

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 June 30, 2008

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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer   
Non-accelerated Filer  Smaller reporting company

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 July 21, 2008, there were issued and outstanding 4,848,385 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)

	June 30, 2008	December 31, 2007
<b>ASSETS</b>		
Cash and cash equivalents	\$ 42,370	\$ 27,387
Investment securities held to maturity	127,864	95,590
Federal Home Loan Bank stock	4,779	4,433
Loans receivable, net	570,135	601,256
Accrued interest receivable	7,923	9,042
Real estate owned, net	20,429	8,120
Office properties and equipment, net	24,953	24,263
Cash surrender value of life insurance	20,012	20,159
Prepaid expenses and other assets	2,021	1,728
<b>TOTAL ASSETS</b>	<b>\$ 820,486</b>	<b>\$ 791,978</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits	\$ 638,090	\$ 630,414
Federal Home Loan Bank advances	104,100	82,087
Advance payments by borrowers for taxes and insurance	433	575
Other liabilities	3,599	5,239
Total liabilities	746,222	718,315
<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, 4,848,385 and 4,844,385 shares outstanding at June 30, 2008 and December 31, 2007, respectively	103	103
Additional paid-in capital	56,647	56,653
Employee stock benefit plans	(32)	(42)
Retained earnings-substantially restricted	88,145	87,600
	144,863	144,314
Treasury stock, at cost, 5,459,117 and 5,463,117 shares at June 30, 2008 and December 31, 2007, respectively	(70,599)	(70,651)
Total stockholders' equity	74,264	73,663
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 820,486</b>	<b>\$ 791,978</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		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
<b>INTEREST INCOME:</b>				
Loans receivable	\$ 9,520	\$ 12,004	\$ 19,495	\$ 24,205
Investment securities:				
Taxable	1,645	712	2,852	1,367
Nontaxable	190	178	376	359
Other	112	302	280	490
Total interest income	<u>11,467</u>	<u>13,196</u>	<u>23,003</u>	<u>26,421</u>
<b>INTEREST EXPENSE:</b>				
Deposits	4,779	6,044	10,347	11,892
Other borrowings	879	1,106	1,782	2,366
Total interest expense	<u>5,658</u>	<u>7,150</u>	<u>12,129</u>	<u>14,258</u>
<b>NET INTEREST INCOME</b>	5,809	6,046	10,874	12,163
<b>PROVISION FOR LOAN LOSSES</b>	971	370	2,499	2,332
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<u>4,838</u>	<u>5,676</u>	<u>8,375</u>	<u>9,831</u>
<b>NONINTEREST INCOME:</b>				
Deposit fee income	1,344	1,269	2,555	2,426
Earnings on life insurance policies	191	184	1,562	373
Gain on sale of loans	91	237	266	463
Other	422	271	870	559
Total noninterest income	<u>2,048</u>	<u>1,961</u>	<u>5,253</u>	<u>3,821</u>
<b>NONINTEREST EXPENSES:</b>				
Salaries and employee benefits	3,244	3,287	6,632	6,729
Net occupancy expense	645	569	1,285	1,193
Real estate owned, net	269	121	698	282
Data processing	370	351	688	805
Professional fees	142	142	272	282
Advertising and public relations	218	251	560	610
Postage and supplies	182	184	421	459
Other	578	556	1,164	1,166
Total noninterest expenses	<u>5,648</u>	<u>5,461</u>	<u>11,720</u>	<u>11,526</u>
<b>INCOME BEFORE INCOME TAXES</b>	1,238	2,176	1,908	2,126
<b>INCOME TAX PROVISION (BENEFIT)</b>	229	642	(188)	433
<b>NET INCOME</b>	<u>\$ 1,009</u>	<u>\$ 1,534</u>	<u>\$ 2,096</u>	<u>\$ 1,693</u>
<b>EARNINGS PER SHARE:</b>				
Basic	<u>\$ 0.21</u>	<u>\$ 0.32</u>	<u>\$ 0.43</u>	<u>\$ 0.35</u>
Diluted	<u>\$ 0.21</u>	<u>\$ 0.32</u>	<u>\$ 0.43</u>	<u>\$ 0.35</u>
Cash Dividends Declared	<u>\$ 0.16</u>	<u>\$ 0.16</u>	<u>\$ 0.32</u>	<u>\$ 0.32</u>

See notes to unaudited consolidated financial statements.

**FIRST FEDERAL BANCSHARES OF ARKANSAS, INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2008**

(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 (Substantially Restricted)</u>
	<u>Shares</u>	<u>Amount</u>			
Balance, January 1, 2008	10,307,502	\$ 103	\$ 56,653	\$ (42)	\$ 87,600
Net income					2,096
Tax effect of stock compensation plan			(2)		
Treasury shares reissued due to exercise of stock options			(6)		
Stock compensation expense			2	10	
Dividends paid					(1,551)
Balance, June 30, 2008	<u>10,307,502</u>	<u>\$ 103</u>	<u>\$ 56,647</u>	<u>\$ (32)</u>	<u>\$ 88,145</u>

	<u>Treasury Stock</u>		<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>	
Balance, January 1, 2008	5,463,117	\$ (70,651)	\$ 73,663
Net income			2,096
Tax effect of stock compensation plan			(2)
Treasury shares reissued due to exercise of stock options	(4,000)	52	46
Stock compensation expense			12
Dividends paid			(1,551)
Balance, June 30, 2008	<u>5,459,117</u>	<u>\$ (70,599)</u>	<u>\$ 74,264</u>

See notes to unaudited consolidated financial statements.

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

(In Thousands)  
(Unaudited)

	Six Months Ended June 30,	
	2008	2007
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 2,096	\$ 1,693
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,499	2,332
Provision for real estate losses	316	77
Deferred tax benefit	(83)	(1,006)
Accretion of discounts on investment securities, net	(50)	(12)
Federal Home Loan Bank stock dividends	(85)	(179)
Gain on disposition of office properties and equipment	(19)	(5)
Loss on sale of repossessed assets, net	28	51
Originations of loans held for sale	(17,336)	(35,468)
Proceeds from sales of loans held for sale	19,069	33,138
Gain on sale of loans originated to sell	(265)	(354)
Depreciation	726	701
Amortization of deferred loan fees, net	179	220
Stock compensation expense	12	24
Earnings on life insurance policies	(382)	(373)
Changes in operating assets and liabilities:		
Accrued interest receivable	1,119	(1,055)
Prepaid expenses and other assets	333	960
Other liabilities	351	350
Net cash provided by operating activities	8,508	1,094
<b>INVESTING ACTIVITIES:</b>		
Purchases of investment securities held to maturity	(96,693)	(15,439)
Proceeds from maturities/calls of investment securities held to maturity	62,474	5,050
Federal Home Loan Bank stock purchased	(261)	--
Federal Home Loan Bank stock redeemed	--	2,404
Loan participations sold	4,045	7,208
Loan participations purchased	(1,147)	--
Net loan repayments	10,672	38,608
Proceeds from sales of repossessed assets	1,001	1,738
Improvements to real estate owned	(261)	(343)
Proceeds from sales of office properties and equipment	30	10
Purchases of office properties and equipment	(1,427)	(1,013)
Net cash provided by (used in) investing activities	(21,567)	38,223
<b>FINANCING ACTIVITIES:</b>		
Net increase (decrease) in deposits	7,676	(4,073)
Advances from FHLB	51,500	4,000
Repayment of advances from FHLB	(29,487)	(32,489)
Net decrease in advance payments by borrowers for taxes and insurance	(142)	(322)
Purchase of treasury stock	--	(1,998)
Reissued treasury stock	46	324
Dividends paid	(1,551)	(1,557)
Net cash provided by (used in) financing activities	28,042	(36,115)
Net increase in cash and cash equivalents	14,983	3,202

(Continued)

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

(In Thousands)  
(Unaudited)

	Six Months Ended June 30,	
	2008	2007
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	\$ 27,387	\$ 35,518
End of period	\$ 42,370	\$ 38,720
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid for:		
Interest	\$ 12,244	\$ 14,516
Income taxes	\$ --	\$ 236
<b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING ACTIVITIES:</b>		
Real estate and other assets acquired in settlement of loans	\$ 16,369	\$ 5,005
Loans to facilitate sales of real estate owned	\$ 2,964	\$ 252
Investment securities traded, recorded in investments not yet settled in cash	\$ 1,195	\$ 3,070

(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 material intercompany transactions have been eliminated in consolidation.

The results of operations for the three and six months ended June 30, 2008, are not necessarily indicative of the results to be expected for the year ending December 31, 2008. 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, 2007, contained in the Company's 2007 Annual Report to Stockholders.

#### **Note 2 – Recently Adopted Accounting Standards**

We adopted Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements*, as of January 1, 2008. See Note 6.

We adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, as of January 1, 2008 and have elected not to measure any of our current eligible financial assets or liabilities at fair value upon adoption; however, we may elect to measure future eligible financial assets or liabilities at fair value.

#### **Note 3 – Accounting Standards Issued Not Yet Effective**

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*. The objective of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this statement establishes principles and requirements for how the acquirer:

- a. Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- b. Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- c. Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. Based on our current activities, we estimate that the adoption of this statement will not have a material effect on the financial statements of the Company.

In March 2008, the FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities*, effective for financial statements issued for fiscal years beginning after November 15, 2008. The objective of this statement is to provide enhanced disclosures about derivative instruments and related hedging items. Based on the Bank's current activities, we estimate that the adoption of this statement will not have a material effect on the financial statements of the Company.

**Note 4 - Earnings per Share**

The weighted average number of common shares used to calculate earnings per share for the periods ended June 30, 2008 and 2007 were as follows:

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Basic weighted - average shares	4,848,385	4,868,377	4,848,341	4,869,112
Effect of dilutive securities	1,091	16,140	1,748	27,271
Diluted weighted - average shares	<u>4,849,476</u>	<u>4,884,517</u>	<u>4,850,089</u>	<u>4,896,383</u>

**Note 5 – Allowances for Loan and Real Estate Losses**

A summary of the activity in the allowances for loan and real estate losses is as follows for the quarters ended June 30 (in thousands):

	Three Months Ended June 30, 2008		Three Months Ended June 30, 2007	
	Loans	Real Estate	Loans	Real Estate
Balance—beginning of period	\$ 6,107	\$ --	\$ 4,294	\$ --
Provisions for estimated losses	971	87	370	3
Recoveries	58	--	39	--
Losses charged off	(1,921)	(87)	(412)	(3)
Balance—end of period	<u>\$ 5,215</u>	<u>\$ --</u>	<u>\$ 4,291</u>	<u>\$ --</u>

	Six Months Ended June 30, 2008		Six Months Ended June 30, 2007	
	Loans	Real Estate	Loans	Real Estate
Balance—beginning of period	\$ 5,162	\$ --	\$ 2,572	\$ --
Provisions for estimated losses	2,499	316	2,332	77
Recoveries	194	--	88	--
Losses charged off	(2,640)	(316)	(701)	(77)
Balance—end of period	<u>\$ 5,215</u>	<u>\$ --</u>	<u>\$ 4,291</u>	<u>\$ --</u>

## **Note 6 – Fair Value Measurement**

Effective January 1, 2008, the Bank adopted SFAS 157, which provides a framework for measuring fair value. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1 Unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.
- Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data at the measurement date for substantially the full term of the assets or liabilities.
- Level 3 Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The assets presented at fair value on the Bank's financial statements are related to real estate owned, net, and impaired loans, both of which are valued based on Level 3 inputs. Management utilizes appraisals, listing prices, market information from local realtors and market research reports to base the fair value measurement.

The table below presents a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3):

	December 31, 2007	Additions	Fair Value Adjustments	Transfers Out	Gain (Loss)	June 30, 2008
			(in thousands)			
Real estate owned, net	\$ 8,120	\$ 18,867	\$ (2,458)	\$ (4,085)	\$ (15)	\$ 20,429
Impaired loans	\$ 14,894	\$ 1,088	\$ (515)	\$ (8,970)	\$ --	\$ 6,497

Realized and unrealized gains and losses on real estate owned are recognized in noninterest expenses in the consolidated statements of income under the caption "Real estate owned, net." Gains on sales of real estate owned which are financed by the Bank are deferred in certain circumstances and recognized as the borrower pays down the related loan. Fair value adjustments to impaired loans are recorded through the allowance for loan losses.

**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, valuation of real estate owned and the methodology for the determination of our allowance for loan losses, due to the judgments, estimates and assumptions inherent in those policies, are critical to preparation of our financial statements. These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis and in the notes to the unaudited financial statements included herein. 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 these critical accounting policies, 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 and for real estate owned, 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 June 30, 2008 and December 31, 2007 are presented in the following table (dollars in thousands). Material changes between the periods are discussed in the sections which follow the table.

	June 30, 2008	December 31, 2007	Increase (Decrease)	Percentage Change
<b>ASSETS</b>				
Cash and cash equivalents	\$ 42,370	\$ 27,387	\$ 14,983	54.7%
Investment securities held to maturity	127,864	95,590	32,274	33.8
Federal Home Loan Bank stock	4,779	4,433	346	7.8
Loans receivable, net	570,135	601,256	(31,121)	(5.2)
Accrued interest receivable	7,923	9,042	(1,119)	(12.4)
Real estate owned, net	20,429	8,120	12,309	151.6
Office properties and equipment, net	24,953	24,263	690	2.8
Prepaid expenses and other assets	22,033	21,887	146	0.7
<b>TOTAL</b>	<b>\$ 820,486</b>	<b>\$ 791,978</b>	<b>\$ 28,508</b>	<b>3.6%</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
<b>LIABILITIES:</b>				
Deposits	\$ 638,090	\$ 630,414	\$ 7,676	1.2%
Federal Home Loan Bank advances	104,100	82,087	22,013	26.8
Other liabilities	4,032	5,814	(1,782)	(30.7)
Total liabilities	746,222	718,315	27,907	3.9
<b>STOCKHOLDERS' EQUITY</b>	<b>74,264</b>	<b>73,663</b>	<b>601</b>	<b>0.8</b>
<b>TOTAL</b>	<b>\$ 820,486</b>	<b>\$ 791,978</b>	<b>\$ 28,508</b>	<b>3.6%</b>
<b>BOOK VALUE PER SHARE</b>	<b>\$ 15.32</b>	<b>\$ 15.21</b>		
<b>EQUITY TO ASSETS</b>	<b>9.1%</b>	<b>9.3%</b>		

**Loans Receivable.** Changes in loan composition between June 30, 2008 and December 31, 2007 are presented in the following table (dollars in thousands).

	June 30, 2008	December 31, 2007	Increase (Decrease)	% Change
One- to four-family residences	\$ 229,481	\$ 230,005	\$ (524)	(0.2)%
Home equity lines of credit and second mortgage	33,631	34,315	(684)	(2.0)
Multifamily	18,170	15,616	2,554	16.4
Commercial real estate	114,570	117,548	(2,978)	(2.5)
Land	43,471	42,843	628	1.5
Construction:				
One- to four-family residences	15,046	20,815	(5,769)	(27.7)
Speculative one-to four-family residences	26,217	40,893	(14,676)	(35.9)
Multifamily	18,505	18,632	(127)	(0.7)
Commercial real estate	16,941	31,239	(14,298)	(45.8)
Land development	32,389	42,145	(9,756)	(23.1)
Total construction loans	<u>109,098</u>	<u>153,724</u>	<u>(44,626)</u>	<u>(29.0)</u>
Total mortgage loans	<u>548,421</u>	<u>594,051</u>	<u>(45,630)</u>	<u>(7.7)</u>
Commercial	<u>24,808</u>	<u>24,846</u>	<u>(38)</u>	<u>(0.2)</u>
Automobile	9,140	9,531	(391)	(4.1)
Other	<u>13,284</u>	<u>14,537</u>	<u>(1,253)</u>	<u>(8.6)</u>
Total consumer	<u>22,424</u>	<u>24,068</u>	<u>(1,644)</u>	<u>(6.8)</u>
Total loans receivable	595,653	642,965	(47,312)	(7.4)
Undisbursed loan funds	(20,768)	(36,868)	16,100	(43.7)
Deferred loan costs – net	465	321	144	44.9
Allowance for loan losses	<u>(5,215)</u>	<u>(5,162)</u>	<u>(53)</u>	<u>1.0</u>
Loans receivable, net	<u>\$ 570,135</u>	<u>\$ 601,256</u>	<u>\$ (31,121)</u>	<u>(5.2)%</u>

The decrease in the Bank's loan portfolio was primarily due to the continued softening of the housing market in the Bank's market area. Market data indicates an overall decrease in home sales in Benton and Washington counties in 2008 and 2007. The Bank's loan originations were down 4.1% for the quarter ended June 30, 2008, compared to the second quarter of 2007 and 13.2% for the six months ended June 30, 2008 compared to the first six months in 2007. Although the Northwest Arkansas region continues to experience job market and population growth, the supply of new residential lots and new speculative homes for sale has outpaced demand during the past several years. We expect this trend to continue for the foreseeable future given the level of oversupply in the market.

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

	June 30, 2008	December 31, 2007	Increase (Decrease)	Percentage Change
	(Dollars in Thousands)			
Nonaccrual loans:				
One- to four-family residential	\$ 7,105	\$ 6,800	\$ 305	4.5%
Home equity and second mortgage	904	1,194	(290)	(24.3)
Speculative one- to four-family construction	1,765	4,934	(3,169)	(64.2)
Land development	2,565	11,428	(8,863)	(77.6)
Land	2,156	1,311	845	64.5
Commercial real estate	4,534	4,027	507	12.6
Commercial loans	2,609	3,367	(758)	(22.5)
Consumer loans	212	268	(56)	(20.9)
Total nonaccrual loans	<u>21,850</u>	<u>33,329</u>	<u>(11,479)</u>	<u>(34.4)</u>
Accruing loans 90 days or more past due	2,798	2,412	386	16.0
Real estate owned	<u>20,429</u>	<u>8,120</u>	<u>12,309</u>	<u>151.6</u>
Total nonperforming assets	<u>\$ 45,077</u>	<u>\$ 43,861</u>	<u>\$ 1,216</u>	<u>2.8%</u>
Total nonaccrual and accruing loans 90 days or more past due as a percentage of total loans receivable	<u>4.14%</u>	<u>5.56%</u>		
Total nonperforming assets as a percentage of total assets	<u>5.49%</u>	<u>5.54%</u>		

The decrease in nonaccrual loans is primarily related to the transfer of nonaccrual land development and speculative single family construction loans to real estate owned, which was offset somewhat by an increase in nonaccrual land loans and commercial real estate loans. The Northwest Arkansas market continues to experience an oversupply of lots and speculative homes. Certain of the Bank's homebuilders are experiencing extended marketing times for the sale of their homes which has resulted in inadequate cash flow to service the interest carry on their loans. The specific loan loss allowance related to loans to builders and developers was approximately \$1.5 million at June 30, 2008.

We expect a significant amount of the nonaccrual real estate loans to eventually migrate to real estate owned as \$10.2 million of the nonaccrual real estate loans reported above are in some stage of the foreclosure process as of June 30, 2008. Therefore, we expect real estate owned and associated expenses to continue to increase in future periods as such loans migrate from loans to real estate owned.

The level of nonaccrual speculative construction loans, land development loans and commercial real estate loans is attributable primarily to four loan relationships totaling \$8.0 million, or 37% of nonaccrual loans. These relationships are described in more detail in the paragraphs that follow.

The first relationship totaled \$2.2 million with a specific loan loss allowance of \$885,000 at June 30, 2008, and is comprised of a subdivision located in Cave Springs, Arkansas. The subdivision is 100% complete. The Bank obtained an updated valuation on the subdivision using discounted cash flow analysis. Due to the market conditions and the oversupply of lots in Northwest Arkansas, the valuation indicated lower lot prices and an extended marketing time over that in the original appraisal obtained when the loan was originated. Based on the nature of this loan and the possibility of continued adverse changes in the market conditions, we may incur losses in the future in excess of the amount estimated as of June 30, 2008.

The second relationship totaled \$2.6 million at June 30, 2008, and consists of a \$1.9 commercial loan secured by commercial real estate, franchise rights, inventory and equipment, a \$650,000 loan on the borrower's primary residence, and a \$20,000 unsecured loan. The loans in this relationship became over 90 days past due during the third quarter of 2007. Based on the borrower's workout plans, these loans were maintained on accrual status at that time. However, due to the passage of time with no progress on the workout plan, we placed the loans on nonaccrual status during the fourth quarter of 2007. The borrower is selling all of the collateral securing his loans and has entered into sales contracts on some of the franchises. During the first quarter of 2008 one of the franchise sales closed and the Bank received proceeds from this sale. However, the Bank agreed to accept less than the full amount of proceeds as part of the workout. Based on this and other valuation changes during the first and second quarters of 2008, the Bank recorded an additional \$515,000 in specific loan loss allowances, bringing the total specific allowance to \$536,000 with respect to this relationship as of June 30, 2008.

The third relationship totaled \$2.1 million and represents a single commercial real estate loan secured by a convenience store, car wash, and retail space. This loan became over 90 days past due during the third quarter of 2007. Based on our expectation that the guarantors would cooperate with us on a workout plan and our assessment of their financial strength, these loans were maintained on accrual status at that time. However, due to the passage of time with no progress on a workout plan, we placed this loan on nonaccrual status during the fourth quarter of 2007. In the event of a foreclosure and a possible deficiency judgment, we believe sufficient net worth exists among the guarantors to satisfy their obligation. As of June 30, 2008, based on the then current estimated fair value of the collateral, the Bank estimates it will incur no loss.

The fourth relationship totaled \$1.1 million at June 30, 2008, and is comprised primarily of loans totaling \$1.0 million for 35 completed lots in a subdivision located in Pea Ridge, Arkansas, and a \$96,000 loan on a completed speculative home. As of June 30, 2008, based on the then current estimated fair value of the collateral, the Bank estimates it will incur no loss.

Accruing loans 90 days or more past due at June 30, 2008, primarily consisted of one loan whose past due interest is expected to be paid after June 30, 2008.

The following table sets forth the amounts and categories of the Bank's real estate owned at the dates indicated.

	June 30, 2008	December 31, 2007	Increase	Percentage Change
	(Dollars in Thousands)			
Real estate owned				
One- to four-family residential	\$ 3,887	\$ 1,566	\$ 2,321	148.2%
Speculative one- to four-family construction <sup>(1)</sup>	7,008	5,956	1,052	17.7
Land	8,706	598	8,108	1,355.9
Commercial real estate	828	--	828	--
Total real estate owned	<u>\$ 20,429</u>	<u>\$ 8,120</u>	<u>\$ 12,309</u>	<u>151.6%</u>

(1) At June 30, 2008 \$5.5 million of these properties were 100% complete. The remainder range from 75% to 97% complete.

The increase in real estate owned from December 31, 2007 to June 30, 2008 is primarily related to two subdivisions. The first totaled \$4.0 million, and represents two phases of the same subdivision located in Lowell, Arkansas, one of which is complete and the other is approximately 10% complete. The second subdivision totaled \$3.8 million for a 110 lot subdivision in Springdale, Arkansas. During the first six months of 2008, fourteen single family residential properties were transferred to REO and five were sold. During the same period, fourteen speculative single family properties were transferred to REO and sixteen were sold. At June 30, 2008, the Bank owned seventeen foreclosed one- to four-family residential properties and twenty-six speculative single family residential properties compared to eight and twenty-eight properties, respectively, at December 31, 2007.

The Bank is diligently working to dispose of its REO and has dedicated an experienced special assets officer who is working full-time to liquidate the Bank's properties in the Northwest Arkansas market. Each property is evaluated on a case-by-case basis to determine the best course of action with respect to liquidation. Properties are marketed directly by the Bank or listed with local real estate agents utilizing appraisals, market information from realtors, market research reports, and our own market evaluations to make pricing and selling decisions. The Bank's Chief Lending Officer, loan officers, credit manager, special assets officer, and team members in the collections department all work together in this endeavor. The Bank's goal is to liquidate these properties as soon as possible without incurring extraordinary losses due to quick sale pricing. During the six months ended June 30, 2008, the Bank originated loans to facilitate the sales of real estate owned totaling \$3.0 million. The Bank offers attractive rates and financing options to prospective buyers of real estate owned to help facilitate sales.

**Potential Problem Loans.** Based on the oversupply of lots in Northwest Arkansas, our land development portfolio poses a higher risk of default. These loans are typically structured with interest due at maturity and lot sales as the source of repayment. Since lot sales in the Northwest Arkansas market are significantly slower than when these loans were originated, our borrowers typically must rely on a secondary source of funds to pay the interest as it becomes due. Due to the relatively large balances of these types of loans, the interest due at maturity is usually significant. At June 30, 2008, gross land development loans totaled \$32.4 million with \$1.8 million of accrued interest. Of this total, \$2.6 million is on nonaccrual status with \$454,000 in accrued interest, \$16.9 million with \$818,000 in accrued interest is classified as special mention, and \$12.9 million with \$537,000 in accrued interest is on our watch list. There are three matured land development loans at June 30, 2008 with a total principal balance of \$8.3 million and accrued interest of \$768,000. We are working with all three borrowers and, as of the date of this

report, expect to be repaid in full. However, should any of these land development loans default, the Bank may incur losses in the event of a decline in value of the land securing these loans.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Balance at beginning of period	\$ 6,107	\$ 4,294	\$ 5,162	\$ 2,572
Provisions for estimated losses	971	370	2,499	2,332
Recoveries	58	39	194	88
Losses charged off	(1,921)	(412)	(2,640)	(701)
Balance at end of period	<u>\$ 5,215</u>	<u>\$ 4,291</u>	<u>\$ 5,215</u>	<u>\$ 4,291</u>

Changes in the composition of the allowance for loan losses between June 30, 2008 and December 31, 2007 are presented in the following table (in thousands):

	June 30, 2008	December 31, 2007	Increase (Decrease)
General	\$ 2,939	\$ 2,267	\$ 672
Specific	2,276	2,895	(619)
	<u>\$ 5,215</u>	<u>\$ 5,162</u>	<u>\$ 53</u>

The general component of the allowance for loan losses increased primarily due to increases in the loss factors applied to single family residential loans and land development loans, partially offset by decreases in the related loan balances. These loss factors were increased due to the recent loss history on these types of loans. The specific component of the allowance for loan losses decreased primarily due to the chargeoff of a specific valuation allowance of \$1.4 million in connection with the transfer of a subdivision to REO, offset by an increase of \$515,000 in specific valuation allowances on one borrower. See "Asset Quality."

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes it is likely that a loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses represents management's estimate of incurred credit losses inherent in the Company's loan portfolio as of the balance sheet date. The estimation of the allowance is based on a variety of factors, including past loan loss experience, the current credit profile of the Company's borrowers, adverse situations that have occurred that may affect the borrowers' ability to repay, the estimated value of underlying collateral, and general economic conditions. Losses are recognized when available information indicates that it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or conditions change.

In determining the allowance for loan losses, the Company allocates a portion of the allowance to its various loan categories based on an analysis of individual loans and pools of loans. However, the entire allowance is available to absorb credit losses inherent in the total loan portfolio as of the balance sheet date.

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 short fall 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. Multifamily residential, commercial real estate, land and land development, and commercial loans that are delinquent or where the borrower's total loan relationship exceeds \$1 million are evaluated on a loan by loan basis at least annually.

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 national or local 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 in the event that the Bank has to foreclose or repossess the collateral.

Although we consider the allowance for loan losses of approximately \$5.2 million adequate to cover losses inherent in our loan portfolio at June 30, 2008, no assurance can be given that we will not sustain loan losses that are significantly different from the amount recorded, or that subsequent evaluations of the loan portfolio, in light of factors then prevailing, 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 June 30, 2008 and December 31, 2007 are presented in the following table (in thousands).

	June 30, 2008	December 31, 2007	Increase
U.S. Government and agency obligations	\$ 110,148	\$ 78,501	\$ 31,647
Municipal securities	17,716	17,089	627
Total	<u>\$ 127,864</u>	<u>\$ 95,590</u>	<u>\$ 32,274</u>

During the first six months of 2008, investment securities totaling \$94.7 million with a weighted average tax equivalent yield of 6.05% were purchased and \$62.5 million with a weighted average tax equivalent yield of 6.06% matured or were called.

At June 30, 2008, estimated fair values of investment securities held to maturity were as follows (in thousands):

	Amortized Cost	Fair Value
U.S. Government and agency obligations	\$ 110,148	\$ 109,056
Municipal securities	17,716	17,472
Total	<u>\$ 127,864</u>	<u>\$ 126,528</u>

**Accrued Interest Receivable.** The decrease in accrued interest receivable was primarily due to a decrease in the loans receivable balance as well as a decrease in the loan yield and the number of days accrued at June 30, 2008 compared to December 31, 2007.

**Real Estate Owned, net.** Changes in the composition of real estate owned between June 30, 2008 and December 31, 2007 are presented in the following table (dollars in thousands).

	December 31, 2007	Additions	Fair Value Adjustments	Net Sales Proceeds <sup>(1)</sup>	Gain (Loss)	June 30, 2008
One- to four-family residential	\$ 1,566	\$ 3,196	\$ (265)	\$ (596)	\$ (14)	\$ 3,887
Speculative one- to four-family	5,956	4,887	(643)	(3,155)	(37)	7,008
Land	598	9,926	(1,520)	(334)	36	8,706
Commercial real estate	--	858	(30)	--	--	828
	<u>\$ 8,120</u>	<u>\$18,867</u>	<u>\$ (2,458)</u>	<u>\$ (4,085)</u>	<u>\$ (15)</u>	<u>\$ 20,429</u>

(1) Net sales proceeds include \$3.0 million of loans made by the Bank to facilitate the sale of real estate owned.

**Deposits.** Changes in the composition of deposits between June 30, 2008 and December 31, 2007 are presented in the following table (dollars in thousands).

	June 30, 2008	December 31, 2007	Increase (Decrease)	Percentage Change
Checking accounts	\$ 168,842	\$ 127,491	\$ 41,351	32.4%
Money Market accounts	50,095	51,424	(1,329)	(2.6)
Savings accounts	25,332	25,088	244	1.0
Certificates of deposit	393,821	426,411	(32,590)	(7.6)
Total deposits	<u>\$ 638,090</u>	<u>\$ 630,414</u>	<u>\$ 7,676</u>	1.2%

Deposits increased in the comparison period, primarily due to an increase in checking accounts related to public unit deposits and focused marketing efforts to increase checking accounts with a checking product which has a higher interest rate than the Bank's other checking account products. To earn the maximum rate under the new product, customers must qualify based on usage of electronic banking services such as debit card transactions, e-statements, and direct deposits or automatic payments. The Bank will continue to promote checking accounts as they are an attractive source of funds for the Bank as they offer overall low-interest deposits, fee income potential, and the opportunity to cross-sell other financial services.

**Other Liabilities.** Other liabilities decreased primarily due to a decrease in investment security purchases which settled after period end from \$3.2 million at December 31, 2007, to \$1.2 million at June 30, 2008.

**Stockholders' Equity.** Stockholders' equity increased approximately \$601,000 from December 31, 2007 to June 30, 2008. The increase in stockholders' equity was primarily due to net income totaling \$2.1 million during the first six months of 2008. In addition, during the six months ended June 30, 2008, cash dividends of approximately \$1.6 million were paid. See the Unaudited Consolidated Statement of Stockholders' Equity for the six months ended June 30, 2008 for more detail.



## 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 June 30, 2008 vs. 2007			Total Increase (Decrease)
	Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	
	(In Thousands)			
Interest income:				
Loans receivable	\$ (1,498)	\$ (1,126)	\$ 140	\$ (2,484)
Investment securities	827	61	57	945
Other interest-earning assets	(42)	(172)	24	(190)
Total interest-earning assets	<u>(713)</u>	<u>(1,237)</u>	<u>221</u>	<u>(1,729)</u>
Interest expense:				
Deposits	(31)	(1,240)	6	(1,265)
FHLB advances	(77)	(161)	11	(227)
Total interest-bearing liabilities	<u>(108)</u>	<u>(1,401)</u>	<u>17</u>	<u>(1,492)</u>
Net change in net interest income	<u>\$ (605)</u>	<u>\$ 164</u>	<u>\$ 204</u>	<u>\$ (237)</u>
	Six Months Ended June 30, 2008 vs. 2007			
	Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	Total Increase (Decrease)
	(In Thousands)			
Interest income:				
Loans receivable	\$ (2,999)	\$ (1,953)	\$ 242	\$ (4,710)
Investment securities	1,304	113	85	1,502
Other interest-earning assets	42	(232)	(20)	(210)
Total interest-earning assets	<u>(1,653)</u>	<u>(2,072)</u>	<u>307</u>	<u>(3,418)</u>
Interest expense:				
Deposits	(111)	(1,447)	13	(1,545)
FHLB advances	(370)	(254)	40	(584)
Total interest-bearing liabilities	<u>(481)</u>	<u>(1,701)</u>	<u>53</u>	<u>(2,129)</u>
Net change in net interest income	<u>\$ (1,172)</u>	<u>\$ (371)</u>	<u>\$ 254</u>	<u>\$ (1,289)</u>

## CHANGES IN RESULTS OF OPERATIONS

The table below presents a comparison of results of operations for the three months ended June 30, 2008 and 2007 (dollars in thousands). Specific changes in captions are discussed in the sections which follow the table.

	Three Months Ended June 30,		Increase (Decrease)	Percentage Change
	2008	2007	2008 vs 2007	2008 vs 2007
Interest income:				
Loans receivable	\$ 9,520	\$ 12,004	\$ (2,484)	(20.7)%
Investment securities	1,835	890	945	106.2
Other	112	302	(190)	(62.9)
Total interest income	<u>11,467</u>	<u>13,196</u>	<u>(1,729)</u>	<u>(13.1)</u>
Interest expense:				
Deposits	4,779	6,044	(1,265)	(20.9)
FHLB advances	879	1,106	(227)	(20.5)
Total interest expense	<u>5,658</u>	<u>7,150</u>	<u>(1,492)</u>	<u>(20.9)</u>
Net interest income before provision for loan losses	5,809	6,046	(237)	(3.9)
Provision for loan losses	971	370	601	162.4
Net interest income after provision for loan losses	<u>4,838</u>	<u>5,676</u>	<u>(838)</u>	<u>(14.8)</u>
Noninterest income:				
Deposit fee income	1,344	1,269	75	5.9
Earnings on life insurance policies	191	184	7	3.8
Gain on sale of loans	91	237	(146)	(61.6)
Other	422	271	151	55.7
Total noninterest income	<u>2,048</u>	<u>1,961</u>	<u>87</u>	<u>4.4</u>
Noninterest expenses:				
Salaries and employee benefits	3,244	3,287	(43)	(1.3)
Real estate owned, net	269	121	148	122.3
Other	2,135	2,053	82	4.0
Total noninterest expenses	<u>5,648</u>	<u>5,461</u>	<u>187</u>	<u>3.4</u>
Income before income taxes	1,238	2,176	(938)	(43.1)
Income tax provision	229	642	(413)	(64.3)
Net income	<u>\$ 1,009</u>	<u>\$ 1,534</u>	<u>\$ (525)</u>	<u>(34.2)%</u>
Basic earnings per share	<u>\$ 0.21</u>	<u>\$ 0.32</u>	<u>\$ (0.11)</u>	<u>(34.4)%</u>
Diluted earnings per share	<u>\$ 0.21</u>	<u>\$ 0.32</u>	<u>\$ (0.11)</u>	<u>(34.4)%</u>
Interest rate spread	<u>3.14%</u>	<u>3.12%</u>		
Net interest margin	<u>3.15%</u>	<u>3.19%</u>		
Average full-time equivalents	<u>303</u>	<u>306</u>		
Full-service offices	<u>19</u>	<u>18</u>		

The table below presents a comparison of results of operations for the six months ended June 30, 2008 and 2007 (dollars in thousands). Specific changes in captions are discussed in the sections which follow the table.

	Six Months Ended June 30,		Increase (Decrease) 2008 vs 2007	Percentage Change 2008 vs 2007
	2008	2007		
Interest income:				
Loans receivable	\$ 19,495	\$ 24,205	\$ (4,710)	(19.5)%
Investment securities	3,228	1,726	1,502	87.0
Other	280	490	(210)	(42.9)
Total interest income	<u>23,003</u>	<u>26,421</u>	<u>(3,418)</u>	<u>(12.9)</u>
Interest expense:				
Deposits	10,347	11,892	(1,545)	(13.0)
Other borrowings	1,782	2,366	(584)	(24.7)
Total interest expense	<u>12,129</u>	<u>14,258</u>	<u>(2,129)</u>	<u>(14.9)</u>
Net interest income before provision for loan losses	10,874	12,163	(1,289)	(10.6)
Provision for loan losses	<u>2,499</u>	<u>2,332</u>	<u>167</u>	<u>7.2</u>
Net interest income after provision for loan losses	<u>8,375</u>	<u>9,831</u>	<u>(1,456)</u>	<u>(14.8)</u>
Noninterest income:				
Deposit fee income	2,555	2,426	129	5.3
Earnings on life insurance policies	1,562	373	1,189	318.8
Gain on sale of loans	266	463	(197)	(42.6)
Other	870	559	311	55.6
Total noninterest income	<u>5,253</u>	<u>3,821</u>	<u>1,432</u>	<u>37.5</u>
Noninterest expenses:				
Salaries and employee benefits	6,632	6,729	(97)	(1.4)
Real estate owned, net	698	282	416	147.5
Data processing	688	805	(117)	(14.5)
Other	3,702	3,710	(8)	(0.2)
Total noninterest expenses	<u>11,720</u>	<u>11,526</u>	<u>194</u>	<u>1.7</u>
Income before income taxes	1,908	2,126	(218)	(10.3)
Income tax provision (benefit)	<u>(188)</u>	<u>433</u>	<u>(621)</u>	<u>(143.4)</u>
Net income	<u>\$ 2,096</u>	<u>\$ 1,693</u>	<u>\$ 403</u>	<u>23.8%</u>
Basic earnings per share	<u>\$ 0.43</u>	<u>\$ 0.35</u>	<u>\$ 0.08</u>	<u>22.9%</u>
Diluted earnings per share	<u>\$ 0.43</u>	<u>\$ 0.35</u>	<u>\$ 0.08</u>	<u>22.9%</u>
Interest rate spread	<u>2.94%</u>	<u>3.12%</u>		
Net interest margin	<u>2.97%</u>	<u>3.19%</u>		
Average full-time equivalents	<u>304</u>	<u>306</u>		
Full-service offices	<u>19</u>	<u>18</u>		

**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. The decrease in net interest income was primarily due to the level of nonperforming loans.

## 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 decrease in interest income for the three and six month comparative periods was primarily due to a decrease in the average balance of loans receivable and an increase in the level of deferred interest on nonperforming loans, as well as a decrease in the average yield earned on loans receivable. These decreases were offset by an increase in the average balance of investment securities. The decrease in average yields earned on loans receivable was due to decreases in market interest rates and the level of nonaccrual loans. The average balance of loans receivable decreased due to repayments and maturities as well as a decrease in loan originations.

**Interest Expense.** The decrease in interest expense for the three and six month comparative periods was primarily due to a decrease in the average rates paid on deposits and FHLB advances and decreases in the average balances of deposits and FHLB advances. The decrease in the average rates paid on deposit accounts reflects the recent decreases in market interest rates.

**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 provision for loan losses increased \$601,000 to \$971,000 for the quarter ended June 30, 2008 compared to \$370,000 for the quarter ended June 30, 2007 and increased \$167,000 to \$2.5 million for the six months ended June 30, 2008 compared to \$2.3 million for the same period in 2007. The increases in the provisions for loan losses in both comparable periods were primarily due to an increase in our loss experience on single family residential loans and land development loans.

**Noninterest Income.** The increase in other noninterest income for the six month comparative period in 2008 was primarily due to a \$1.2 million increase in earnings on life insurance policies due to a death benefit claim recorded during the first quarter in 2008.

## Noninterest Expense

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

	Three Months Ended June 30,		Increase (Decrease)	Six Months Ended June 30,		Increase (Decrease)
	2008	2007	2008 vs 2007	2008	2007	2008 vs 2007
Salaries	\$ 2,539	\$ 2,566	\$ (27)	\$ 5,181	\$ 5,230	\$ (49)
Payroll taxes	217	215	2	472	478	(6)
Insurance	167	170	(3)	338	340	(2)
401(k)	79	76	3	157	156	1
Stock compensation (1)	6	10	(4)	12	24	(12)
Defined benefit plan contribution	196	210	(14)	391	420	(29)
Other	40	40	--	81	81	--
Total	\$ 3,244	\$ 3,287	\$ (43)	\$ 6,632	\$ 6,729	\$ (97)

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

**Real estate owned, net.** The changes in the composition of this line item are presented below (in thousands):

	Three Months Ended June 30,		Increase (Decrease)	Six Months Ended June 30,		Increase (Decrease)
	2008	2007	2008 vs 2007	2008	2007	2008 vs 2007
Loss provisions	\$ 87	\$ 3	\$ 84	\$ 316	\$ 77	\$ 239
Net loss (gain) on sales	(25)	9	(34)	28	51	(23)
Taxes and insurance	169	87	82	279	92	187
Other	38	22	16	75	62	13
Total	<u>\$ 269</u>	<u>\$ 121</u>	<u>\$ 148</u>	<u>\$ 698</u>	<u>\$ 282</u>	<u>\$ 416</u>

Expenses associated with real estate owned have increased due to the increase in real estate owned balances as discussed in "Asset Quality." Real estate owned is expected to continue to increase in the foreseeable future and real estate owned expenses associated with maintaining the properties are expected to increase accordingly. Future levels of loss provisions and net gains or losses on sales of real estate owned will be dependent on market conditions.

**Data Processing.** The decrease in the six month comparative period in 2008 was primarily due to credits received in the first quarter of 2008 associated with upgrading our computer system in the first quarter of 2007.

**Income Taxes.** The income tax benefit increased in 2008 primarily due to an increase in nontaxable life insurance earnings for the six month comparative period. The decrease in income tax provision for the three month comparative period was related to a decrease in taxable income resulting from decreased earnings and increased nontaxable interest from investment securities.

#### 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 June 30, 2008, the Bank's off-balance sheet arrangements principally included lending commitments, which are described below. At June 30, 2008, the Company had no interests in non-consolidated special purpose entities.

At June 30, 2008, commitments included:

- total approved commitments to originate or purchase loans amounting to \$3.4 million, including \$415,000 of loans committed to sell;
- rate lock agreements with customers of \$2.2 million, all of which have been locked with an investor;
- funded mortgage loans committed to sell of \$1.4 million;
- unadvanced portion of construction loans of \$20.8 million;
- unused lines of credit of \$21.4 million;
- outstanding standby letters of credit of approximately \$565,000;
- total predetermined overdraft protection limits of \$14.6 million; and
- certificates of deposit scheduled to mature in one year or less totaling \$265.6 million.

Total unfunded commitments to originate loans for sale and the related commitments to sell of \$2.2 million meet the definition of a derivative financial instrument. The related asset and liability are considered immaterial at June 30, 2008.

Historically, a very small percentage of predetermined overdraft limits have been used. At June 30, 2008, overdrafts of accounts with Bounce Protection™ represented usage of 4.4% 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, payments 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. Calls of investment securities are determined by the issuer and are generally influenced by the level of market interest rates at the bond's call date compared to the coupon rate of the bond. 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 that provide liquidity to meet lending requirements and pay deposit withdrawals. The Bank has generally been able to generate enough cash through the retail deposit market, its traditional funding source, to offset the cash utilized in investing activities. As an additional source of funds, the Bank has borrowed from the FHLB of Dallas. During the first six months of 2008, the use of FHLB advances increased by \$22.0 million or 26.8%. The Bank uses U.S. government agency investment securities and eligible one- to four-family loans as collateral for FHLB advances. The Bank's borrowing capacity at the FHLB of Dallas is based on the amount of securities and loans held in custody by the FHLB. The Bank may transfer additional collateral to provide additional borrowing capacity if needed. Currently, the Bank may borrow short-term advances with maturities up to thirty days. In addition, brokered deposits may be used to augment the Bank's primary funding sources. At June 30, 2008, the Bank had outstanding brokered deposits of \$2.2 million.

For each of the six months ended June 30, 2008 and 2007, the Company paid dividends of \$0.32 per share. The determination of future dividends on the Company's common stock will depend on conditions existing at that time with consideration given to the Company's earnings, capital, and liquidity needs.

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 and investment securities. 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, to fund loan commitments, and to purchase investment securities.

As of June 30, 2008, the Bank's regulatory capital was in excess of all applicable regulatory requirements. At June 30, 2008, the Bank's tangible, core and risk-based capital ratios amounted to 8.57%, 8.57% and 12.98%, 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, 2007. Similarly, while there has been no material change in the Company's asset and liability position since such time, the Bank's increased level of nonperforming assets continued to impact the level of net interest income during the three months ended June 30, 2008. Correspondingly, the Bank's net interest margin decreased from 3.19% for the three months ended June 30, 2007 to 3.15% for the same period in 2008. Based on the level of nonperforming assets and competitive pressures on loan and deposit rates, management anticipates continued pressure on the Bank's interest rate spread and interest margin for the third quarter of 2008 although the level of maturing certificate of deposits repricing to lower rates will somewhat offset the pressure on the interest rate spread and margin.

### **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.

**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, 2007.

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
April 1 to April 30, 2008	--	--	--	--
May 1 to May 31, 2008	--	--	--	--
June 1 to June 30, 2008	--	--	--	--

The Company is in its 19th announced repurchase program, which was approved by the board of directors on July 25, 2006, and publicly announced on November 8, 2006. Total shares approved to be purchased in this program are 245,197 of which 214,587 have been purchased as of June 30, 2008. All treasury stock purchases are made under publicly announced repurchase programs.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

On April 23, 2008, the Corporation held an annual meeting of stockholders for the following purposes:

- (1) To elect one director for a term of three years; and
- (2) To ratify the appointment by the Board of Directors of Deloitte and Touche LLP as the Corporation's independent auditors for the year ending December 31, 2008.

The results of the voting are set forth below:

Proposal One (Election of Directors):

<b>NAME</b>	<b>FOR</b>	<b>AGAINST/ WITHHELD</b>	<b>NOT VOTED</b>
Kenneth C. Savells	4,287,697	102,441	458,247

Proposal Two (Ratification of Auditors):

<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>	<b>NOT VOTED</b>
4,386,243	3,285	610	458,247

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: July 24, 2008

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

Date: July 24, 2008

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: July 24, 2008

By: /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: July 24, 2008

By: /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 six months ended June 30, 2008 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.

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

Date: July 24, 2008

**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 six months ended June 30, 2008 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.

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

Date: July 24, 2008