,845 | \$ 5,495 | \$ 20,339 | \$ 15,851 |
| GAAP diluted earnings per share | \$ 0.32 | \$ 0.28 | \$ 0.96 | \$ 0.80 |
| Intangible amortization after-tax | 0.02 | 0.01 | 0.04 | 0.04 |
| Diluted cash earnings per share | \$ 0.34 | \$ 0.29 | \$ 1.00 | \$ 0.84 |

Table 17: Tangible Book Value Per Share

|  | As of <br> September 30, <br> 2008 | As of <br> December 31, <br> 2007 |
| :--- | :---: | :---: | :---: |
| (Dollars in thousands, except per shar |  |  |
| data) |  |  |

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Table 18: Cash Return on Average Assets

|  | Three Months Ended <br> September 30, |  | Nine Months Ended <br> September 30, |  |
| :--- | :---: | :---: | :---: | :---: |
|  | $\mathbf{2 0 0 8}$ | 2007 | $\mathbf{2 0 0 8}$ | $\mathbf{2 0 0 7}$ |
| (Dollars in thousands) |  |  |  |  |
| Return on average assets: A/C | $1.00 \%$ | $0.92 \%$ | $1.01 \%$ | $0.91 \%$ |
| Cash return on average assets: B/(C-D) | 1.07 | 0.99 | 1.08 | 0.98 |


| (A) Net income | $\$$ | 6,564 | $\$$ | 5,228 | $\$ 19,496$ |
| :--- | ---: | ---: | ---: | ---: | ---: |
| (B) Cash earnings | 6,845 | 5,495 | 15,050 |  |  |
| (C) Average assets | $2,603,477$ | $2,243,233$ | $2,574,539$ | 15,851 |  |
| (D) Average goodwill, core deposits |  |  |  | $2,217,923$ |  |
| and other intangible assets | 57,120 | 45,887 | 57,588 | 46,323 |  |

Table 19: Cash Return on Average Tangible Equity

|  | Three Months Ended September 30, |  | Nine Months Ended September 30, |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2008 | 2007 | 2008 | 2007 |
|  | (Dollars in thousands) |  |  |  |
| Return on average stockholders equity: A/C | 9.02\% | 8.60\% | 9.09\% | 8.48\% |
| Return on average tangible equity: $\mathrm{B} /(\mathrm{C}-\mathrm{D})$ | 11.72 | 11.16 | 11.86 | 11.09 |
| (A) Net income | \$ 6,564 | \$ 5,228 | \$ 19,496 | \$ 15,050 |
| (B) Cash earnings | 6,845 | 5,495 | 20,339 | 15,851 |
| (C) Average equity | 289,525 | 241,153 | 286,619 | 237,391 |
| (D) Average goodwill, core deposits and other intangible assets | 57,120 | 45,887 | 57,588 | 46,323 |

Table 20: Tangible Equity to Tangible Assets

|  | As of <br> September 30, <br> $\mathbf{2 0 0 8}$ | As of <br> December 31, <br> (Dollars in thousands) |
| :--- | :---: | :---: |
| Equity to assets: B/A | $10.98 \%$ | $11.04 \%$ |
| Tangible equity to tangible assets: (B-C-D)/(A-C-D) | 9.02 | 9.25 |
|  |  |  |
| (A) Total assets | $\$ 2,650,590$ | $\$ 2,291,630$ |
| (B) Total stockholders equity | 291,039 | 253,056 |
| (C) Goodwill | 50,038 | 37,527 |
| (D) Core deposit and other intangibles | 7,009 | 7,702 |

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## Adoption of Recent Accounting Pronouncements

FAS 157
Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 has been applied prospectively as of the beginning of the period.

FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities
Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities
Available-for-sale securities are the only material instruments valued on a recurring basis which are held by the Company at fair value. The Company does not have any Level 1 securities. Primarily all of the Company s securities are considered to be Level 2 securities. These Level 2 securities consist of U.S. government-sponsored enterprises, mortgage-backed securities plus state and political subdivisions. Level 3 securities were immaterial.

Impaired loans are the only material instruments valued on a non-recurring basis which are held by the Company at fair value. Loan impairment is reported when full payment under the loan terms is not expected. Impaired loans are carried at the present value of estimated future cash flows using the loan s existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to require increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of a loan is confirmed. Impaired loans, net of specific allowance, were $\$ 35.6$ million as of September 30, 2008. This valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

Compared to prior years, the adoption of SFAS 157 did not have a material impact on our 2008 consolidated financial statements.

## FAS 159

Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159) became effective for the Company on January 1, 2008. FAS 159 allows companies an option to report selected financial assets and liabilities at fair value. Because we did not elect the fair value measurement provision for any of our financial assets or liabilities, the adoption of SFAS 159 did not have any impact on our 2008 consolidated financial statements. Presently, we have not determined whether we will elect the fair value measurement provisions for future transactions.

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## EITF 06-4 and 06-10

Effective January 1, 2008, the Company adopted EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements and EITF 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements. As a result of the adoption of EITF 06-4, the Company recognized the effect of applying the EITF with a change in accounting principle through a cumulative-effect adjustment to retained earnings for $\$ 276,000$. Additionally, this change will result in an increase of approximately $\$ 100,000$ in annual non-interest expense as a result of the mortality cost for 2008 and beyond. The adoption of EITF 06-10 did not have any impact on our 2008 consolidated financial statements.

## Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 141(revised 2007), Business Combinations, ( SFAS 141(R) ). SFAS 141(R), which replaces SFAS 141, Business Combinations, establishes accounting standards for all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree) including mergers and combinations achieved without the transfer of consideration. SFAS $141(\mathrm{R})$ requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. Goodwill is measured as the excess of consideration transferred plus the fair value of any noncontrolling interest in the acquiree over the fair value of the identifiable net assets acquired. In the event that the fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any non-controlling interest (referred to as a bargain purchase ), SFAS 141(R) requires the acquirer to recognize that excess in earnings as a gain attributable to the acquirer. In addition, SFAS 141(R) requires costs incurred to effect an acquisition to be recognized separately from the acquisition and requires the recognition of assets or liabilities arising from noncontractual contingencies as of the acquisition date only if it is more likely than not that they meet the definition of an asset or liability in FASB Concepts Statement No. 6, Elements of Financial Statements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for us is the fiscal year beginning January 1 , 2009. The Company is currently evaluating the impact of the adoption of this standard, but does not expect it to have a material effect on the Company sfinancial position or results of operation.

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## Item 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK Liquidity and Market Risk Management

Liquidity Management. Liquidity refers to the ability or the financial flexibility to manage future cash flows to meet the needs of depositors and borrowers and fund operations. Maintaining appropriate levels of liquidity allows us to have sufficient funds available for reserve requirements, customer demand for loans, withdrawal of deposit balances and maturities of deposits and other liabilities. Our primary source of liquidity at our holding company is dividends paid by our bank subsidiaries. Applicable statutes and regulations impose restrictions on the amount of dividends that may be declared by our bank subsidiaries. Further, any dividend payments are subject to the continuing ability of the bank subsidiary to maintain compliance with minimum federal regulatory capital requirements and to retain its characterization under federal regulations as a well-capitalized institution.

Each of our bank subsidiaries has potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers. Many of these obligations and commitments to fund future borrowings to our loan customers are expected to expire without being drawn upon, therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position.

Liquidity needs can be met from either assets or liabilities. On the asset side, our primary sources of liquidity include cash and due from banks, federal funds sold, available-for-sale investment securities and scheduled repayments and maturities of loans. We maintain adequate levels of cash and cash equivalents to meet our day-to-day needs. As of September 30, 2008, our cash and cash equivalents were $\$ 60.7$ million, or $2.3 \%$ of total assets, compared to $\$ 55.0$ million, or $2.4 \%$ of total assets, as of December 31, 2007. Our investment securities and federal funds sold were $\$ 409.9$ million, or $15.5 \%$ of total assets, as of September 30, 2008 and $\$ 430.5$ million, or $18.8 \%$ of total assets, as of December 31, 2007.

We may occasionally use our federal funds lines of credit in order to temporarily satisfy short-term liquidity needs. We have federal funds lines with three other financial institutions pursuant to which we could have borrowed up to $\$ 105.1$ million and $\$ 88.2$ million on an unsecured basis as of September 30, 2008 and December 31, 2007, respectively. These lines may be terminated by the respective lending institutions at any time.

We also maintain lines of credit with the Federal Home Loan Bank. Our FHLB borrowings were $\$ 278.2$ million as of September 30, 2008 and $\$ 251.8$ million as of December 31, 2007. The outstanding balance for September 30, 2008 included $\$ 25.0$ million of short-term advances and $\$ 253.2$ million of FHLB long-term advances. The outstanding balance for December 31, 2007, included $\$ 116.0$ million of short-term advances and $\$ 135.8$ million of FHLB long-term advances. Our FHLB borrowing capacity was $\$ 255.8$ million and $\$ 186.6$ million as of September 30, 2008 and December 31, 2007.

We believe that we have sufficient liquidity to satisfy our current operations.
Market Risk Management. Our primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on a large portion of our assets and liabilities, and the market value of all interest-earning assets and interest-bearing liabilities, other than those which possess a short term to maturity. We do not hold market risk sensitive instruments for trading purposes. The information provided should be read in connection with our audited consolidated financial statements.

Asset/Liability Management. Our management actively measures and manages interest rate risk. The asset/liability committees of the boards of directors of our holding company and bank subsidiaries are also responsible for approving our asset/liability management policies, overseeing the formulation and implementation of strategies to improve balance sheet positioning and earnings, and reviewing our interest rate sensitivity position.

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One of the tools that our management uses to measure short-term interest rate risk is a net interest income simulation model. This analysis calculates the difference between net interest income forecasted using base market rates and using a rising and a falling interest rate scenario. The income simulation model includes various assumptions regarding the re-pricing relationships for each of our products. Many of our assets are floating rate loans, which are assumed to re-price immediately, and proportional to the change in market rates, depending on their contracted index. Some loans and investments include the opportunity of prepayment (embedded options), and accordingly the simulation model uses indexes to estimate these prepayments and reinvest their proceeds at current yields. Our non-term deposit products re-price more slowly, usually changing less than the change in market rates and at our discretion.

This analysis indicates the impact of changes in net interest income for the given set of rate changes and assumptions. It assumes the balance sheet remains static and that its structure does not change over the course of the year. It does not account for all factors that impact this analysis, including changes by management to mitigate the impact of interest rate changes or secondary impacts such as changes to our credit risk profile as interest rates change.

Furthermore, loan prepayment rate estimates and spread relationships change regularly. Interest rate changes create changes in actual loan prepayment rates that will differ from the market estimates incorporated in this analysis. Changes that vary significantly from the assumptions may have significant effects on our net interest income.

Interest Rate Sensitivity. Our primary business is banking and the resulting earnings, primarily net interest income, are susceptible to changes in market interest rates. It is management s goal to maximize net interest income within acceptable levels of interest rate and liquidity risks.

A key element in the financial performance of financial institutions is the level and type of interest rate risk assumed. The single most significant measure of interest rate risk is the relationship of the repricing periods of earning assets and interest-bearing liabilities. The more closely the repricing periods are correlated, the less interest rate risk we assume. We use repricing gap and simulation modeling as the primary methods in analyzing and managing interest rate risk.

Gap analysis attempts to capture the amounts and timing of balances exposed to changes in interest rates at a given point in time. As of September 30, 2008, our gap position was slightly liability sensitive with a one-year cumulative repricing gap of $1.3 \%$, compared to $-5.2 \%$ as of December 31, 2007. During these periods, the amount of change our asset base realizes in relation to the total change in market interest rates is approximately that of the liability base.

We have a portion of our securities portfolio invested in mortgage-backed securities. Mortgage-backed securities are included based on their final maturity date. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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Table 21 presents a summary of the repricing schedule of our interest-earning assets and interest-bearing liabilities (gap) as of September 30, 2008.

Table 21: Interest Rate Sensitivity


Cumulative
interest rate
sensitivity gap
Cumulative
rate sensitive
assets to rate
sensitive
$\begin{array}{llllllll}\text { liabilities } & 245.6 \% & 166.0 \% & 119.3 \% & 102.2 \% & 110.7 \% & 117.0 \% & 114.6 \%\end{array}$
Cumulative
gap as a \% of total earning assets
$21.0 \% \quad 16.5 \%$
7.8\%
$1.3 \%$
7.4\%
13.5\%
$12.7 \%$

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## Item 4: CONTROLS AND PROCEDURES

## Article I. Evaluation of Disclosure Controls

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Additionally, our disclosure controls and procedures were also effective in ensuring that information required to be disclosed in our Exchange Act report is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer to allow timely decisions regarding required disclosures.
Article II. Changes in Internal Control Over Financial Reporting
There have not been any changes in the Company s internal controls over financial reporting during the quarter ended September 30, 2008, which have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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## PART II: OTHER INFORMATION

## Item 1. Legal Proceedings

There are no material pending legal proceedings, other than ordinary routine litigation incidental to its business, to which Home BancShares, Inc. or any of its subsidiaries is a party or of which any of their property is the subject.

## Item 1A. Risk Factors

There were no material changes from the risk factors set forth in Part I, Item 1A, Risk Factors, of our Form 10-K for the year ended December 31, 2007. See the discussion of our risk factors in the Form 10-K, as filed with the SEC. The risks described are not the only risks facing the Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

## Item 2: Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.
Item 3: Defaults Upon Senior Securities
Not applicable.

## Item 4: Submission of Matters to a Vote of Security Holders

Not applicable.

## Item 5: Other Information

Not applicable.

## Item 6: Exhibits

15 Awareness of Independent Registered Public Accounting Firm
31.1 CEO Certification Pursuant Rule 13a-14(a)/15d-14(a)
31.2 CFO Certification Pursuant Rule 13a-14(a)/15d-14(a)
32.1 CEO Certification Pursuant 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes Oxley Act of 2002
32.2 CFO Certification Pursuant 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes Oxley Act of 2002

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## SIGNATURES

Pursuant to the requirements 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.

## HOME BANCSHARES, INC.

## (Registrant)

Date: October 29, 2008

Date: October 29, 2008
/s/ John W. Allison

John W. Allison, Chief Executive Officer
/s/ Randy E. Mayor

Randy E. Mayor, Chief Financial Officer
66

