PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
November 06, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(mark one)

x **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

o **TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**

For the transition period from ____ to ____

Commission File Number: 000-31225

, Inc.

(Exact name of registrant as specified in its charter)

Tennessee	62-1812853
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
211 Commerce Street, Suite 300, Nashville, Tennessee	37201
(Address of principal executive offices)	(Zip Code)

(615) 744-3700

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changes since last report)

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

Yes x 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 definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o	Accelerated Filer x
Non-accelerated Filer o (do not check if you are a smaller reporting company)	Smaller reporting company o

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

Yes o No x

As of October 31, 2008 there were 23,708,607 shares of common stock, $1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
September 30, 2008
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FORWARD-LOOKING STATEMENTS

Pinnacle Financial Partners, Inc. (Pinnacle Financial) may from time to time make written or oral statements, including statements contained in this report which may constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the Exchange Act). The words expect, anticipate, intend, consider, plan, believe, seek, should, estimate, and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management s belief as well as assumptions made by, and information currently available to, management pursuant to safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Pinnacle Financial s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors are described in Item 1A. Risk Factors of Pinnacle Financial s Annual Report on Form 10-K for the fiscal year ended December 31, 2007 and include, without limitation, (i) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (ii) the inability of Pinnacle to continue to grow its loan portfolio at historic rates in the Nashville-Davidson-Murfreesboro-Franklin MSA and the Knoxville MSA, (iii) increased competition with other financial institutions, (iv) lack of sustained growth in the economy in the Nashville-Davidson-Murfreesboro-Franklin MSA and the Knoxville MSA, (v) rapid fluctuations or unanticipated changes in interest rates, and (vi) changes in state and Federal legislation or regulations applicable to Banks and other financial services providers, including regulatory or legislative developments arising out of current unsettled conditions in the economy.. Many of such factors are beyond Pinnacle Financial s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Pinnacle Financial does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Pinnacle Financial.

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

	September 30, 2008	December 31, 2007
ASSETS		
Cash and noninterest-bearing due from banks	$ 58,670,045	$ 76,941,931
Interest-bearing due from banks	3,688,622	24,706,966
Federal funds sold	29,039,938	20,854,966
Cash and cash equivalents	91,398,605	122,503,863
Securities available-for-sale, at fair value	617,909,350	495,651,939
Securities held-to-maturity (fair value of $10,813,596 and $26,883,473 at September 30, 2008 and December 31, 2007, respectively)	10,897,923	27,033,356
Mortgage loans held-for-sale	15,161,830	11,251,652
Loans	3,202,909,472	2,749,640,689
Less allowance for loan losses	(34,840,853)	(28,470,207)
Loans, net	3,168,068,619	2,721,170,482
Premises and equipment, net	67,296,594	68,385,946
Other investments	25,660,787	22,636,029
Accrued interest receivable	17,125,958	18,383,004
Goodwill	243,250,854	243,573,636
Core deposit and other intangible assets	17,659,468	17,325,988
Other assets	63,122,391	46,254,566
Total assets	$ 4,337,552,379	$ 3,794,170,461
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Non-interest-bearing	$ 457,542,942	$ 400,120,147
Interest-bearing	331,706,748	410,661,187
Savings and money market accounts	677,367,407	742,354,465
Time	1,828,546,046	1,372,183,317
Total deposits	3,295,163,143	2,925,319,116
Securities sold under agreements to repurchase	198,806,912	156,070,830
Federal Home Loan Bank advances and other borrowings	207,239,268	141,666,133
Subordinated debt	97,476,000	82,476,000
Accrued interest payable	8,419,326	10,374,538
Other liabilities	17,879,022	11,653,550
Total liabilities	3,824,983,671	3,327,560,167

Stockholders equity:		
Preferred stock, no par value; 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, par value $1.00; 90,000,000 shares authorized; 23,699,790 issued and outstanding at September 30, 2008 and 22,264,817 issued and outstanding at December 31, 2007	23,699,790	22,264,817
Additional paid-in capital	416,105,723	390,977,308
Retained earnings	76,373,045	54,150,679
Accumulated other comprehensive loss, net of taxes	(3,609,850)	(782,510)
Total stockholders equity	512,568,708	466,610,294
Total liabilities and stockholders equity	$ 4,337,552,379	$ 3,794,170,461

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Interest income:				
Loans, including fees	$ 44,075,167	$ 32,750,403	$ 131,694,867	$ 92,283,516
Securities:				
Taxable	6,005,024	3,387,464	15,434,782	10,127,943
Tax-exempt	1,339,930	743,921	4,030,699	2,106,857
Federal funds sold and other	452,690	1,464,795	1,647,725	3,075,372
Total interest income	51,872,811	38,346,583	152,808,073	107,593,688
Interest expense:				
Deposits	18,778,955	16,043,425	57,583,697	44,037,317
Securities sold under agreements to repurchase	681,912	2,061,333	2,081,055	5,664,167
Federal Home Loan Bank advances and other borrowings	3,130,448	1,282,159	8,820,575	4,189,055
Total interest expense	22,591,315	19,386,917	68,485,327	53,890,539
Net interest income	29,281,496	18,959,666	84,322,746	53,703,149
Provision for loan losses	3,124,819	772,064	7,503,412	2,460,028
Net interest income after provision for loan losses	26,156,677	18,187,602	76,819,334	51,243,121
Noninterest income:				
Service charges on deposit accounts	2,778,097	1,965,965	8,036,320	5,683,199
Investment services	1,271,284	868,738	3,759,779	2,453,505
Insurance sales commissions	959,104	563,367	2,612,255	1,829,282
Gain on loan sales, net	1,460,478	378,682	2,996,390	1,380,883
Net gain on sale of premises			1,010,881	56,078
Trust fees	584,927	466,581	1,621,385	1,312,076
Other noninterest income	2,199,051	1,088,430	6,641,819	3,193,840
Total noninterest income	9,252,941	5,331,763	26,678,829	15,908,863
Noninterest expense:				
Salaries and employee benefits	13,013,116	9,106,256	39,382,393	26,167,610
Equipment and occupancy	3,731,932	2,632,747	11,235,137	7,209,977
Marketing and other business development	380,555	375,066	1,234,933	1,057,092
Postage and supplies	761,744	474,083	2,253,371	1,453,197

Amortization of intangibles	788,267	515,754	2,312,333	1,547,262
Other noninterest expense	3,485,581	2,005,752	9,854,795	5,282,516
Merger related expense	1,165,177		5,620,216	
Total noninterest expense	23,326,372	15,109,658	71,893,178	42,717,654
Income before income taxes	12,083,246	8,409,707	31,604,985	24,434,330
Income tax expense	3,288,104	2,637,897	8,783,920	7,634,815
Net income	$ 8,795,142	$ 5,771,810	$ 22,821,065	$ 16,799,515
Per share information:				
Basic net income per common share	$ 0.38	$ 0.37	$ 1.01	$ 1.09
Diluted net income per common share	$ 0.36	$ 0.35	$ 0.96	$ 1.01
Weighted average shares outstanding:				
Basic	23,174,998	15,503,284	22,559,449	15,477,339
Diluted	24,439,642	16,609,328	23,826,368	16,630,311

See accompanying notes to consolidated financial statements.

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

	Common Stock					
	Shares	**Amount**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Loss**	**Total Stockholders Equity**
Balances, December 31, 2006	15,446,074	$ 15,446,074	$ 211,502,516	$ 31,109,324	$ (2,040,893)	$ 256,017,021
Exercise of employee common stock options and related tax benefits	78,437	78,437	645,118			723,555
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan, net of forfeitures	28,526	28,526	(28,526)			
Compensation expense for restricted shares			272,260			272,260
Compensation expense for stock options			1,252,638			1,252,638
Comprehensive income:						
Net income				16,799,515		16,799,515
Net unrealized holding losses on securities available-for-sale , net of deferred tax benefit of $1,285,456					(428,559)	(428,559)
Total comprehensive income						16,370,956
Balances, September 30, 2007	15,553,037	$ 15,553,037	$ 213,644,006	$ 47,908,839	$ (2,469,452)	$ 274,636,430
Balances, December 31, 2007	22,264,817	$ 22,264,817	$ 390,977,308	$ 54,150,679	$ (782,510)	$ 466,610,294
Cumulative effect of change in accounting				(598,699)		(598,699)

principle due to adoption of EITF 06-4, net of tax						
Proceeds from sale of common stock (less offering expenses of $45,242)	1,000,000	1,000,000	20,454,758			21,454,758
Exercise of employee common stock options, stock appreciation rights, common stock warrants and related tax benefits	267,403	267,403	3,134,699			3,402,102
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan, net of forfeitures	167,570	167,570	(167,570)			
Compensation expense for restricted shares			260,439			260,439
Compensation expense for stock options			1,446,089			1,446,089
Comprehensive income:						
Net income				22,821,065		22,821,065
Net unrealized holding losses on securities available-for-sale, net of deferred tax benefit of $1,712,941					(2,827,340)	(2,827,340)
Total comprehensive income						19,993,725
Balances, September 30, 2008	23,699,790	$ 23,699,790	$ 416,105,723	$ 76,373,045	$ (3,609,850)	$ 512,568,708

See accompanying notes to consolidated financial statements.

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

	Nine months ended September 30,	
	2008	**2007**
Operating activities:		
Net income	$ 22,821,065	$ 16,799,515
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization/accretion of premium/discount on securities	526,022	376,450
Depreciation and amortization	4,788,550	2,010,487
Provision for loan losses	7,503,412	2,460,028
Gains on loans and loan participations sold, net	(2,996,390)	(1,380,883)
Net gains on sale of premises	(1,010,881)	56,078
Stock-based compensation expense	1,706,528	1,524,898
Deferred tax (benefit) expense	(1,274,403)	1,587,523
Other non-cash operating activities	194,558	
Excess tax benefit from stock compensation	(805,414)	(128,678)
Mortgage loans held for sale:		
Loans originated	(212,279,309)	(125,018,617)
Loans sold	211,353,184	126,137,833
Decrease in other assets	7,912,982	1,672,572
Increase (decrease) in other liabilities	2,672,391	(3,461,145)
Net cash provided by operating activities	41,112,295	22,636,061
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(233,008,882)	(36,988,675)
Sales		
Maturities, prepayments and calls	105,725,683	30,193,241
Activities in securities held-to-maturity:		
Purchases		
Sales		
Maturities, prepayments and calls	16,080,000	
Increase in loans, net	(472,054,326)	(232,911,778)
Purchases of premises and equipment and software	(6,198,441)	(5,097,092)
Proceeds from the sale of premises and equipment	2,821,702	
Cash used for acquisition	(3,800,000)	
Investments in unconsolidated subsidiaries and other entities	(2,583,983)	(1,222,570)
Net cash used in investing activities	(593,018,247)	(246,026,874)
Financing activities:		
Net increase in deposits	371,825,090	205,095,262

Net increase in securities sold under agreements to repurchase	42,736,082	4,313,965
Net (decrease) increase in Federal funds purchased	(39,862,000)	19,986,000
Advances from Federal Home Loan Bank:		
Issuances	110,478,047	35,000,000
Payments	(13,882,995)	(53,040,828)
Net increase in borrowings under lines of credit	9,000,000	
Proceeds from issuance of subordinated debt	15,000,000	
Proceeds from the sale of common stock, net of expenses	21,454,758	
Exercise of common stock options	3,246,298	594,877
Excess tax benefit from stock compensation	805,414	128,678
Net cash provided by financing activities	520,800,694	212,079,954
Net decrease in cash and cash equivalents	(31,105,258)	(11,310,859)
Cash and cash equivalents, beginning of period	122,503,863	92,518,850
Cash and cash equivalents, end of period	$ 91,398,605	$ 81,207,991

See accompanying notes to consolidated financial statements.

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

Note 1. Summary of Significant Accounting Policies

Nature of Business Pinnacle Financial Partners, Inc. (Pinnacle Financial) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, Pinnacle National Bank (Pinnacle National). Pinnacle National is a commercial bank headquartered in Nashville, Tennessee. Pinnacle National provides a full range of banking services in its primary market areas of the Nashville-Davidson-Rutherford-Franklin and Knoxville Metropolitan Statistical Areas.

In addition to Pinnacle National, Pinnacle Financial, for the time period following its merger with Mid-America Bancshares, Inc. (Mid-America) on November 30, 2007 through February 29, 2008, conducted banking operations through the two banks formerly owned by Mid-America: PrimeTrust Bank in Nashville, Tennessee and Bank of the South in Mt. Juliet, Tennessee. On February 29, 2008, Pinnacle National purchased all of the assets and assumed all of the liabilities of PrimeTrust Bank and contemporaneously, through a series of transactions, sold the PrimeTrust Bank charter and rights to operate a branch in Tennessee to an unaffiliated out-of-state third party for $500,000. Pinnacle Financial also merged Bank of the South into Pinnacle National on that date. References to Pinnacle National as of December 31, 2007 include PrimeTrust Bank and Bank of the South.

Basis of Presentation The accompanying unaudited consolidated financial statements have been prepared in accordance with instructions to Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial position, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles All adjustments consisting of normally recurring accruals that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods covered by the report have been included. The accompanying unaudited consolidated financial statements should be read in conjunction with the Pinnacle Financial consolidated financial statements and related notes appearing in the 2007 Annual Report previously filed on Form 10-K.

These consolidated financial statements include the accounts of Pinnacle Financial and its wholly-owned subsidiaries. PNFP Statutory Trust I, PNFP Statutory Trust II, PNFP Statutory Trust III, PNFP Statutory Trust IV and Collateral Plus, LLC, are affiliates of Pinnacle Financial and are included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

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

Cash Flow Information Supplemental cash flow information addressing certain cash payments and noncash transactions for each of the nine months ended September 30, 2008 and 2007 was as follows:

	For the nine months ended September 30,	
	2008	***2007***
Cash Payments:		
Interest	$ 72,581,518	$ 53,491,752
Income taxes	7,500,000	7,850,000
Noncash Transactions:		
Loans charged-off to the allowance for loan losses	2,442,259	809,703
Loans foreclosed upon with repossessions transferred to other assets	18,195,935	240,878

Net unrealized holding losses on available-for-sale securities, net of deferred tax benefit	(2,827,340)	(428,559)

Income Per Common Share Basic earnings per share (EPS) is computed by dividing net income by the weighted average common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue

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common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding was attributable to common stock options, common stock appreciation rights, warrants and restricted shares. The dilutive effect of outstanding options, common stock appreciation rights, warrants and restricted shares is reflected in diluted earnings per share by application of the treasury stock method.

As of September 30, 2008, there were 2,253,000 stock options and 12,000 stock appreciation rights outstanding to purchase common shares. As of September 30, 2007, there were 1,929,000 stock options outstanding to purchase common shares. Most of these options and stock appreciation rights have exercise prices, which when considered in relation to the average market price of Pinnacle Financial s common stock, are considered dilutive and are considered in Pinnacle Financial s diluted income per share calculation for the three and nine months ended September 30, 2008 and 2007. There were common stock options of 418,000 and 352,000 outstanding as of September 30, 2008 and 2007, respectively, which were considered anti-dilutive and thus have not been considered in the diluted earnings per share calculations below. Additionally, as of September 30, 2008 and 2007, Pinnacle Financial had outstanding warrants to purchase 370,000 and 395,000, respectively, common shares which have been considered in the calculation of Pinnacle Financial s diluted net income per share for the three and nine months ended September 30, 2008 and 2007.

The following is a summary of the basic and diluted earnings per share calculation for the three and nine months ended September 30, 2008 and 2007:

	For the three months ended September 30,		*For the nine months ended September 30,*	
	2008	***2007***	***2008***	***2007***
Basic earnings per share calculation:				
Numerator - Net income	$ 8,795,142	$ 5,771,810	$ 22,821,065	$ 16,799,515
Denominator - Average common shares outstanding	23,174,998	15,503,284	22,559,449	15,477,339
Basic net income per share	$ 0.38	$ 0.37	$ 1.01	$ 1.09
Diluted earnings per share calculation:				
Numerator - Net income	$ 8,795,142	$ 5,771,810	$ 22,821,065	$ 16,799,515
Denominator - Average common shares outstanding	23,174,998	15,503,284	22,559,449	15,477,339
Dilutive shares contingently issuable	1,264,644	1,106,044	1,266,919	1,152,972
Average diluted common shares outstanding	24,439,642	16,609,328	23,826,368	16,630,311
Diluted net income per share	$ 0.36	$ 0.35	$ 0.96	$ 1.01

Newly Adopted Accounting Pronouncements

Split-Dollar Life Insurance Arrangements Pinnacle Financial acquired Cavalry Banking, Inc. in March of 2006. Certain executives and directors of Cavalry Banking, Inc. were participants in a deferred compensation arrangement which included split-dollar life insurance arrangements. In September 2006, the FASB ratified the consensuses reached by the Task Force on Issue No. 06-4 (EITF 06-4) Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The EITF concluded that deferred compensation or postretirement benefit aspects of an endorsement split-dollar life insurance arrangement should be recognized as a liability by the employer and the obligation is not effectively settled by the purchase of a life insurance policy. The effective date was for fiscal years beginning after December 15, 2007. On January 1, 2008, we

adopted this EITF as a change in accounting principle and recorded a liability of $985,000 along with a corresponding adjustment to beginning retained earnings of $599,000, net of tax.

Accounting for the Sale of Real Estate including Buy-Sell Clauses In December 2007, the EITF reached a consensus on EITF Issue No. 07-6, Accounting for Sales of Real Estate Subject to the Requirements of FASB Statement No. 66, Accounting for Sales of Real Estate, When the Agreement Includes a Buy-Sell Clause (EITF 07-6). EITF 07-6 clarifies whether a buy-sell clause is a

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
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(Unaudited)

prohibited form of continuing involvement that would preclude partial sales treatment under FAS No. 66. EITF 07-6 is effective for new arrangements entered into and assessments of existing transactions originally accounted for under the deposit, profit-sharing, leasing, or financing methods for reasons other than the exercise of a buy-sell clause performed in fiscal years beginning after December 15, 2007.

Fair Value Measurement - In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 (SFAS 157), Fair Value Measurements. SFAS 157, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies only to fair-value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. The definition of fair value focuses on the exit price, i.e., 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, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The effective date for SFAS No. 157 was for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Pinnacle Financial partially adopted SFAS 157 effective January 1, 2008 for financial assets and liabilities. The partial adoption of SFAS 157 had no impact on the consolidated financial statements of Pinnacle Financial. SFAS 157 has not been applied to nonfinancial assets and liabilities pursuant to Financial Statement Position, (FSP) FAS 157-2. This standard is applicable for nonfinancial assets and liabilities for fiscal periods beginning after November 30, 2008. There was no cumulative adjustment required upon partial adoption of SFAS 157.

In February of 2007, the FASB issued SFAS No. 159 (SFAS 159), The Fair Value Option for Financial Assets and Financial Liabilities , which gives entities the option to measure eligible financial assets and financial liabilities at fair value, on an instrument by instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability. Subsequent changes in fair value must be recorded in earnings. This statement was effective as of January 1, 2008; however, it had no impact on the consolidated financial statements of Pinnacle Financial because Pinnacle Financial did not elect the fair value option for any financial instrument not presently being accounted for at fair value.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This FSP clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective for the Company upon issuance, including prior periods for which financial statements have not been issued; and, therefore was effective for the Company s financial statements as of and for the three and nine month periods ended September 30, 2008. Adoption of FSP No. FAS 157-3 did not have a significant impact on the Company s financial position or results of operations.

Pinnacle Financial has an established process for determining fair values. Fair value is based upon quoted market prices, where available. If listed prices or quotes are not available, fair value is based upon internally developed models or processes that use primarily market-based or independently-sourced market data, including interest rate yield curves, option volatilities and third party information. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. Furthermore, while Pinnacle Financial believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Valuation Hierarchy

SFAS 157 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows.

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

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Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Assets

Securities Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other products. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows and are classified within Level 2 of the valuation hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy.

Mortgage loans held-for-sale - Mortgage loans held-for-sale are carried at the lower of cost or fair value and are classified within level 2 of the valuation hierarchy. The inputs for valuation of these assets are based on the anticipated sales price of these loans as the loans are usually sold within a few weeks of their origination.

Impaired loans A loan is considered to be impaired when it is probable Pinnacle Financial will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan s original effective rate as the discount rate, the loan s observable market price, or the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses. Impaired loans are classified within level 3 of the hierarchy.

Other investments Included in other investments are investments in certain nonpublic private equity funds. The valuation of nonpublic private equity investments requires significant management judgment due to the absence of quoted market prices, inherent lack of liquidity and the long-term nature of such assets. These investments are valued initially based upon transaction price. The carrying values of other investments are adjusted either upwards or downwards from the transaction price to reflect expected exit values as evidenced by financing and sale transactions with third parties, or when determination of a valuation adjustment is confirmed through ongoing reviews by senior investment managers. A variety of factors are reviewed and monitored to assess positive and negative changes in valuation including, but not limited to, current operating performance and future expectations of the particular investment, industry valuations of comparable public companies, changes in market outlook and the third-party financing environment over time. In determining valuation adjustments resulting from the investment review process, emphasis is placed on current company performance and market conditions. These investments are included in level 3 of the valuation hierarchy.

Other assets Included in other assets are certain assets carried at fair value, including the cash surrender value of bank owned life insurance policies and interest rate swap agreements. The carrying amount of the cash surrender value of bank owned life insurance is based on information received from the insurance carriers indicating the financial performance of the policies and the amount Pinnacle Financial would receive should the policies be surrendered. Pinnacle Financial reflects these assets within level 3 of the valuation hierarchy. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. Pinnacle Financial reflects these assets within level 2 of the valuation hierarchy.

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Liabilities

Other liabilities Pinnacle Financial has certain liabilities carried at fair value including certain interest rate swap agreements. The fair value of these liabilities is based on information obtained from a third party bank and is reflected within level 2 of the valuation hierarchy.

The following table presents the financial instruments carried at fair value as of September 30, 2008, by caption on the consolidated balance sheets and by SFAS 157 valuation hierarchy (as described above) (dollars in thousands):

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2008

	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Internal models with significant observable market parameters (Level 2)	Internal models with significant unobservable market parameters (Level 3)
Securities available-for-sale	$ 617,909	$	$ 617,909	$
Mortgage loans held-for-sale	15,162		15,162	
Other investments	1,667			1,667
Other assets	37,341		2,099	35,242
Total assets at fair value	$ 672,079	$	$ 635,170	$ 36,909
Other liabilities	2,192		2,192	
Total liabilities at fair value	$ 2,192	$	$ 2,192	$

Assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2008

	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Internal models with significant observable market parameters (Level 2)	Internal models with significant unobservable market parameters (Level 3)

Impaired loans	$	17,743	$		$		$	17,743
Total assets at fair value	$	17,743	$		$		$	17,743
Other liabilities								
Total liabilities at fair value	$		$		$		$	

Changes in level 3 fair value measurements

The table below includes a rollforward of the balance sheet amounts for the third quarter of 2008 (including the change in fair value) for financial instruments classified by Pinnacle Financial within level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis. When a determination is made to classify a financial instrument within level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, since level 3 financial instruments typically include, in addition to the unobservable or level 3 components,

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observable components (that is, components that are actively quoted and can be validated to external sources), the gains and losses in the table below include changes in fair value due in part to observable factors that are part of the valuation methodology.

Nine months ended September 30, 2008 (in thousands)	**Assets**	**Liabilities**
Fair value, January 1, 2008	$ 35,336	$
Total realized and unrealized gains included in income	633	
Purchases, issuances and settlements, net	940	
Transfers in and/or out of level 3		
Fair value, September 30, 2008	$ 36,909	$
Total unrealized gains included in income related to financial assets and liabilities still on the consolidated balance sheet at September 30, 2008	$ 633	$

Note 2. Mergers and Acquisitions

On November 30, 2007, Pinnacle Financial consummated its merger with Mid-America, a two-bank holding company headquartered in Nashville, Tennessee.

In accordance with SFAS No. 141, Accounting for Business Combinations (SFAS No. 141), SFAS No. 142, Goodwill and Intangible Assets (SFAS No. 142) and SFAS No. 147, Acquisition of Certain Financial Institutions (SFAS No. 147), Pinnacle Financial recorded at fair value the following assets and liabilities of Mid-America as of November 30, 2007. The table below details the amounts reported in our consolidated financial statements as of December 31, 2007 and the updated amounts as of September 30, 2008 for changes in the purchase price allocation recorded during the nine months ended September 30, 2008 (in thousands):

Mid-America Purchase Price Allocation	**November 30, 2007 purchase price allocation**	**Changes in purchase price allocation recorded during 2008**	**Final purchase price allocation**
Cash and cash equivalents	$ 60,795	$	$ 60,795
Investment securities available-for-sale	147,766		147,766
Loans, net of an allowance for loan losses of $8,695	855,887		855,887
Goodwill	129,334	2,298	131,632
Core deposit intangible	8,085	1,351	9,436
Other assets	49,854	139	49,993
Total assets acquired	1,251,721	3,788	1,255,509
Deposits	957,076		957,076

Federal Home Loan Bank advances	61,383		61,383
Other liabilities	27,107	79	27,186
Total liabilities assumed	1,045,566	79	1,045,645
Total consideration paid for Mid-America	$ 206,155	$ 3,709	$ 209,864

In accordance with SFAS Nos. 141 and 142, Pinnacle Financial has recognized $9.4 million as a core deposit intangible. This identified intangible is being amortized over ten years using an accelerated method which anticipates the life of the underlying deposits to which the intangible is attributable. For the three and nine months ended September 30, 2008, approximately $283,000 and $850,000 of amortization was recognized in the accompanying consolidated statements of income as other noninterest expense,

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related to this intangible. Amortization expense associated with this identified intangible will approximate $700,000 to $1.1 million per year for the next ten years.

Pinnacle Financial also recorded other adjustments to the carrying value of Mid-America s assets and liabilities in order to reflect the fair value at the date of acquisition. The discounts and premiums related to financial assets and liabilities are being accreted and amortized into the consolidated statements of income using a method that approximates the level yield over the anticipated lives of the underlying financial assets or liabilities. For the three and nine months ended September 30, 2008, the accretion and amortization of the fair value discounts and premiums related to the acquired assets and liabilities increased net interest income by approximately $426,000 and $2.2 million, respectively. Based on the estimated useful lives of the acquired loans, deposits and FHLB advances, Pinnacle Financial will recognize increases in net interest income related to amortization and accretion of these purchase accounting adjustments of approximately $2.1 million over the next ten years.

The following pro forma income statements assume the merger was consummated on January 1, 2007 and thus the amounts in the pro forma information below will differ from the actual results as presented in the accompanying consolidated statements of income. The pro forma information does not reflect Pinnacle Financial s results of operations that would have actually occurred had the merger been consummated on such date (dollars in thousands).

	Nine months ended September 30,	
	2008	**2007**
	(unaudited)	
Pro Forma Income Statements:		
Net interest income	$ 82,665	$ 80,692
Provision for loan losses	7,503	3,692
Noninterest income	26,679	21,775
Noninterest expense	71,869	65,306
Net income before taxes	29,972	33,469
Income tax expense	8,153	10,735
Net income	$ 21,819	$ 22,734
Pro Forma Per Share Information:		
Basic net income per common share	$ 0.97	$ 1.03
Diluted net income per common share	$ 0.92	$ 0.98
Weighted average shares outstanding:		
Basic	22,559,449	22,153,919
Diluted	23,826,368	23,306,891

During the three and nine months ended September 30, 2008, Pinnacle Financial incurred expenses related to the merger with Mid-America of $1,165,000 and $5,620,000, respectively. These expenses were directly related to the merger and consisted primarily of retention awards and costs to integrate systems and are reflected on the accompanying consolidated statements of income as merger related expense.

Following the merger with Mid-America, on February 29, 2008, Pinnacle National purchased all of the assets and assumed all of the liabilities of PrimeTrust Bank and simultaneously sold the charter of PrimeTrust Bank to an unaffiliated third party for $500,000. Goodwill was reduced for the proceeds of the sale of the charter, and therefore

no gain was recorded. Pinnacle Financial also merged Bank of the South into Pinnacle National on that date, leaving Pinnacle National as the sole banking subsidiary of Pinnacle Financial.

Additionally, during the third quarter of 2008 Pinnacle National acquired Murfreesboro, Tenn.-based Beach & Gentry Insurance LLC (Beach & Gentry). Concurrently, Beach & Gentry merged with Miller & Loughry Insurance & Services Inc., a wholly-owned subsidiary of Pinnacle National, also located in Murfreesboro. In connection with this acquisition we recorded a customer list intangible of $1,270,000 which is being amortized over 20 years on an accelerated basis. Amortization of this intangible amounted to $30,000 during the three months ended September 30, 2008. Additionally, if certain performance thresholds

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are met over the next three years following the date of acquisition, Pinnacle National will be required to pay up to an additional $1.0 million to the former principal of Beach & Gentry.

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2008 and December 31, 2007 are summarized as follows:

	September 30, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$	$	$	$
U.S. government agency securities	54,462,796	168,371	844,920	53,786,247
Mortgage-backed securities	440,946,820	1,962,453	1,770,346	441,138,927
State and municipal securities	126,505,072	253,013	5,483,414	121,274,671
Corporate notes and other	1,910,267	9,884	210,646	1,709,505
	$ 623,824,955	$ 2,393,721	$ 8,309,326	$ 617,909,350
Securities held-to-maturity:				
U.S. government agency securities	$ 1,997,859	$	$ 38,335	$ 1,959,524
State and municipal securities	8,900,064	6,691	52,683	8,854,072
	$ 10,897,923	$ 6,691	$ 91,018	$ 10,813,596

	December 31, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$	$	$	$
U.S. Government agency securities	69,481,328	220,833	39,598	69,662,563
Mortgage-backed securities	297,909,174	1,237,807	1,441,635	297,705,346
State and municipal securities	127,220,978	206,102	1,521,273	125,905,807
Corporate notes	2,415,783		37,560	2,378,223
	$ 497,027,263	$ 1,664,742	$ 3,040,066	$ 495,651,939
Securities held-to-maturity:				
U.S. government agency securities	$ 17,747,589	$ 4,436	$	$ 17,752,025
State and municipal securities	9,285,767	4,242	158,561	9,131,448
	$ 27,033,356	$ 8,678	$ 158,561	$ 26,883,473

At September 30, 2008, approximately $584.9 million of Pinnacle Financial s investment portfolio was pledged to secure public funds and other deposits and securities sold under agreements to repurchase.

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At September 30, 2008 and December 31, 2007, included in securities were the following investments with unrealized losses. The information below classifies these investments according to the term of the unrealized loss of less than twelve months or twelve months or longer:

	Investments with an Unrealized Loss of less than 12 months		Investments with an Unrealized Loss of 12 months or longer		Total Investments with an Unrealized Loss	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At September 30, 2008:						
U.S. government agency securities	$ 36,202,253	$ 883,255	$	$	$ 36,202,253	$ 883,255
Mortgage-backed securities	169,658,031	1,440,885	19,573,225	329,461	189,231,256	1,770,346
State and municipal securities	99,241,374	5,246,285	4,560,036	289,812	103,801,410	5,536,097
Corporate notes	273,760	126,240	905,600	84,406	1,179,360	210,646
Total temporarily-impaired securities	$ 305,375,418	$ 7,696,665	$ 25,038,861	$ 703,679	$ 330,414,279	$ 8,400,344
At December 31, 2007:						
U.S. government agency securities	$ 13,942,078	$ 25,198	$ 2,985,600	$ 14,400	$ 16,927,678	$ 39,598
Mortgage-backed securities	51,240,090	181,098	97,593,453	1,260,537	148,833,543	1,441,635
State and municipal securities	54,467,544	1,193,763	35,481,739	486,071	89,949,283	1,679,834
Corporate notes	527,115	300	1,451,108	37,260	1,978,223	37,560
Total temporarily-impaired securities	$ 120,176,827	$ 1,400,359	$ 137,511,900	$ 1,798,268	$ 257,688,727	$ 3,198,627

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

ability and intent to hold all of these investments until a market price recovery or maturity, the impairment of these investments is not deemed to be other-than-temporary.

Note 4. Loans and Allowance for Loan Losses

The composition of loans at September 30, 2008 and December 31, 2007 is summarized in the table below. Certain loans have been reclassified at December 31, 2007 to be consistent with the September 30, 2008 classification.

	At September 30, 2008	At December 31, 2007
Commercial real estate Mortgage	$ 907,289,656	$ 710,545,533
Consumer real estate Mortgage	631,460,709	539,768,302
Construction and land development	651,802,960	582,958,584
Commercial and industrial	924,753,114	794,419,213
Consumer and other	87,603,033	121,949,057
Total Loans	3,202,909,472	2,749,640,689
Allowance for loan losses	(34,840,853)	(28,470,207)
Loans, net	$ 3,168,068,619	$ 2,721,170,482

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Changes in the allowance for loan losses for the nine months ended September 30, 2008 and for the year ended December 31, 2007 are as follows:

	September 30, 2008	December 31, 2007
Balance at beginning of period	$ 28,470,207	$ 16,117,978
Charged-off loans	(2,442,259)	(1,341,890)
Recovery of previously charged-off loans	1,309,493	279,491
Allowance from Mid-America acquisition		8,694,787
Provision for loan losses	7,503,412	4,719,841
Balance at end of period	$ 34,840,853	$ 28,470,207

At September 30, 2008 and at December 31, 2007, Pinnacle Financial had impaired loans on nonaccruing interest status. The principal balance of these nonaccrual loans amounted to $17,743,000 and $19,677,000 at September 30, 2008 and December 31, 2007, respectively. In each case, at the date such loans were placed on nonaccrual status, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Had nonaccruing loans been on accruing status, interest income would have been higher by $794,000 and $108,000 for the nine months ended September 30, 2008 and 2007, respectively.

At September 30, 2008, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately $33,374,000 to directors, executive officers, and their related entities, of which $25,708,000 had been drawn upon. During the nine months ended September 30, 2008, $11,163,000 of loan and other commitment increases and $4,925,000 of principal and other reductions were made by directors, executive officers, and their related entities. The terms on these loans and extensions are on substantially the same terms customary for other persons for the type of loan involved. None of these loans to directors, executive officers, and their related entities were impaired at September 30, 2008.

During the three and nine months ended September 30, 2008 and 2007, Pinnacle Financial sold participations in certain loans to correspondent banks and other investors at an interest rate that was less than that of the borrower s rate of interest. In accordance with U.S. generally accepted accounting principles, Pinnacle Financial recognized a net gain on the sale of these participated loans for the nine months ended September 30, 2008 and 2007 of approximately $12,000 and $230,000, respectively, which is attributable to the present value of the future net cash flows of the difference between the interest payments the borrower is projected to pay Pinnacle Financial and the amount of interest that will be owed the correspondent bank based on their participation in the loans. Net gains recognized for the three months ended September 30, 2008 and 2007 were $695,000 and $19,000, respectively. The gain recognized for the three months ended September 30, 2008 of $695,000 resulted from the sale of four related impaired loans to a group of outside investors. At September 30, 2008, Pinnacle Financial was servicing $143.6 million of loans for correspondent banks and other entities, of which $136.1 million were commercial loans.

At September 30, 2008, Pinnacle Financial had $15,162,000 of mortgage loans held-for-sale compared to $11,252,000 at December 31, 2007. These loans are marketed to potential investors prior to closing the loan with the borrower such that there is an agreement for the subsequent sale of the loan between the eventual investor and Pinnacle National prior to the loan being closed with the borrower. Pinnacle Financial sells loans to investors on a loan-by-loan basis and has not entered into any forward commitments with investors for future loan sales. All of these loan sales transfer servicing rights to the buyer. During the three and nine months ended September 30, 2008, Pinnacle Financial recognized $765,000 and $2,289,000 gains on the sale of these loans, respectively, compared to $360,000 and $1,151,000 gains on the sale of these loans for the three and nine months ended September 30, 2007, respectively.

At September 30, 2008, Pinnacle Financial owned $12,143,000 in other real estate which had been acquired, usually through foreclosure, from borrowers compared to $1,673,000 at December 31, 2007. Substantially all of these amounts relate to homes and residential development projects that are either completed or are in various stages of construction for which Pinnacle Financial believes it has adequate collateral. Other real estate is included in Other assets on the consolidated balance sheet.

Note 5. Stockholders Equity and Subordinated Debt

On July 22, 2008, Pinnacle Financial issued one million shares of its authorized but unissued common stock via a private placement to mutual funds and certain other institutional accounts managed by T. Rowe Price Associates, Inc. at $21.50 per share.

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Proceeds from this sale of common stock are expected to be used for general corporate purposes, including supporting the continued, anticipated growth of Pinnacle National.

On August 5, 2008, Pinnacle National entered into a subordinated term loan agreement with a regional bank for $15 million. The loan will bear interest at 90-day Libor plus 3.5%, mature in seven years and borrowings under the loan qualify as Tier 2 capital for regulatory capital purposes. Proceeds from this issuance of subordinated debt are expected to be used for the anticipated growth of Pinnacle National.

Note 6. Income Taxes

Pinnacle Financial s income tax expense differs from the amounts computed by applying the Federal income tax statutory rates of 35% to income before income taxes. A reconciliation of the differences for the three and nine months ended September 30, 2008 and 2007 is as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2008	**2007**	**2008**	**2007**
Income taxes at statutory rate	$ 4,229,136	$ 2,943,397	$ 11,061,745	$ 8,552,015
State tax (benefit) expense, net of Federal tax effect	(103,272)	45,352	(262,076)	135,762
Federal tax credits	(90,000)	(90,000)	(270,000)	(270,000)
Tax-exempt securities	(397,123)	(217,167)	(1,246,644)	(615,896)
Bank owned life insurance	(78,750)	(46,248)	(313,129)	(141,066)
Insurance premiums	(83,007)	(103,130)	(290,542)	(307,291)
Other items	(188,880)	105,693	104,566	281,291
Income tax expense	$ 3,288,104	$ 2,637,897	$ 8,783,920	$ 7,634,815

The effective tax rate for 2008 and 2007 is impacted by Federal tax credits related to the New Markets Tax Credit program whereby a subsidiary of Pinnacle National has been awarded approximately $2.3 million in future Federal tax credits which are available through 2010. Tax benefits related to these credits will be recognized for financial reporting purposes in the same periods that the credits are recognized in the Company s income tax returns. The credit that was available for the years ended December 31, 2008 and 2007 was $360,000. Pinnacle Financial believes that it will comply with the various regulatory provisions of the New Markets Tax Credit program, and therefore has reflected the impact of the credits in its estimated annual effective tax rate for 2008 and 2007.

Note 7. Commitments and Contingent Liabilities

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

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless

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

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

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

A summary of Pinnacle Financial s total contractual amount for all off-balance sheet commitments at September 30, 2008 is as follows:

Commitments to extend credit	$ 954,825,000
Standby letters of credit	93,971,000

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of these claims outstanding at September 30, 2008 will not have a material impact on Pinnacle Financial s financial statements.

Visa Litigation Pinnacle National is a member of the Visa USA network. Under Visa USA bylaws, Visa members are obligated to indemnify Visa USA and/or its parent company, Visa, Inc. (Visa), for potential future settlement of, or judgments resulting from, certain litigation, which Visa refers to as the covered litigation. Pinnacle National s indemnification obligation is limited to its membership proportion of Visa USA. On November 7, 2007, Visa announced the settlement of its American Express litigation, and disclosed in its annual report to the SEC on Form 10-K for the year ended September 30, 2007 that Visa had accrued a contingent liability for the estimated settlement of its Discover litigation. Accordingly, Pinnacle National expensed and recognized a contingent liability in the amount of $145,000 as an estimate for its membership proportion of the American Express settlement and the potential Discover settlement, as well as its membership proportion of the amount that Pinnacle National estimates will be required for Visa to settle the remaining covered litigation.

Visa completed an initial public offering (IPO) in March 2008. Visa used a portion of the proceeds from the IPO to establish a $3.0 billion escrow for settlement of covered litigation and used substantially all of the remaining portion to redeem class B and class C shares held by Visa issuing members. During the three months ended March 31, 2008, Pinnacle Financial recognized a pre-tax gain of $140,000 on redemption proceeds received from Visa, Inc. and reversed $63,000 of the $145,000 litigation expense recognized as its pro-rata share of the $3.0 billion escrow funded by Visa, Inc. The timing for ultimate settlement of all covered litigation is not determinable at this time.

Note 8. Equity Compensation

Pinnacle Financial has two equity incentive plans under which it has granted stock options to its employees to purchase common stock at or above the fair market value on the date of grant and granted restricted share awards to employees and directors. At September 30, 2008, there were 442,186 shares available for issue under these plans.

During the first quarter of 2006 and in connection with its merger with Cavalry, Pinnacle Financial assumed a third equity incentive plan, the 1999 Cavalry Bancorp, Inc. Stock Option Plan (the Cavalry Plan). All options granted under the Cavalry Plan were fully vested prior to Pinnacle Financial s merger with Cavalry and expire at various dates between January 2011 and June 2012. In connection with the merger, all options to acquire Cavalry common stock were converted to options to acquire Pinnacle Financial s common stock at the 0.95 exchange ratio. The exercise price of the outstanding options under the Cavalry Plan was adjusted using the same exchange ratio. All other terms of the Cavalry options were unchanged. There were 195,551 Pinnacle shares which could be acquired by the participants in

the Cavalry Plan at exercise prices that ranged between $10.26 per share and $13.68 per share.

On November 30, 2007 and in connection with its merger with Mid-America, Pinnacle Financial assumed several equity incentive plans, including the Mid-America Bancshares, Inc. 2006 Omnibus Equity Incentive Plan (the Mid-America Plans). All options and stock appreciation rights granted under the Mid-America Plans were fully vested prior to Pinnacle Financial s merger

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with Mid-America and expire at various dates between June 2011 and July 2017. In connection with the merger, all options and stock appreciation rights to acquire Mid-America common stock were converted to options or stock appreciation rights, as applicable, to acquire Pinnacle Financial common stock at the 0.4655 exchange ratio. The exercise price of the outstanding options and stock appreciation rights under the Mid-America Plans were adjusted using the same exchange ratio with the exercise price also being reduced by $1.50 per share. All other terms of the Mid-America options and stock appreciation rights were unchanged. There were 487,835 Pinnacle shares which could be acquired by the participants in the Mid-America Plan at exercise prices that ranged between $6.63 per share and $21.37 per share. At September 30, 2008, there were 88,435 shares available for issue under the Mid-America Plans.

Common Stock Options and Stock Appreciation Rights

As of September 30, 2008, of the approximately 2,253,000 stock options and 12,000 stock appreciation rights outstanding, 1,264,000 options were granted with the intention to be incentive stock options qualifying under Section 422 of the Internal Revenue Code for favorable tax treatment to the option holder while 989,000 options would be deemed non-qualified stock options or stock appreciation rights and thus not subject to favorable tax treatment to the option holder. All stock options granted under the Pinnacle equity incentive plans vest in equal increments over five years from the date of grant and are exercisable over a period of ten years from the date of grant. All stock options and stock appreciation rights granted under the Cavalry Plan and Mid-America Plans were fully vested at the date of those mergers.

A summary of the stock option and stock appreciation rights activity during the nine months ended September 30, 2008 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters was as follows:

	Number	Weighted-Average Exercise Price	Weighted-Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value (1) (000 s)
Outstanding at December 31, 2007	**2,398,823**	**$ 16.84**	**6.9**	**$ 23,784**
Granted	163,360	21.51		
Exercised **(2)**	(244,815)	13.02		
Forfeited	(51,917)	26.53		
Outstanding at September 30, 2008	**2,265,451**	**$ 17.36**	**6.3**	**$ 30,868**
Outstanding and expected to vest as of September 30, 2008	**2,232,966**	**$ 17.19**	**6.2**	**$ 30,784**
Options exercisable at September 30, 2008 (3)	**1,503,119**	**$ 12.50**	**5.3**	**$ 26,464**

(1) The aggregate intrinsic value is calculated as the difference

between the exercise price of the underlying awards and the quoted price of Pinnacle Financial common stock of $30.80 per common share for the approximately 1.95 million options and stock appreciation rights that were in-the-money at September 30, 2008.

(2) There were 2,367 stock appreciation rights exercised during nine months ended September 30, 2008 resulting in the issuance of 833 shares of Pinnacle Financial common stock.

(3) In addition to these outstanding options, there were 370,000 and 395,000 warrants outstanding at September 30, 2008 and December 31, 2007, respectively. These warrants, when exercised, will result in the

issuance of
common shares.

During the nine months ended September 30, 2008, 214,890 option awards vested at an average exercise price of $23.75 and an intrinsic value of approximately $6.2 million. On January 18, 2008, Pinnacle Financial granted options to purchase 163,360 common shares to certain employees at an exercise price of $21.51 per share. These options, which were issued as non-qualified stock options, will vest in varying increments over five years beginning one year after the date of the grant and are exercisable over a period of ten years from the date of grant. Pursuant to SAB 110, Share-Based Payment, Pinnacle Financial will continue to use the simplified method for estimating the expense of stock compensation during 2008.

During the nine months ended September 30, 2008, the aggregate intrinsic value of options and stock appreciation rights exercised was $3.7 million determined as of the date of exercise. As of September 30, 2008, there was approximately $5.8 million

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of total unrecognized compensation cost related to unvested stock options granted. That cost is expected to be recognized over a weighted-average period of 2.4 years.

During the nine months ended September 30, 2008 and 2007, Pinnacle Financial recorded stock-based compensation expense of $1,707,000 and $1,525,000, respectively using the Black-Scholes valuation model for awards granted prior to, but not yet vested, as of January 1, 2006 and for stock-based awards granted after January 1, 2006. For these awards, Pinnacle Financial has recognized compensation expense using a straight-line amortization method. Stock-based compensation expense has been reduced for estimated forfeitures.

The fair value of options granted for each of the nine month periods ended September 30, 2008 and 2007 was estimated using the Black-Scholes option pricing model and the following assumptions:

	2008	***2007***
Risk free interest rate	3.20%	4.72%
Expected life of options	6.50 years	6.50 years
Expected dividend yield	0.00%	0.00%
Expected volatility	24.60%	21.12%
Weighted average fair value	$ 7.07	$ 10.59

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

Restricted Shares

Additionally, Pinnacle Financial s 2004 Equity Incentive Plan and the Mid-America Plans provide for the granting of restricted share awards and other performance or market-based awards. There were no market-based awards outstanding as of September 30, 2008 under the 2004 Equity Incentive Plan. During the nine months ended September 30, 2008, Pinnacle Financial awarded 173,168 shares of restricted common stock to Pinnacle Financial directors, officers and associates. The weighted average fair value of these awards as of the date of grant was $22.87 per share. The forfeiture restrictions on 109,795 of the restricted shares awarded to Pinnacle Financial associates lapse in annual increments of 20% over the next five years. The forfeiture restrictions on 26,805 restricted shares awarded to members of Pinnacle Financial s senior management lapse in three separate traunches should Pinnacle Financial achieve certain earnings and soundness targets over the subsequent three year period. Additionally, the forfeiture restrictions on 26,805 restricted shares issued to members of Pinnacle Financial s senior management lapse in annual increments of 10% over the next ten years if Pinnacle Financial is profitable in the prior year. The remaining 9,763 restricted shares were awarded to Pinnacle Financial directors with the restrictions on these shares lapsing on the one year anniversary date of the award based on each individual board member meeting their attendance goals for the various board and board committee meetings to which each member was scheduled to attend during the period from March 1, 2008 through February 28, 2009.

Compensation expense associated with the performance based restricted share awards is recognized over the time period that the restrictions associated with the awards are anticipated to lapse based on a graded vesting schedule such that each traunche is amortized separately. Compensation expense associated with the time based restricted share awards is recognized over the time period that the restrictions associated with the awards lapse based on the total cost of the award. For the nine months ended September 30, 2008, Pinnacle Financial recognized approximately $260,000 in compensation costs attributable to all restricted share awards issued prior to September 30, 2008. During the nine months ended September 30, 2008, $390,000 in previously expensed compensation associated with certain traunches of restricted share awards was reversed when Pinnacle Financial determined that the performance targets required to vest the awards were unlikely to be achieved.

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A summary of activity for unvested restricted share awards for the nine months ended September 30, 2008 follows:

	Number
Unvested awards at December 31, 2007	**54,349**
New awards granted	173,168
Awards whereby restrictions have lapsed and shares released to participants	(3,230)
Forfeited awards (i.e., restrictions not met by participants)	(5,610)
Unvested awards at September 30, 2008	**218,677**

Note 9. Regulatory Matters

Pinnacle National is subject to restrictions on the payment of dividends to Pinnacle Financial under federal banking laws and the regulations of the Office of the Comptroller of the Currency. Pinnacle Financial is also subject to limits on payment of dividends to its shareholders by the rules, regulations and policies of federal banking authorities. Pinnacle Financial has not paid any cash dividends since inception, and it does not anticipate that it will consider paying dividends until Pinnacle Financial generates sufficient capital through net income from operations to support both anticipated asset growth and dividend payments. During the nine months ended September 30, 2008, Pinnacle National paid dividend payments of $2.7 million to Pinnacle Financial to fund Pinnacle Financial s interest payments due on its subordinated indebtedness. At September 30, 2008, pursuant to federal banking regulations, Pinnacle National had approximately $64.9 million of net retained profits from the previous two years available for future dividend payments to Pinnacle Financial.

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

Quantitative measures established by regulation to ensure capital adequacy require Pinnacle Financial and its banking subsidiaries to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes, as of September 30, 2008, that Pinnacle Financial and its banking subsidiary met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized, Pinnacle National must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. Pinnacle Financial and its banking subsidiaries actual capital amounts and ratios are presented in the following table (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
At September 30, 2008						

Total capital to risk weighted assets:						
Pinnacle Financial	$ 392,721	11.24%	$ 279,959	8.0%	not applicable	
Pinnacle National	$ 365,172	10.45%	$ 279,470	8.0%	$ 349,338	10.0%
Tier I capital to risk weighted assets:						
Pinnacle Financial	$ 342,880	9.81%	$ 139,979	4.0%	not applicable	
Pinnacle National	$ 315,275	9.02%	$ 139,735	4.0%	$ 209,603	6.0%
Tier I capital to average assets (*):						
Pinnacle Financial	$ 342,880	8.68%	$ 157,975	4.0%	not applicable	
Pinnacle National	$ 315,275	8.00%	$ 157,618	4.0%	$ 197,022	5.0%

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

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Note 10. Derivative Instruments

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. Beginning in 2007, Pinnacle Financial entered into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, Pinnacle Financial enters into offsetting positions in order to minimize the risk to Pinnacle Financial. These swaps qualify as derivatives, but are not designated as hedging instruments.

Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counter party or customer owes Pinnacle Financial, and results in credit risk to Pinnacle Financial. When the fair value of a derivative instrument contract is negative, Pinnacle Financial owes the customer or counterparty and therefore, has no credit risk.

A summary of Pinnacle Financial s interest rate swaps as of September 30, 2008 is included in the following table (in thousands):

	September 30, 2008	
	Notional Amount	Estimated Fair Value
Interest rate swap agreements:		
Pay fixed/receive variable swaps	$ 138,778	$ 2,099
Pay variable/receive fixed swaps	138,778	(2,192)
Total	$ 277,556	$ (93)

Note 11. Business Segment Information

Pinnacle Financial has four reporting segments comprised of commercial banking, trust and investment services, mortgage origination and insurance services. Pinnacle Financial s primary segment is commercial banking which consists of commercial loan and deposit services as well as the activities of Pinnacle National s branch locations. Trust and investment services include trust services offered by Pinnacle National and all brokerage and investment activities associated with Pinnacle Asset Management, an operating unit within Pinnacle National. Mortgage origination is also a separate unit within Pinnacle National and focuses on the origination of residential mortgage loans for sale to investors in the secondary residential mortgage market. Insurance Services reflect the activities of Pinnacle National s wholly owned subsidiary, Miller Loughry Beach Insurance and Services, Inc. Miller Loughry Beach is a general insurance agency located in Murfreesboro, Tennessee and is licensed to sell various commercial and consumer insurance products.

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The following tables present financial information for each reportable segment as of September 30, 2008 and 2007 and for the three and nine months ended September 30, 2008 and 2007 (dollars in thousands):

	Commercial Banking	Trust and Investment Services	Mortgage Origination	Insurance Services	Total Company
For the three months ended September 30, 2008:					
Net interest income	$ 29,225	$	$ 56	$	$ 29,281
Provision for loan losses	3,125				3,125
Noninterest income	5,624	1,660	1,009	960	9,253
Noninterest expense	20,614	1,256	590	866	23,326
Income tax expense	2,904	159	186	39	3,288
Net income	$ 8,206	$ 245	$ 289	$ 55	$ 8,795
For the three months ended September 30, 2007:					
Net interest income	$ 18,916	$	$ 44	$	$ 18,960
Provision for loan losses	772				772
Noninterest income	2,606	1,458	704	564	5,332
Noninterest expense	13,162	915	582	451	15,110
Income tax expense	2,315	213	65	45	2,638
Net income	$ 5,273	$ 330	$ 101	$ 68	$ 5,772
For the nine months ended September 30, 2008:					
Net interest income	$ 84,151	$	$ 171	$	$ 84,322
Provision for loan losses	7,503				7,503
Noninterest income	16,350	4,987	2,729	2,613	26,679
Noninterest expense	64,437	3,849	1,833	1,774	71,893
Income tax expense	7,586	447	418	333	8,784
Net income	$ 20,975	$ 691	$ 649	$ 506	$ 22,821
For the nine months ended September 30, 2007:					
Net interest income	$ 53,557	$	$ 146	$	$ 53,703
Provision for loan losses	2,460				2,460
Noninterest income	8,506	3,394	2,172	1,837	15,909

Noninterest expense	38,016	1,633	1,712	1,357	42,718
Income tax expense	6,514	691	238	191	7,634
Net income	$ 15,073	$ 1,070	$ 368	$ 289	$ 16,800
As of September 30, 2008:					
End of period assets	$ 4,311,549	$ 683	$ 17,926	$ 7,394	$ 4,337,552
As of September 30, 2007:					
End of period assets	$ 2,351,546	$ 393	$ 11,783	$ 4,357	$ 2,368,079

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

The following is a discussion of our financial condition at September 30, 2008 and December 31, 2007 and our results of operations for the three and nine months ended September 30, 2008 and 2007. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Overview

General. Our rapid organic growth together with our merger with Mid-America Bancshares, Inc. (Mid-America), a two-bank holding company in Nashville, Tennessee, on November 30, 2007 and our expansion in the Knoxville, Tennessee market has had a material impact on Pinnacle Financial s financial condition and results of operations in 2008 as compared to 2007. This rapid growth along with the Mid-America merger and the Knoxville market expansion are discussed more fully below. Our fully diluted net income per share for the three months ended September 30, 2008 and 2007 was $0.36 and $0.35, respectively. Our fully diluted net income per share for the nine months ended September 30, 2008 and 2007 was $0.96 and $1.01, respectively. At September 30, 2008, loans totaled $3.203 billion, as compared to $2.750 billion at December 31, 2007, while total deposits increased to $3.295 billion at September 30, 2008 from $2.925 billion at December 31, 2007.

Acquisition Mid-America. On November 30, 2007, we consummated a merger with Mid-America. Pursuant to the merger agreement, Mid-America shareholders received a fixed exchange ratio of 0.4655 shares of our common stock and $1.50 in cash for each share of Mid-America common stock, or approximately 6.7 million Pinnacle Financial shares and $21.6 million in cash. We financed the cash portion of the merger consideration with the proceeds of a $30 million trust preferred securities offering by an affiliated trust. The accompanying consolidated financial statements include the activities of the former Mid-America since November 30, 2007.

During the three and nine months ended September 30, 2008, we incurred merger integration expense related to the merger with Mid-America of $1.2 million and $5.6 million, respectively. These expenses were directly related to the merger, and consisted primarily of severance costs and costs to integrate processing systems and are reflected in the accompanying consolidated statement of income as merger related expense.

Knoxville expansion. During April of 2007, we announced a de novo expansion of our firm to the Knoxville MSA. At that time, we had hired several new associates from other financial institutions in that market and had negotiated a lease agreement for our main office facility with future plans to construct four additional offices over the next few years. In June of 2007, we opened our first full service branch facility in Knoxville and we anticipate opening a second office during the second quarter of 2009. At September 30, 2008, our Knoxville facility had recorded $286.7 million in loan balances and $168.5 million in deposit balances. At September 30, 2008, we employed 27 associates in the Knoxville MSA.

Results of Operations. Our net interest income increased to $29.3 million for the third quarter of 2008 compared to $19.0 million for the third quarter of 2007. The net interest margin (the ratio of net interest income to average earning assets) for the three months ended September 30, 2008 was 3.14% compared to 3.54% for the same period in 2007. Our net interest income increased to $84.3 million for the nine months ended September 30, 2008 compared to $53.7 million for the nine months ended September 30, 2007. The net interest margin for the nine months ended September 30, 2008 was 3.24% compared to 3.59% for the same period in 2007.

Our provision for loan losses was $3.1 million for the third quarter of 2008 compared to $772,000 for the same period in 2007. The provision for loan losses was $7.5 million for the nine months ended September 30, 2008 compared to $2.5 million for the same period in 2007. Impacting the provision for loan losses in any accounting period are several matters including the amount of loan growth during the period, the level of charge-offs or recoveries incurred during the period, the changes in the amount of impaired loans and the results of our quarterly assessment of the inherent risks of our loan portfolio.

Noninterest income for the three and nine months ended September 30, 2008 compared to the same periods in 2007 increased by $3.9 million, or 73.5% and $10.8 million or 67.7%, respectively. This increase is largely attributable to the fee businesses associated with the Mid-America acquisition, particularly with regard to service charges on deposit

accounts, investment services

commissions, gains on the sale of branch premises and other noninterest income. Included in insurance commissions during the first nine months of 2008 were approximately $450,000 in insurance commissions received from one of our carriers due to favorable claims experience by that carrier.

Our continued growth in 2008 resulted in increased noninterest expense compared to 2007 due to the addition of Mid-America and our expansion into the Knoxville MSA, increases in salaries and employee benefits, equipment and occupancy expenses and other operating expenses. The number of full-time equivalent employees increased from 450.5 at September 30, 2007 to 723 at September 30, 2008. As a result, we experienced increases in compensation and employee benefit expense. In addition to incurring a full year of the Mid-America-related expense in 2008, we expect to add additional employees throughout 2008 which will also cause our compensation and employee benefit expense to increase in 2008 when compared to the comparable period in 2007. Additionally, our branch expansion efforts during the last few years and the addition of the eleven Mid-America branches will also increase noninterest expense. The increased operational expenses for the recently opened branches will continue to result in increased noninterest expense in future periods. Our efficiency ratio (the ratio of noninterest expense to the sum of net interest income and noninterest income) was 60.53% for the third quarter of 2008 compared to 62.20% for the same period in 2007. Our efficiency ratio was 64.80% for the first nine months of 2008 compared with 61.37% for the same period in 2007. These calculations include the impact of approximately $1.2 million and $5.6 million in Mid-America pre-tax merger related charges incurred during the three and nine months ended September 30, 2008, respectively.

The effective income tax expense rate for the three and nine months ended September 30, 2008 was approximately 27.2% and 27.8%, respectively, compared to an effective income tax expense rate for the three and nine months ended September 30, 2007 of approximately 31.37% and 31.25%, respectively. The decrease in the effective rate for 2008 compared to 2007 was due to increased investments in bank qualified municipal securities and bank owned life insurance as well as an increase in the state tax benefit.

Net income for the third quarter of 2008 was $8.8 million compared to $5.8 million for the same period in 2007, an increase of 52.4%. Net income for the first nine months of 2008 was $22.8 million compared to $16.8 million for the same period in 2007, an increase of 35.8%.

Financial Condition. Loans increased $453.3 million during the first nine months of 2008. As we seek to increase our loan portfolio, we must also continue to monitor the risks inherent in our lending operations. If our allowance for loan losses is not sufficient to cover the estimated loan losses in our loan portfolio, increases to the allowance for loan losses would be required which would decrease our earnings.

We have grown our total deposits to $3.295 billion at September 30, 2008 compared to $2.925 billion at December 31, 2007, an increase of $369.8 million. In comparing the composition of the average balances of our deposits between the first nine months of 2008 with the first nine months of 2007, we have experienced increased growth in our higher cost certificate of deposit balances than in any other category. This increase in reliance on higher cost deposits has contributed to a reduced net interest margin between the two periods.

Capital and Liquidity. At September 30, 2008, our capital ratios, including our bank s capital ratios, met regulatory minimum capital requirements. Additionally, at September 30, 2008, our bank would be considered to be well-capitalized pursuant to banking regulations. As our bank grows it will require additional capital from us over that which can be earned through operations. We anticipate that we will continue to use various capital raising techniques in order to support the growth of our bank.

In the past, we have been successful in procuring additional capital from the capital markets via public and private offerings of trust preferred securities and common stock. On July 22, 2008, Pinnacle Financial received $21.5 million in proceeds from the sale of one million shares of its authorized but unissued common stock via a private placement to mutual funds and certain other institutional accounts managed by T. Rowe Price Associates, Inc. at $21.50 per share. Proceeds from this sale of common stock are expected to be used for general corporate purposes, including supporting the continued, anticipated growth of Pinnacle National. On August 5, 2008, Pinnacle National also entered into a $15 million subordinated term loan with a regional bank. The loan will bear interest at three month Libor plus 3.5%, mature in seven years and will qualify as Tier 2 capital for regulatory capital purposes. This additional capital was required to support our growth.

On October 14, 2008, the United States Department of the Treasury announced the TARP Capital Purchase Program, pursuant to which Treasury will make direct capital investments in participating financial institutions. Under this revised program, healthy

banks are encouraged to participate in the program. The minimum investment for a financial institution considering participating in the Capital Purchase Program is an amount equal to 1% of its risk-weighted assets and the maximum amount is the lesser of $25 billion or 3% of its risk-weighted assets. The application to participate in this Capital Purchase Program must be received by the institution s primary banking regulator no later than November 14, 2008 and the investment is expected to be made by December 31, 2008. Pinnacle Financial is evaluating the program.

Critical Accounting Estimates

The accounting principles we follow and our methods of applying these principles conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses and the assessment of impairment of the intangibles resulting from the Mid-America and Cavalry mergers have been critical to the determination of our financial position and results of operations.

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

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

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

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

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

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

The allowance allocation for commercial and commercial real estate loans begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based

on our internal system of

credit risk ratings and historical loss data for industry and various peer bank groups. The estimated loan loss allocation rate for our internal system of credit risk grades for commercial and commercial real estate loans is based on management s experience with similarly graded loans, discussions with banking regulators and our internal loan review processes. During the nine months ended September 30, 2008, we also performed a migration analysis of all loans that were charged-off during the previous two years. A migration analysis assists in evaluating loan loss allocation rates for the various risk grades assigned to loans in our portfolio. We utilized the migration analysis to some extent to determine the loss allocation rates for the commercial and commercial real estate portfolios. Subsequently, we weighted the allocation methodologies for the commercial and commercial real estate portfolios and determine a weighted average allocation for these portfolios.

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

The estimated loan loss allocation for all four loan portfolio segments is then adjusted for management s estimate of probable losses for several environmental factors. The allocation for environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated inherent credit losses which may exist, but have not yet been identified, as of the balance sheet date based upon quarterly trend assessments in delinquent and nonaccrual loans, unanticipated charge-offs, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These environmental factors are considered for each of the four loan segments and the allowance allocation, as determined by the processes noted above for each segment, is increased or decreased based on the incremental assessment of these various environmental factors.

We then test the resulting allowance by comparing the balance in the allow