

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

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

OR

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-28312

FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of incorporation  
or organization)

71-0785261

(I.R.S. Employer  
Identification Number)

1401 Highway 62-65 North  
Harrison, Arkansas

(Address of principal executive office)

72601

(Zip Code)

(870) 741-7641

(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of October 23, 2006, there were issued and outstanding 4,977,393 shares of the Registrant's Common Stock, par value \$.01 per share.

# FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.

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**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
(In thousands, except share data)  
(Unaudited)

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Cash and cash equivalents	\$ 30,671	\$ 21,109
Investment securities held to maturity	60,855	56,695
Federal Home Loan Bank stock	8,329	8,412
Loans receivable, net	716,669	719,214
Accrued interest receivable	10,011	7,490
Real estate acquired in settlement of loans, net	1,688	892
Office properties and equipment, net	19,509	18,522
Cash surrender value of life insurance	19,210	18,654
Prepaid expenses and other assets	1,237	1,423
<b>TOTAL ASSETS</b>	<b>\$ 868,179</b>	<b>\$ 852,411</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits	\$ 641,600	\$ 611,667
Federal Home Loan Bank advances	144,032	158,240
Advance payments by borrowers for taxes and insurance	528	847
Other liabilities	3,317	3,815
<b>Total liabilities</b>	<b>789,477</b>	<b>774,569</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, no par value, 5,000,000 shares authorized, none issued		
Common stock, \$.01 par value, 20,000,000 shares authorized, 10,307,502 shares issued, 4,977,393 and 5,048,662 shares outstanding at September 30, 2006 and December 31, 2005, respectively	103	103
Additional paid-in capital	56,708	56,252
Employee stock benefit plans	(83)	(140)
Retained earnings—substantially restricted	87,376	83,584
	144,104	139,799
Treasury stock, at cost, 5,330,109 and 5,258,840 shares at September 30, 2006 and December 31, 2005, respectively	(65,402)	(61,957)
<b>Total stockholders' equity</b>	<b>78,702</b>	<b>77,842</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 868,179</b>	<b>\$ 852,411</b>

See notes to unaudited consolidated financial statements.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
<b>INTEREST INCOME:</b>				
Loans receivable	\$ 12,627	\$ 11,150	\$ 37,703	\$ 31,300
Investment securities:				
Taxable	650	561	1,853	1,610
Nontaxable	185	180	558	538
Other	219	25	393	64
Total interest income	<u>13,681</u>	<u>11,916</u>	<u>40,507</u>	<u>33,512</u>
<b>INTEREST EXPENSE:</b>				
Deposits	5,449	3,742	14,819	10,505
Other borrowings	1,858	1,393	5,378	3,345
Total interest expense	<u>7,307</u>	<u>5,135</u>	<u>20,197</u>	<u>13,850</u>
<b>NET INTEREST INCOME</b>	<u>6,374</u>	<u>6,781</u>	<u>20,310</u>	<u>19,662</u>
<b>PROVISION FOR LOAN LOSSES</b>	<u>484</u>	<u>285</u>	<u>1,128</u>	<u>820</u>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<u>5,890</u>	<u>6,496</u>	<u>19,182</u>	<u>18,842</u>
<b>NONINTEREST INCOME:</b>				
Deposit fee income	1,264	1,193	3,579	3,307
Earnings on life insurance policies	187	191	556	579
Gain on sale of loans	252	195	727	511
Other	327	239	1,570	714
Total noninterest income	<u>2,030</u>	<u>1,818</u>	<u>6,432</u>	<u>5,111</u>
<b>NONINTEREST EXPENSES:</b>				
Salaries and employee benefits	3,195	3,256	10,174	9,272
Net occupancy expense	613	532	1,784	1,537
Data processing	341	392	1,100	1,145
Professional fees	93	101	288	321
Advertising and public relations	342	318	982	801
Postage and supplies	188	186	605	566
Other	694	528	1,934	1,546
Total noninterest expenses	<u>5,466</u>	<u>5,313</u>	<u>16,867</u>	<u>15,188</u>
<b>INCOME BEFORE INCOME TAXES</b>	<u>2,454</u>	<u>3,001</u>	<u>8,747</u>	<u>8,765</u>
<b>INCOME TAX PROVISION</b>	<u>754</u>	<u>965</u>	<u>2,787</u>	<u>2,815</u>
<b>NET INCOME</b>	<u>\$ 1,700</u>	<u>\$ 2,036</u>	<u>\$ 5,960</u>	<u>\$ 5,950</u>
<b>EARNINGS PER SHARE:</b>				
Basic	<u>\$ 0.34</u>	<u>\$ 0.41</u>	<u>\$ 1.19</u>	<u>\$ 1.19</u>
Diluted	<u>\$ 0.33</u>	<u>\$ 0.39</u>	<u>\$ 1.16</u>	<u>\$ 1.14</u>
Cash Dividends Declared	<u>\$ 0.15</u>	<u>\$ 0.13</u>	<u>\$ 0.43</u>	<u>\$ 0.37</u>

See notes to unaudited consolidated financial statements.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006**  
(In thousands, except share data)  
(Unaudited)

	<u>Issued Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Employee Stock Benefit Plans</u>	<u>Retained Earnings</u>
	<u>Shares</u>	<u>Amount</u>			
Balance, January 1, 2006	10,307,502	\$ 103	\$ 56,252	\$ (140)	\$ 83,584
Net income					5,960
Release of ESOP shares			407	104	
Tax effect of stock compensation plan			252		
Treasury shares reissued due to exercise of stock options			(270)		
Purchase of treasury stock, at cost					
Stock compensation expense			67	(47)	
Dividends paid					(2,168)
Balance, September 30, 2006	<u>10,307,502</u>	<u>\$ 103</u>	<u>\$ 56,708</u>	<u>\$ (83)</u>	<u>\$ 87,376</u>

	<u>Treasury Stock</u>		<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>	
Balance, January 1, 2006	5,258,840	\$(61,957)	\$ 77,842
Net income			5,960
Release of ESOP shares			511
Tax effect of stock compensation plan			252
Treasury shares reissued due to exercise of stock options	(113,631)	1,176	906
Purchase of treasury stock, at cost	188,900	(4,667)	(4,667)
Stock compensation expense	(4,000)	46	66
Dividends paid			(2,168)
Balance, September 30, 2006	<u>5,330,109</u>	<u>\$(65,402)</u>	<u>\$ 78,702</u>

See notes to unaudited consolidated financial statements.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In Thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 5,960	\$ 5,950
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,128	820
Provision for real estate losses	--	30
Deferred tax provision (benefit)	9	(95)
Accretion of discounts on investment securities, net	(5)	(1)
Federal Home Loan Bank stock dividends	(294)	(168)
(Gain) loss on disposition of office properties and equipment	(233)	4
Gain on sale of repossessed assets, net	(43)	(14)
Originations of loans held for sale	(52,436)	(37,565)
Proceeds from sales of loans held for sale	53,404	36,901
Gain on sale of loans originated to sell	(727)	(511)
Depreciation	966	885
Amortization of deferred loan fees, net	192	115
Release of ESOP shares	511	1,503
Stock compensation expense	66	20
Earnings on life insurance policies	(556)	(579)
Changes in operating assets and liabilities:		
Accrued interest receivable	(2,521)	(2,042)
Prepaid expenses and other assets	187	323
Other liabilities	(255)	1,056
Net cash provided by operating activities	5,353	6,632
<b>INVESTING ACTIVITIES:</b>		
Purchases of investment securities held to maturity	(6,445)	(3,939)
Proceeds from maturities/calls of investment securities held to maturity	2,290	4,416
Purchases of FHLB stock	--	(3,285)
Redemptions of FHLB stock	377	--
Loan participations sold	3,419	1,787
Loan originations, net of repayments	(5,964)	(81,199)
Proceeds from sales of repossessed assets	2,775	492
Proceeds from sales of office properties and equipment	251	4
Purchases of office properties and equipment	(1,971)	(3,340)
Net cash used in investing activities	(5,268)	(85,064)
<b>FINANCING ACTIVITIES:</b>		
Net increase in deposits	29,933	6,874
Advances from FHLB	55,000	131,243
Repayment of advances from FHLB	(69,208)	(51,508)
Net decrease in advance payments by borrowers for taxes and insurance	(319)	(162)
Purchase of treasury stock	(4,667)	(5,722)
Reissued treasury stock	906	1,952
Dividends paid	(2,168)	(1,872)
Net cash provided by financing activities	9,477	80,805
Net increase in cash and cash equivalents	9,562	2,373

(Continued)

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In Thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	\$ 21,109	\$ 16,003
End of period	\$ 30,671	\$ 18,376
 <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid for:		
Interest	\$ 19,820	\$ 13,443
Income taxes	\$ 2,625	\$ 2,053
 <b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING ACTIVITIES:</b>		
Real estate and other assets acquired in settlement of loans	\$ 3,529	\$ 293

(Concluded)

See notes to unaudited consolidated financial statements.

# FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### **Note 1 - Basis of Presentation and Principles of Consolidation**

First Federal Bancshares of Arkansas, Inc. (the "Company") is a unitary holding company which owns all of the stock of First Federal Bank (the "Bank"). The Bank provides a broad line of financial products to individuals and small- to medium-sized businesses. The unaudited consolidated financial statements also include the accounts of the Bank's wholly-owned subsidiary, First Harrison Service Corporation ("FHSC"), which is inactive.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, such information reflects all adjustments which are, in the opinion of management, necessary for a fair statement of results for the interim periods.

The accompanying unaudited consolidated financial statements include the accounts of the Company and the Bank. All intercompany transactions have been eliminated in consolidation.

The results of operations for the nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the year ending December 31, 2006. The unaudited consolidated financial statements and notes thereto should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2005, contained in the Company's 2005 Annual Report to Stockholders.

### **Note 2 – Recent Accounting Standards**

We adopted SFAS No. 123(R), *Share-Based Payment*, as of January 1, 2006, using the modified prospective approach. The adoption of this Statement did not have a material effect on the financial statements of the Company nor is it expected to have a material effect on any future periods for existing stock-based compensation grants.

In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109* which is effective for fiscal years beginning after December 15, 2006. FIN No. 48 provides guidance regarding the recognition, measurement, presentation and disclosure in the financial statements of tax positions taken or expected to be taken on a tax return, including the decision whether to file or not file in a particular jurisdiction. The cumulative effect of the changes arising from the initial application of FIN 48 is required to be reported as an adjustment to the opening balance of retained earnings in the period of adoption. We are currently evaluating the impact, if any, of the adoption of FIN 48 on our financial statements.

### **Note 3 - Earnings per Share**

The weighted average number of common shares used to calculate earnings per share for the periods ended September 30, 2006 and 2005 were as follows:

	<u>Three months ended September 30,</u>		<u>Nine months ended September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Basic weighted - average shares	5,006,730	4,990,081	5,021,110	4,984,411
Effect of dilutive securities	111,206	222,985	124,131	251,165
Diluted weighted - average shares	<u>5,117,936</u>	<u>5,213,066</u>	<u>5,145,241</u>	<u>5,235,576</u>

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**CRITICAL ACCOUNTING POLICIES**

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, the methodology for the determination of our allowance for loan losses, due to the judgments, estimates and assumptions inherent in that policy, is critical to preparation of our financial statements. This policy and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis. We believe that the judgments, estimates and assumptions used in the preparation of our financial statements are appropriate given the factual circumstances at the time. However, given the sensitivity of our financial statements to this critical accounting policy, the use of other judgments, estimates and assumptions could result in material differences in our financial condition or results of operations.

In estimating the amount of credit losses inherent in our loan portfolio, various judgments and assumptions are made. For example, when assessing the condition of the overall economic environment, assumptions are made regarding future market conditions and their impact on the loan portfolio. In the event the local or national economy were to sustain a prolonged downturn, the loss factors applied to our portfolios may need to be revised, which may significantly impact the measurement of the allowance for loan losses. For impaired loans that are collateral-dependent, the estimated fair value of the collateral may deviate significantly from the proceeds received when the collateral is sold.

**CHANGES IN FINANCIAL CONDITION**

Changes in financial condition between September 30, 2006 and December 31, 2005 are presented in the following table (dollars in thousands). Material changes between the periods are discussed in the sections which follow the table.

	September 30, 2006	December 31, 2005	Increase (Decrease)	Percentage Change
<b>ASSETS</b>				
Cash and cash equivalents	\$ 30,671	\$ 21,109	\$ 9,562	45.3%
Investment securities held to maturity	60,855	56,695	4,160	7.3%
Loans receivable, net	716,669	719,214	(2,545)	(0.4)%
Accrued interest receivable	10,011	7,490	2,521	33.7%
Real estate acquired in settlement of loans, net	1,688	892	796	89.2%
Office properties and equipment, net	19,509	18,522	987	5.3%
Prepaid expenses and other assets	28,776	28,489	287	1.0%
<b>TOTAL</b>	<b>\$ 868,179</b>	<b>\$ 852,411</b>	<b>\$ 15,768</b>	<b>1.9%</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
<b>LIABILITIES:</b>				
Deposits	\$ 641,600	\$ 611,667	\$ 29,933	4.9%
Federal Home Loan Bank advances	144,032	158,240	(14,208)	(9.0)%
Other liabilities	3,845	4,662	(817)	(17.5)%
<b>Total liabilities</b>	<b>789,477</b>	<b>774,569</b>	<b>14,908</b>	<b>1.9%</b>
<b>STOCKHOLDERS' EQUITY</b>	<b>78,702</b>	<b>77,842</b>	<b>860</b>	<b>1.1%</b>
<b>TOTAL</b>	<b>\$ 868,179</b>	<b>\$ 852,411</b>	<b>\$ 15,768</b>	<b>1.9%</b>
<b>BOOK VALUE PER SHARE</b>	<b>\$ 15.81</b>	<b>\$ 15.42</b>		
<b>EQUITY TO ASSETS</b>	<b>9.1%</b>	<b>9.1%</b>		

**Loans Receivable.** Changes in loan composition between September 30, 2006 and December 31, 2005 are presented in the following table (dollars in thousands).

	<u>September 30, 2006</u>	<u>December 31, 2005</u>	<u>Increase (Decrease)</u>	<u>Percentage Change</u>
One- to four-family residences	\$ 257,678	\$ 269,660	\$ (11,982)	
Multi-family	9,974	12,900	(2,926)	
Commercial real estate	116,789	119,323	(2,534)	
Land	43,509	38,355	5,154	
Construction:				
One- to four-family residences	40,110	51,579	(11,469)	
Speculative one- to four-family residences	91,702	104,001	(12,299)	
Multi-family	10,220	20,919	(10,699)	
Commercial real estate	24,729	22,331	2,398	
Land development	47,680	40,232	7,448	
Total first mortgage loans	<u>642,391</u>	<u>679,300</u>	<u>(36,909)</u>	(5.4)%
Commercial	<u>39,818</u>	<u>32,693</u>	<u>7,125</u>	21.8%
Home equity and second mortgage	53,795	49,680	4,115	
Automobile	13,186	15,748	(2,562)	
Other	14,114	13,149	965	
Total consumer	<u>81,095</u>	<u>78,577</u>	<u>2,518</u>	3.2%
Total loans receivable	763,304	790,570	(27,266)	(3.4)%
Less:				
Undisbursed construction loan funds	(44,290)	(69,086)	24,796	
Unearned discounts and net deferred loan costs (fees)	86	(156)	242	
Allowance for loan losses	<u>(2,431)</u>	<u>(2,114)</u>	<u>(317)</u>	
Loans receivable, net	<u>\$ 716,669</u>	<u>\$ 719,214</u>	<u>\$ (2,545)</u>	(0.4)%

The decrease in the Bank's loan portfolio was primarily due to a softening of the housing market in Northwest Arkansas. Market data indicates an overall decrease in home sales in Benton and Washington counties in 2006 compared to 2005. The Bank's mortgage loan originations were down 32% for the nine months ended September 30, 2006, compared to the same period in 2005, with half of this reduction occurring in the third quarter. Although the economy in the Northwest Arkansas region continues to be strong as reflected in sustained job and population growth, the supply of new residential lots and new speculative homes for sale has outpaced demand in recent months. The \$34 million decrease in one- to four-family, speculative and multi-family construction loans was both a result of a general slowdown in housing finance and the Bank's decision to reduce its lending activity in these areas due to the oversupply in the Northwest Arkansas market.

Originations of loans for sale in the secondary market increased by 40% for the nine months ended September 30, 2006, compared to the same period in 2005. This component of our mortgage loan business has remained strong due to continued low long-term secondary market mortgage interest rates.

The Bank will continue to emphasize residential, consumer, and commercial real estate lending and to a lesser degree construction lending. Construction lending will generally be reduced and will primarily be focused on custom homes for primary residences and to a lesser degree on speculative construction loans. The loans will also be used as an opportunity to cross-sell its other banking products, as long as prudent lending opportunities are available.

**Asset Quality.** The following table sets forth the amounts and categories of the Bank's nonperforming assets at the dates indicated.

	<u>September 30, 2006</u>	<u>December 31, 2005</u>
	(Dollars in Thousands)	
Nonaccrual loans:		
One- to four-family residential	\$ 2,811	\$ 2,630
Construction loans	6,734	1,177
Commercial real estate	1,015	707
Commercial loans	1,977	236
Consumer loans	1,186	556
Total nonaccrual loans	<u>13,723</u>	<u>5,306</u>
Accruing loans 90 days or more past due	3,009	1,600
Restructured loans	--	6,264
Real estate owned	<u>1,688</u>	<u>892</u>
 Total nonperforming assets	 <u>\$ 18,420</u>	 <u>\$ 14,062</u>
 Total nonaccrual and restructured loans as a percentage of total loans receivable	 <u>2.19%</u>	 <u>1.67%</u>
 Total nonperforming assets as a percentage of total assets	 <u>2.12%</u>	 <u>1.65%</u>

Total nonaccrual loans increased \$8.4 million to \$13.7 million at September 30, 2006, compared to December 31, 2005, due primarily to an increase of \$5.6 million in nonaccrual construction loans. As indicated previously, in recent months the Northwest Arkansas market has experienced a general slowdown in housing as well as an oversupply of lots and speculative homes. Certain of the Bank's homebuilders are experiencing extended marketing times for the sales of their speculative homes which has resulted in inadequate cash flow to service the interest carry on their loans. The Bank's policy is to cease accrual of interest on loans more than 90 days delinquent unless the Bank reasonably believes it will collect the interest without extraordinary collection efforts. The Bank is exercising forbearance with some of its construction borrowers in order to allow additional time to liquidate the homes and believes it is adequately collateralized on these loans.

The increase in real estate owned was due to the addition of six speculative homes during the third quarter, two of which were sold and closed prior to quarter end. Three of the four remaining homes are not complete and the Bank plans to complete the construction of these homes. Construction costs are added to the real estate owned balance to the extent that the resulting balance does not exceed the estimated fair value of the property less estimated selling costs.

At December 31, 2005, restructured loans consisted of commercial and commercial real estate loans to two borrowers. During the quarter ended September 30, 2006, one of these relationships was removed from the nonperforming asset list as the loans have paid as agreed for over one year since the restructuring took place and the Bank believes it will be able to collect all principal and interest due under the notes. The other borrowing relationship totaled \$3.8 million at September 30, 2006, \$800,000 of which is reported under the commercial category of nonaccrual loans. All of the loans in this relationship are over 90 days past due at September 30, 2006. We have estimated a loss of approximately \$128,000 on this relationship and have recorded such as a specific loan loss allowance as of September 30, 2006. However, the collateral on certain of these loans includes accounts receivable, inventory, and franchise rights which are inherently more difficult to value than real estate. The Bank intends to obtain updated financial information to estimate the current value of the collateral. Subsequent to September 30, 2006, the Bank's counsel sent a letter to the borrower demanding payment in full of the outstanding indebtedness owed to the Bank. The Bank may be required to record loan losses significantly greater than the amount estimated, particularly in light of the nature of the collateral.

In addition, the Bank has \$10.0 million of potential problem loans with three homebuilders. The first relationship totals \$6.6 million and consists of five speculative homes, two subdivision development loans, and a first mortgage and a home equity loan on the borrower's primary residence. At September 30, 2006, the two subdivision loans had matured and were less than 30 days past due. The borrower has formulated a plan to pay the interest due and has

made a partial payment. The second relationship totals \$2.4 million and consists of three speculative homes and three lots totaling \$1.8 million and commercial loans totaling \$600,000. At September 30, 2006, four of the loans totaling \$441,000 were over 90 days past due and are reflected in the commercial loans total in nonaccrual loans above. Four additional loans totaling \$1.1 million were less than 30 days past due and the remainder of the loans were current. The third relationship totals \$1.1 million and consists of six speculative homes. This borrower filed for bankruptcy protection subsequent to quarter end. Based on facts and circumstances at September 30, 2006, including market conditions, we have estimated no loss on these relationships.

**Allowance for Loan Losses.** A summary of the activity in the allowance for loan losses is as follows (in thousands):

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Balance at beginning of period	\$ 2,448	\$ 2,022	\$ 2,114	\$ 1,846
Provisions for estimated losses	484	285	1,128	820
Recoveries	55	31	139	82
Losses charged off	(556)	(262)	(950)	(672)
Balance at end of period	<u>\$ 2,431</u>	<u>\$ 2,076</u>	<u>\$ 2,431</u>	<u>\$ 2,076</u>

Changes in the composition of the allowance for loan losses between September 30, 2006 and December 31, 2005 are presented in the following table (in thousands):

	<u>September 30,</u>	<u>December 31,</u>	<u>Increase</u>
	<u>2006</u>	<u>2005</u>	<u>(Decrease)</u>
General	\$ 2,011	\$ 1,831	\$ 180
Specific	383	183	200
Unallocated	37	100	(63)
	<u>\$ 2,431</u>	<u>\$ 2,114</u>	<u>\$ 317</u>

The general component of the allowance for loan losses increased due to an increase in loss experience on construction loans. The specific component of the allowance for loan losses increased primarily due to specific allowances on home equity loans and the \$128,000 specific allowance discussed previously.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as conditions change and more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as loss, doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based primarily on historical loss experience. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The Bank reviews its non-homogeneous loans for impairment on a quarterly basis. The Bank considers commercial real estate, construction, multi-family, and commercial loans to be non-homogeneous loans. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the

borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures. Homogeneous loans are those that are considered to have common characteristics that provide for evaluation on an aggregate or pool basis. The Bank considers the characteristics of (1) one- to four-family residential first mortgage loans; (2) unsecured consumer loans; and (3) collateralized consumer loans to permit consideration of the appropriateness of the allowance for losses of each group of loans on a pool basis. The primary methodology used to determine the appropriateness of the allowance for losses includes segregating certain specific, poorly performing loans based on their performance characteristics from the pools of loans as to type, valuing these loans, and then applying a loss factor to the remaining pool balance based on several factors, including past loss experience, inherent risks, and economic conditions in the primary market areas.

In estimating the amount of credit losses inherent in our loan portfolio, various judgments and assumptions are made. For example, when assessing the condition of the overall economic environment, assumptions are made regarding future market conditions and their impact on the loan portfolio. In the event the economy were to sustain a prolonged downturn, the loss factors applied to our portfolios may need to be revised, which may significantly impact the measurement of the allowance for loan losses. For impaired loans that are collateral-dependent, the estimated fair value of the collateral may deviate significantly from the proceeds received when the collateral is sold.

Although we consider the allowance for loan losses of approximately \$2.4 million appropriate and adequate to cover losses inherent in our loan portfolio at September 30, 2006, no assurance can be given that we will not sustain loan losses that are significantly different from the amount provided, or that subsequent evaluations of the loan portfolio, in light of factors then prevailing, including future declines in real estate market conditions, would not result in a significant change in the allowance for loan losses.

**Investment Securities.** Changes in the composition of investment securities held to maturity between September 30, 2006 and December 31, 2005 are presented in the following table (in thousands).

	September 30, 2006	December 31, 2005	Increase (Decrease)
U.S. Government and agency obligations	\$ 44,357	\$ 40,034	\$ 4,323
Municipal securities	16,498	16,661	(163)
Total	<u>\$ 60,855</u>	<u>\$ 56,695</u>	<u>\$ 4,160</u>

During the first nine months of 2006, investment securities totaling \$6.4 million were purchased and \$2.3 matured or were called.

At September 30, 2006, estimated fair values of investment securities held to maturity were as follows (in thousands):

	Amortized Cost	Fair Value
U.S. Government and agency obligations	\$ 44,357	\$ 43,199
Municipal securities	16,498	16,627
Total	<u>\$ 60,855</u>	<u>\$ 59,826</u>

**Accrued Interest Receivable.** The increase in accrued interest receivable was primarily due to an increase in the number of days accrued as well as an increase in the loan yield at September 30, 2006 compared to December 31, 2005.

**Real Estate Acquired in Settlement of Loans, Net.** The increase in real estate acquired in settlement of loans, net, was due to four construction loans foreclosed in the third quarter. See Asset Quality section.

**Deposits.** Changes in the composition of deposits between September 30, 2006 and December 31, 2005 are presented in the following table (dollars in thousands).

	September 30, 2006	December 31, 2005	Increase (Decrease)	Percentage Change
DDA and NOW accounts	\$ 134,143	\$ 125,397	\$ 8,746	7.0%
Money Market accounts	53,816	64,021	(10,205)	(15.9)%
Savings accounts	28,004	30,521	(2,517)	(8.3)%
Certificates of deposit	425,637	391,728	33,909	8.7%
Total deposits	<u>\$ 641,600</u>	<u>\$ 611,667</u>	<u>\$ 29,933</u>	4.9%

Deposits increased in the comparison period primarily due to an increase in public unit accounts, focused marketing efforts to increase checking accounts and the offering of CD specials. During the period, DDA and NOW account balances increased by \$8.7 million and the number of such accounts increased by 3.4%. The Bank will continue to aggressively promote checking accounts by targeting households and small- and medium-sized business accounts with its direct mail campaign and “thank you” gifts. Checking accounts are an attractive source of funds for the Bank as they offer low-interest deposits, fee income potential, and the opportunity to cross-sell other financial services.

Certificates of deposit have continued to increase as interest rates continue to rise. Further, the Bank has advertised several CD products with special rates and terms ranging from 7 to 40 months. The cost of deposit funds increased from 2.85% at December 31, 2005 to 3.51% at September 30, 2006.

**Federal Home Loan Bank Advances.** The Bank was able to use funds from deposit growth to repay FHLB of Dallas advances during the quarter. FHLB advances decreased by \$14.2 million or 9% during the nine months ended September 30, 2006. The balance of advances at September 30, 2006 of \$144.0 million consisted of \$90.0 million of fixed rate advances with an average cost of 4.20% and \$54.0 million of floating rate advances with an average cost of 5.35%.

**Stockholders' Equity.** Stockholders' equity increased \$860,000 from December 31, 2005 to September 30, 2006. The increase in stockholders' equity was primarily due to net income of \$6.0 million and the issuance of treasury stock due to proceeds received from the exercise of stock options of \$906,000, offset by the purchase of treasury stock totaling \$4.7 million during the first nine months of 2006. In addition, during the nine months ended September 30, 2006, cash dividends of \$2.2 million were paid. See the Unaudited Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2006 for more detail.

## Average Balance Sheets

The following table sets forth certain information relating to the Company's average balance sheets and reflects the average yield on assets and average cost of liabilities for the periods indicated and the yields earned and rates paid at September 30, 2006. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods presented and outstanding balances at September 30, 2006. Average balances are based on daily balances during the period.

	September 30, 2006	Three Months Ended September 30,					
		2006			2005		
	Yield/Cost	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
(Dollars in Thousands)							
<b>Interest-earning assets:</b>							
Loans receivable(1)	7.33%	\$ 730,630	\$ 12,627	6.91%	\$ 697,983	\$ 11,150	6.39%
Investment securities(2)	4.89	68,496	835	4.87	63,272	741	4.68
Other interest-earning assets	5.21	16,972	219	5.17	3,079	25	3.29
Total interest-earning assets	7.08	816,098	13,681	6.71	764,334	11,916	6.24
Noninterest-earning assets		62,556			51,215		
Total assets		<u>878,654</u>			<u>\$815,549</u>		
<b>Interest-bearing liabilities:</b>							
Deposits	3.51	635,245	5,449	3.43	588,858	3,742	2.54
FHLB advances	4.63	157,615	1,858	4.72	148,273	1,393	3.76
Total interest-bearing liabilities	3.71	792,860	7,307	3.69	737,131	5,135	2.79
Noninterest-bearing liabilities		6,216			5,354		
Total liabilities		799,076			742,485		
Stockholders' equity		79,578			73,064		
Total liabilities and stockholders' equity		<u>\$ 878,654</u>			<u>\$ 815,549</u>		
Net interest income			<u>\$ 6,374</u>			<u>\$ 6,781</u>	
Net earning assets		<u>\$ 23,238</u>			<u>\$ 27,203</u>		
Interest rate spread	<u>3.37%</u>			<u>3.02%</u>			<u>3.45%</u>
Net interest margin				<u>3.12%</u>			<u>3.55%</u>
Ratio of interest-earning assets to interest-bearing liabilities				<u>102.93%</u>			<u>103.69%</u>
<b>Nine Months Ended September 30,</b>							
		2006			2005		
		Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
(Dollars in Thousands)							
<b>Interest-earning assets:</b>							
Loans receivable(1)		\$ 733,842	\$ 37,703	6.85%	\$ 676,037	\$ 31,300	6.17%
Investment securities(2)		66,917	2,411	4.80	62,097	2,148	4.61
Other interest-earning assets		10,769	393	4.87	2,986	64	2.86
Total interest-earning assets		811,528	40,507	6.66	741,120	33,512	6.03
Noninterest-earning assets		61,233			51,709		
Total assets		<u>872,761</u>			<u>\$ 792,829</u>		
<b>Interest-bearing liabilities:</b>							
Deposits		626,745	14,819	3.15	586,762	10,505	2.39
FHLB advances		161,103	5,378	4.45	126,015	3,345	3.54
Total interest-bearing liabilities		787,848	20,197	3.42	712,777	13,850	2.59
Noninterest-bearing liabilities		6,194			5,227		
Total liabilities		794,042			718,004		
Stockholders' equity		78,719			74,825		
Total liabilities and stockholders' equity		<u>\$ 872,761</u>			<u>\$ 792,829</u>		
Net interest income			<u>\$ 20,310</u>			<u>\$ 19,662</u>	
Net earning assets		<u>\$ 23,680</u>			<u>\$ 28,343</u>		
Interest rate spread				<u>3.24%</u>			<u>3.44%</u>
Net interest margin				<u>3.34%</u>			<u>3.54%</u>
Ratio of interest-earning assets to interest-bearing liabilities				<u>103.01%</u>			<u>103.98%</u>

(1) Includes nonaccrual loans.

(2) Includes FHLB of Dallas stock.

## Rate/Volume Analysis

The table below sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (changes in average volume multiplied by prior rate); (ii) changes in rate (change in rate multiplied by prior average volume); (iii) changes in rate-volume (changes in rate multiplied by the change in average volume); and (iv) the net change.

	Three Months Ended September 30, 2006 vs. 2005			
	Increase (Decrease)			
	Due to			
	Volume	Rate	Rate/ Volume	Total Increase (Decrease)
(In Thousands)				
Interest income:				
Loans receivable	\$ 522	\$ 913	\$ 42	\$ 1,477
Investment securities	61	30	3	94
Other interest-earning assets	114	14	66	194
Total interest-earning assets	<u>697</u>	<u>957</u>	<u>111</u>	<u>1,765</u>
Interest expense:				
Deposits	295	1,309	103	1,707
FHLB advances	88	355	22	465
Total interest-bearing liabilities	<u>383</u>	<u>1,664</u>	<u>125</u>	<u>2,172</u>
Net change in net interest income	<u>\$ 314</u>	<u>\$ (707)</u>	<u>\$ (14)</u>	<u>\$ (407)</u>
	Nine Months Ended September 30, 2006 vs. 2005			
	Increase (Decrease)			
	Due to			
	Volume	Rate	Rate/ Volume	Total Increase
(In Thousands)				
Interest income:				
Loans receivable	\$ 2,676	\$ 3,434	\$ 293	\$ 6,403
Investment securities	167	89	7	263
Other interest-earning assets	167	45	117	329
Total interest-earning assets	<u>3,010</u>	<u>3,568</u>	<u>417</u>	<u>6,995</u>
Interest expense:				
Deposits	716	3,369	229	4,314
FHLB advances	931	862	240	2,033
Total interest-bearing liabilities	<u>1,647</u>	<u>4,231</u>	<u>469</u>	<u>6,347</u>
Net change in net interest income	<u>\$ 1,363</u>	<u>\$ (663)</u>	<u>\$ (52)</u>	<u>\$ 648</u>

## CHANGES IN RESULTS OF OPERATIONS

The table below presents a comparison of results of operations for the three months ended September 30, 2006 and 2005 (dollars in thousands). Specific changes in captions are discussed in the sections which follow the table.

	Three Months Ended September 30,		Increase (Decrease) 2006 vs 2005	Percentage Change 2006 vs 2005
	2006	2005		
Interest income:				
Loans receivable	\$ 12,627	\$ 11,150	\$ 1,477	13.2%
Investment securities	835	741	94	12.7%
Other	219	25	194	776.0%
Total interest income	13,681	11,916	1,765	14.8%
Interest expense:				
Deposits	5,449	3,742	1,707	45.6%
Other borrowings	1,858	1,393	465	33.4%
Total interest expense	7,307	5,135	2,172	42.3%
Net interest income before provision for loan losses	6,374	6,781	(407)	(6.0)%
Provision for loan losses	484	285	199	69.8%
Net interest income after provision for loan losses	5,890	6,496	(606)	(9.3)%
Noninterest income:				
Deposit fee income	1,264	1,193	71	6.0%
Gain on sale of loans	252	195	57	29.2%
Other	514	430	84	19.5%
Total noninterest income	2,030	1,818	212	11.7%
Noninterest expenses:				
Salaries and employee benefits	3,195	3,256	(61)	(1.9)%
Net occupancy expense	613	532	81	15.2%
Advertising and public relations	342	318	24	7.6%
Other	1,316	1,207	109	9.0%
Total noninterest expenses	5,466	5,313	153	2.9%
Income before income taxes	2,454	3,001	(547)	(18.2)%
Provision for income taxes	754	965	(211)	(21.9)%
Net income	\$ 1,700	\$ 2,036	\$ (336)	(16.5)%
Basic earnings per share	\$ 0.34	\$ 0.41	\$ (0.07)	(17.1)%
Diluted earnings per share	\$ 0.33	\$ 0.39	\$ (0.06)	(15.4)%
Interest rate spread	3.02%	3.45%		
Net interest margin	3.12%	3.55%		
Average full-time equivalents	305	276		
Full-service offices	18	16		

The table below presents a comparison of results of operations for the nine months ended September 30, 2006 and 2005 (dollars in thousands). Specific changes in captions are discussed in the sections which follow the table.

	Nine Months Ended September 30,		Increase (Decrease)	Percentage Change
	2006	2005	2006 vs 2005	2006 vs 2005
Interest income:				
Loans receivable	\$ 37,703	\$ 31,300	\$ 6,403	20.5%
Investment securities	2,411	2,148	263	12.2%
Other	393	64	329	514.1%
Total interest income	40,507	33,512	6,995	20.9%
Interest expense:				
Deposits	14,819	10,505	4,314	41.1%
Other borrowings	5,378	3,345	2,033	60.8%
Total interest expense	20,197	13,850	6,347	45.8%
Net interest income before provision for loan losses	20,310	19,662	648	3.3%
Provision for loan losses	1,128	820	308	37.6%
Net interest income after provision for loan losses	19,182	18,842	340	1.8%
Noninterest income:				
Deposit fee income	3,579	3,307	272	8.2%
Gain on sale of loans	727	511	216	42.3%
Other	2,126	1,293	833	64.4%
Total noninterest income	6,432	5,111	1,321	25.9%
Noninterest expenses:				
Salaries and employee benefits	10,174	9,272	902	9.7%
Net occupancy expense	1,784	1,537	247	16.1%
Advertising and public relations	982	801	181	22.6%
Other	3,927	3,578	349	9.8%
Total noninterest expenses	16,867	15,188	1,679	11.1%
Income before income taxes	8,747	8,765	(18)	(.2)%
Provision for income taxes	2,787	2,815	(28)	(1.0)%
Net income	\$ 5,960	\$ 5,950	\$ 10	.2%
Basic earnings per share	\$ 1.19	\$ 1.19	\$ 0.00	0.0%
Diluted earnings per share	\$ 1.16	\$ 1.14	\$ 0.02	1.8%
Interest rate spread	3.24%	3.44%		
Net interest margin	3.34%	3.54%		
Average full-time equivalents	306	261		
Full-service offices	18	16		

**Net Interest Income.** Net interest income is determined by the Company's interest rate spread (i.e., the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities.

## **INTEREST INCOME AND INTEREST EXPENSE**

Dollar changes in interest income and interest expense for the comparison periods are presented in the Rate/Volume Analysis table which appears on a previous page.

**Interest Income.** The increase in interest income for the three and nine month comparative periods was primarily due to an increase in the average balance of loans, an increase in the average yield earned on loans, an increase in the average balance of other interest-earning assets, and an increase in the average yield earned on other interest-earning assets. The increase in the average yield earned on loans was due to increased rates on new loans, particularly construction loans, in conjunction with recent increases in market interest rates. The average balance of loans increased primarily due to an increase in the average balance of construction loans. The average balance of other interest-earning assets increased due to an increase in the average balance of our FHLB demand deposit account, which occurred primarily as a result of funds generated from the increase in deposits. The average yield earned on other interest-earning assets increased due to increases in market interest rates.

**Interest Expense.** The increase in interest expense for the three and nine month comparative periods was primarily due to an increase in the average rates paid on deposits and FHLB advances as well as an increase in the average balances of deposits and FHLB advances. The increase in the average rates paid on deposit accounts reflects both the shift in deposits from money market accounts to higher rate certificates of deposit as well as increases in market interest rates. The rates paid on FHLB advances increased due to increases in market interest rates. The average balance of deposits increased due to growth in certificates of deposit. The average balance of FHLB advances increased due to the use of advances to fund loan growth.

**Provision for Loan Losses.** The provision for loan losses includes charges to maintain an allowance for loan losses adequate to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio that have been incurred as of the balance sheet date. Such provision and the adequacy of the allowance for loan losses is evaluated quarterly by management of the Bank based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral and current economic conditions.

The increase in the provision for loan losses in the three and nine month comparative periods was due primarily to an increase in loss experience on construction loans, specific allowances on home equity loans and an increase in specific loan loss allowances on commercial loans. The chargeoffs and net gains/losses on sales of speculative real estate owned have been taken into consideration in estimating the general loan loss allowance on speculative construction loans and as a result, the loss rate used for that portion of the portfolio has been increased during the quarter.

**Noninterest Income.** Deposit fee income increased for both the three and nine month comparative periods as a result of the Bank's continued promotion of Bounce Protection<sup>TM</sup> overdraft service as well as an increase in the number of checking accounts. The number of checking accounts increased approximately 4.3% from September 30, 2005 to September 30, 2006. The Bank will continue to aggressively promote checking accounts through direct mail campaigns to expand its checking accounts and increase deposit fee income.

Gain on sale of loans increased for the three and nine month comparative period due to an increase in volume of loans sold.

The increase in other noninterest income for the nine month comparative period was primarily due to nonrecurring gains on the sales of two properties totaling approximately \$528,000 during the first quarter of 2006. These properties represented excess land and a building adjacent to two existing branches.

## Noninterest Expense

**Salaries and Employee Benefits.** The changes in the composition of this line item are presented below (in thousands):

	Three Months Ended September 30,		Increase (Decrease)	Nine Months Ended September 30,		Increase (Decrease)
	2006	2005	2006 vs 2005	2006	2005	2006 vs 2005
Salaries	\$ 2,495	\$ 2,187	\$ 308	\$ 7,620	\$ 6,187	\$ 1,433
Payroll taxes	194	174	20	662	582	80
Insurance	173	161	12	517	461	56
ESOP (1)	--	502	(502)	508	1,478	(970)
401(k)	72	--	72	94	--	94
Stock compensation (2)	12	7	5	54	20	34
Defined benefit plan contribution	210	186	24	603	431	172
Other	39	39	--	116	113	3
Total	\$ 3,195	\$ 3,256	\$ (61)	\$ 10,174	\$ 9,272	\$ 902

(1) Employee Stock Ownership Plan

(2) Includes stock options and Management Recognition and Retention Plan ("MRP") expense.

The increases in salaries for the three and nine months ended September 30, 2006 compared to the same periods in 2005 were due primarily to an increase in the number of employees and normal salary and merit increases. Payroll taxes increased during the periods due to the increase in salaries. The decreases in employee stock ownership plan expense during the three and nine month comparative periods were due to the plan shares becoming fully allocated as of March 31, 2006. Defined benefit plan expense increased due to an increase in the required contribution to our multi-employer plan primarily resulting from an increase in amortization cost.

The Company implemented a 401(k) Plan on June 1, 2006. Employer matching of employee 401(k) contributions averages approximately 3% of salary expense.

**Net Occupancy Expense.** Net occupancy expense increased in the three and nine month periods ended September 30 due to the opening of two new branches since the third quarter of 2005.

**Advertising and Public Relations.** Advertising and public relations increased for the three and nine months ended September 30, 2006, compared to the same periods in 2005, primarily due to expenses associated with grand openings of branches during the first quarter of 2006.

**Other Expenses.** Other expenses increased in the three and nine month comparative periods primarily due to increases in loan-related expenses, REO-related expenses, and consulting fees. Loan expenses increased primarily due to secondary market-related loan expenses resulting from increased secondary market loan volume. REO-related expenses increased primarily due to losses on sales of REO and delinquent taxes paid in connection with sales of REO. Consulting fees increased due to fees paid to third party providers for internal control self-assessment and implementation of new software.

**Income Taxes.** Income tax expense for the three month and nine month comparable periods ended September 30 decreased primarily due to decreases in taxable income in each of the periods.

## OFF-BALANCE SHEET ARRANGEMENTS

The Company, in the normal course of business, makes commitments to buy or sell assets or to incur or fund liabilities. Commitments include, but are not limited to:

- the origination, purchase or sale of loans;
- the fulfillment of commitments under letters-of-credit, extensions of credit on home equity lines of credit, construction loans, and predetermined overdraft protection limits; and
- the commitment to fund withdrawals of certificates of deposit at maturity.

At September 30, 2006, the Bank's off-balance sheet arrangements principally included lending commitments, which are described below. At September 30, 2006, the Company had no interests in non-consolidated special purpose entities.

At September 30, 2006, commitments included:

- total approved commitments to originate loans amounting to \$7.4 million, including \$3.3 million of loans committed to sell;
- rate lock agreements with customers of \$7.8 million, all of which have been locked with an investor;
- funded mortgage loans committed to sell of \$2.4 million;
- unadvanced portion of construction loans of \$44.3 million;
- unused lines of credit of \$32.6 million;
- outstanding standby letters of credit of approximately \$4.0 million;
- total predetermined overdraft protection limits of \$11.7 million; and
- certificates of deposit scheduled to mature in one year or less totaling \$314.5 million.

Total unfunded commitments to originate loans for sale and the related commitments to sell of \$3.3 million meet the definition of a derivative financial instrument. The related asset and liability are considered immaterial at September 30, 2006.

Historically, a very small percentage of predetermined overdraft limits have been used. At September 30, 2006, overdrafts of accounts with Bounce Protection<sup>TM</sup> represented usage of 2.5% of the limit. We expect utilization of these overdraft limits to remain at comparable levels in the future.

Based on historical experience, management believes that a significant portion of maturing deposits will remain with the Bank. We anticipate that we will continue to have sufficient funds, through repayments, deposits and borrowings, to meet our current commitments.

## LIQUIDITY AND CAPITAL RESOURCES

The Bank's liquidity, represented by cash and cash equivalents and eligible investment securities, is a product of its operating, investing and financing activities. The Bank's primary sources of funds are deposits, borrowings, collections on outstanding loans, maturities and calls of investment securities and other short-term investments and funds provided from operations. While scheduled loan amortization and maturing investment securities and short-term investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank manages the pricing of its deposits to maintain a steady deposit balance. In addition, the Bank invests excess funds in overnight deposits and other short-term interest-earning assets which provide liquidity to meet lending requirements. At September 30, 2006, available borrowing capacity with the FHLB was in excess of \$168.5 million.

Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments such as overnight deposits and certificates of deposit. On a longer-term basis, the Bank maintains a strategy of investing in various lending products. The Bank uses its sources of funds primarily to meet its ongoing commitments, to pay maturing savings certificates and savings withdrawals, to repay maturing FHLB of Dallas advances, and to fund loan commitments.

As of September 30, 2006, the Bank's regulatory capital was in excess of all applicable regulatory requirements. At September 30, 2006, the Bank's tangible, core and risk-based capital ratios amounted to 8.89%, 8.89% and 12.12%, respectively, compared to regulatory requirements of 1.5%, 4.0% and 8.0%, respectively.

## **IMPACT OF INFLATION AND CHANGING PRICES**

The financial statements and related financial data presented herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars, without considering changes in relative purchasing power over time due to inflation.

Unlike most industrial companies, virtually all of the Bank's assets and liabilities are monetary in nature. As a result, interest rates generally have a more significant impact on a financial institution's performance than does the effect of inflation.

## **FORWARD-LOOKING STATEMENTS**

The Company's Quarterly Report on Form 10-Q contains certain forward-looking statements and information relating to the Company that are based on the beliefs of management as well as assumptions made by and information currently available to management. In addition, in this document, the words "anticipate", "believe," "estimate," "expect," "intend," "should" and similar expressions, or the negative thereof, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future looking events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected or intended. The Company does not intend to update these forward-looking statements.

## **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There has been no material change in the market value of the Bank's portfolio equity since December 31, 2005. Similarly, while there has been no material change in the Company's asset and liability position since such time, the Bank's negative gap position has adversely impacted net income as interest expense during the nine months ended September 30, 2006 increased at a greater pace than the comparable increase in interest income. Correspondingly, the Bank's net interest margin decreased from 3.54% for the nine months ended September 30, 2005 to 3.34% for the same period in 2006. Based on the current market interest rate environment and increased competition, management anticipates continued pressure on the Bank's interest rate spread and interest margin for the fourth quarter of 2006.

## **CONTROLS AND PROCEDURES**

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e)) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f)) under the Securities Exchange Act) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. However, in the third quarter of 2006, the Company converted to a new general ledger system. This conversion did not have a material affect on our internal control over financial reporting.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**

**Part II**

Item 1. Legal Proceedings

Neither the Company nor the Bank is involved in any pending legal proceedings other than non-material legal proceedings occurring in the ordinary course of business.

Item 1A. Risk Factors

There have been no material changes in the Company's risk factors from those previously disclosed in the Company's Form 10-K for the year ended December 31, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, to July 31, 2006	--	--	--	--
August 1, to August 31, 2006	10,000	\$22.72	10,000	101,084
September 1, to September 31, 2006	48,763	\$24.05	48,763	52,321

The Company is in its 18th announced repurchase program, which was approved by the board of directors on July 28, 2005, and publicly announced on December 2, 2005. Total shares approved to be purchased in this program are 248,316 of which 195,995 have been purchased as of September 30, 2006.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit 31.1 – Certification of Chief Executive Officer,  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)

Exhibit 31.2 – Certification of Chief Financial Officer,  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)

Exhibit 32.1 – Certification of Chief Executive Officer,  
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)

Exhibit 32.2 – Certification of Chief Financial Officer,  
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**

Date: October 26, 2006

By: /s/Larry J. Brandt  
Larry J. Brandt  
Chief Executive Officer

Date: October 26, 2006

By: /s/Sherri R. Billings  
Sherri R. Billings  
Chief Financial Officer and  
Chief Accounting Officer

**PURSUANT TO RULES 13a-14 AND 15d-14 OF THE SECURITIES EXCHANGE ACT OF 1934 AND  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002  
CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER**

I, Larry J. Brandt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Federal Bancshares of Arkansas, Inc. (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: October 26, 2006

/s/ Larry J. Brandt  
Larry J. Brandt  
Chief Executive Officer

**PURSUANT TO RULES 13a-14 AND 15d-14 OF THE SECURITIES EXCHANGE ACT OF 1934 AND  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002  
CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Sherri R. Billings, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Federal Bancshares of Arkansas, Inc. (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15e and 15d-15e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: October 26, 2006

/s/ Sherri R. Billings

Sherri R. Billings  
Chief Financial Officer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)**

The undersigned executive officer of First Federal Bancshares of Arkansas, Inc. (the "Registrant") hereby certifies that the Registrant's Form 10-Q for the three and nine months ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained therein fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/Larry J. Brandt  
Larry J. Brandt  
Chief Executive Officer

Date: October 26, 2006

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350)**

The undersigned executive officer of First Federal Bancshares of Arkansas, Inc. (the "Registrant") hereby certifies that the Registrant's Form 10-Q for the three and nine months ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained therein fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/Sherri R. Billings  
Sherri R. Billings  
Chief Financial Officer

Date: October 26, 2006