PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
November 09, 2006

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

FORM 10-Q

(mark one)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d)
OF THE SECURITIES AND EXCHANGE ACT OF 1934
For the transition period from ____ to ____ Commission File Number: 000-31225

, Inc.
(Exact name of registrant as specified in its charter)

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

(615) 744-3700
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changes since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer o Accelerated Filer x Non-accelerated Filer o

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

As of October 31, 2006 there were 15,410,541 shares of common stock, $1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
September 30, 2006

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FORWARD-LOOKING STATEMENTS

Pinnacle Financial Partners, Inc. ("Pinnacle Financial") may from time to time make written or oral statements, including statements contained in this report which may constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the "Exchange Act"). The words "expect", "anticipate", "intend", "consider", "plan", "believe", "seek", "should", "estimate", and similar expressions are intended to identify such forward-looki statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management's belief as well as assumptions made by, and information currently available to, management pursuant to "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Pinnacle Financial's actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors are described below and in Pinnacle Financial's Form 10-K and include, without limitation, (i) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (ii) increased competition with other financial institutions, (iii) lack of sustained growth in the economy in the Nashville/Davidson/Murfreesboro MSA, (iv) rapid fluctuations or unanticipated changes in interest rates, (v) the inability of our bank subsidiary, Pinnacle National Bank, to satisfy regulatory requirements for its expansion plans, (vi) the ability to successfully integrate Pinnacle Financial's operations with the former Cavalry Bancorp, Inc., (vii) the ability of Pinnacle Financial to grow its loan portfolio at historic rates, (viii) the ability of Pinnacle Financial to execute its expansion plans and (ix) changes in the legislative and regulatory environment, including compliance with the various provisions of the Sarbanes-Oxley Act of 2002. Many of such factors are beyond Pinnacle Financial's ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Pinnacle Financial does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Pinnacle Financial.

Item 1. Part I. FINANCIAL INFORMATION

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

	September 30, 2006	December 31, 2005
ASSETS		
Cash and noninterest-bearing due from banks	$ 55,199,117	$ 25,935,948
Interest-bearing due from banks	6,176,891	839,960
Federal funds sold	51,623,544	31,878,362
Cash and cash equivalents	112,999,552	58,654,270
Securities available-for-sale, at fair value	303,483,224	251,749,094
Securities held-to-maturity (fair value of $26,531,147 and $26,546,297 at September 30, 2006 and December 31, 2005, respectively)	27,275,651	27,331,251
Mortgage loans held-for-sale	8,960,447	4,874,323
Loans	1,405,401,429	648,024,032
Less allowance for loan losses	(15,172,446)	(7,857,774)
Loans, net	1,390,228,983	640,166,258
Premises and equipment, net	36,222,088	12,915,595
Investments in unconsolidated subsidiaries and other entities	11,278,614	6,622,645
Accrued interest receivable	10,455,981	4,870,197
Goodwill	115,064,500	-
Core deposit intangible	11,920,001	-
Other assets	24,363,133	9,588,097
Total assets	$ 2,052,252,174	$ 1,016,771,730
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$ 306,296,117	$ 155,811,214
Interest-bearing demand	199,967,210	72,520,757
Savings and money market accounts	481,684,245	304,161,625
Time	597,290,358	277,657,129
Total deposits	1,585,237,930	810,150,725
Securities sold under agreements to repurchase	122,354,264	65,834,232
Federal Home Loan Bank advances	28,739,443	41,500,000
Subordinated debt	51,548,000	30,929,000
Accrued interest payable	4,183,121	1,884,596
Other liabilities	11,130,028	3,036,752
Total liabilities	1,803,192,786	953,335,305
Stockholders’ equity:		
Preferred stock, no par value; 10,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, par value $1.00; 90,000,000 shares authorized; 15,409,341 issued and outstanding at September 30, 2006 and	15,409,341	8,426,551

8,426,551 issued and outstanding at December 31, 2005		
Additional paid-in capital	210,752,785	44,890,912
Unearned compensation	-	(169,689)
Retained earnings	25,455,618	13,182,291
Accumulated other comprehensive loss, net	(2,558,356)	(2,893,640)
Stockholders' equity	249,059,388	63,436,425
Total liabilities and stockholders' equity	$ 2,052,252,174	$ 1,016,771,730

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Interest income:				
Loans, including fees	$ 26,771,110	$ 9,470,954	$ 64,195,835	$ 24,427,821
Securities:				
Taxable	3,240,878	2,245,019	9,250,455	6,401,537
Tax-exempt	521,240	318,235	1,416,862	758,572
Federal funds sold and other	806,829	344,498	1,591,941	601,468
Total interest income	31,340,057	12,378,706	76,455,093	32,189,398
Interest expense:				
Deposits	11,800,394	3,968,648	27,213,738	8,999,838
Securities sold under agreements to repurchase	1,382,418	399,731	2,569,383	803,114
Federal funds purchased and other borrowings	997,899	554,694	3,110,660	1,635,506
Total interest expense	14,180,711	4,923,073	32,893,781	11,438,458
Net interest income	17,159,346	7,455,633	43,561,312	20,750,940
Provision for loan losses	586,589	366,304	2,680,638	1,450,244
Net interest income after provision for loan losses	16,572,757	7,089,329	40,880,674	19,300,696
Noninterest income:				
Service charges on deposit accounts	1,357,280	228,994	3,151,664	732,130
Investment sales commissions	644,931	474,354	1,811,428	1,403,231
Insurance sales commissions	549,584	-	1,562,946	-
Gain on loans and loan participations sold, net	490,254	348,577	1,285,609	899,393
Trust fees	311,997	-	675,994	-
Gain on sales of investment securities, net	-	-	-	114,410
Other noninterest income	1,069,811	247,208	2,364,592	743,689
Total noninterest income	4,423,857	1,299,133	10,852,233	3,892,853
Noninterest expense:				
Compensation and employee benefits	7,576,011	3,410,436	19,314,365	9,491,712
Equipment and occupancy	2,070,727	1,034,661	5,325,274	2,712,624
Marketing and other business development	351,432	186,430	899,807	479,313
Postage and supplies	487,689	159,782	1,118,308	453,716
Amortization of core deposit intangible	534,957	-	1,248,335	-
Other noninterest expense	1,815,392	729,528	3,999,832	1,927,564

Merger related expense		218,167		-		1,582,734		-
Total noninterest expense		13,054,375		5,520,837		33,488,655		15,064,929
Income before income taxes		7,942,239		2,867,625		18,244,252		8,128,620
Income tax expense		2,595,465		789,382		5,963,112		2,311,455
Net income	$	5,346,774	$	2,078,243	$	12,281,140	$	5,817,165
Per share information:								
Basic net income per common share	$	0.35	$	0.25	$	0.91	$	0.69
Diluted net income per common share	$	0.32	$	0.22	$	0.84	$	0.62
Weighted average shares outstanding:								
Basic		*15,393,735*		*8,417,980*		*13,450,282*		*8,402,916*
Diluted		*16,655,349*		*9,495,187*		*14,649,418*		*9,455,756*

See accompanying notes to consolidated financial statements.

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PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(Unaudited)
For the nine months ended September 30, 2006 and 2005

	Common Stock						
	Shares	**Amount**	**Additional Paid-in Capital**	**Unearned Compensation**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Total Stockholders' Equity**
Balances, December 31, 2004	8,389,232	$ 8,389,232	$ 44,376,307	$ (37,250)	$ 5,127,023	$ 24,863	$ 57,880,175
Exercise of employee common stock options and related tax benefits	18,619	18,619	124,951	-	-	-	143,570
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan	16,366	16,366	403,601	(419,967)	-	-	-
Amortization of unearned compensation associated with restricted shares	-	-	-	128,920	-	-	128,920
Comprehensive loss:							
Net income	-	-	-	-	5,817,165	-	5,817,165
Net unrealized holding losses on available-for-sale securities, net of deferred tax benefit of $153,376	-	-	-	-	-	(1,078,951)	(1,078,951)
Total comprehensive income							4,738,214
Balances, September 30, 2005	8,424,217	$ 8,424,217	$ 44,904,859	$ (328,297)	$ 10,944,188	$ (1,054,088)	$ 62,890,879
Balances, December 31, 2005	8,426,551	$ 8,426,551	$ 44,890,912	$ (169,689)	$ 13,182,291	$ (2,893,640)	$ 63,436,425

Transfer of unearned compensation to additional paid-in capital upon adoption of SFAS No. 123(R)	-	-	(169,689)	169,689	-	-	-
Exercise of employee common stock options and related tax benefits	93,435	93,435	964,582	-	-	-	1,058,017
Issuance of restricted common shares pursuant to 2004 Equity Incentive Plan	22,057	22,057	(22,057)	-	-	-	-
Exercise of director common stock warrants	11,000	11,000	44,000	-	-	-	55,000
Amortization expense for restricted shares	-	-	311,229	-	-	-	311,229
Dividends paid to minority interest shareholders of PNFP Properties, Inc.	-	-	-	-	(7,813)	-	(7,813)
Merger with Cavalry Bancorp, Inc.	6,856,298	6,856,298	164,231,274	-	-	-	171,087,572
Costs to register common stock issued in connection with the merger with Cavalry Bancorp, Inc.	-	-	(187,609)	-	-	-	(187,609)
Stock based compensation expense	-	-	690,143	-	-	-	690,143
Comprehensive income:							
Net income	-	-	-	-	12,281,140	-	12,281,140
Net unrealized holding gains on available-for-sale securities, net of deferred tax expense of $205,497	-	-	-	-	-	335,284	335,284
							12,616,424

Total comprehensive income							
Balances, September 30, 2006	15,409,341	$ 15,409,341	$ 210,752,785	$ -	$ 25,455,618	$ (2,558,356)	$ 249,059,388

See accompanying notes to consolidated financial statements.

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

	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Operating activities:		
Net income	$ 12,281,140	$ 5,817,165
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of securities	591,794	838,169
Depreciation and amortization	3,645,465	1,293,099
Provision for loan losses	2,680,638	1,450,244
Gain on sale of investment securities, net	-	(114,410)
Gains on loans and loan participations sold, net	(1,285,609)	(899,393)
Stock-based compensation expense	1,001,372	128,920
Deferred tax benefit	(1,110,490)	(460,109)
Tax benefit on exercise of stock awards	-	26,200
Excess tax benefit from stock compensation arrangements	(110,244)	-
Mortgage loans held for sale:		
Loans originated	(104,455,073)	(74,482,774)
Loans sold	102,030,399	70,543,400
Increase in other assets	(3,580,936)	(3,218,949)
Increase (decrease) in other liabilities	(9,368,829)	1,118,840
Net cash provided by operating activities	2,319,627	2,040,402
Investing activities:		
Activities in securities available-for-sale:		
Purchases	(38,573,610)	(70,642,913)
Sales	-	6,791,867
Maturities, prepayments and calls	26,320,244	22,642,721
	(12,253,366)	(41,208,325)
Net increase in loans	(207,144,996)	(131,791,769)
Purchases of premises and equipment and software	(3,708,595)	(3,334,110)
Cash and cash equivalents acquired in merger with Cavalry Bancorp, Inc.	37,420,210	-
Purchases of other assets	(1,271,982)	(827,850)
Net cash used in investing activities	(186,958,729)	(177,102,054)
Financing activities:		
Net increase in deposits	191,447,162	217,900,717
Net increase in securities sold under agreements to repurchase	56,520,032	35,723,929
Advances from Federal Home Loan Bank:		
Issuances	31,000,000	27,000,000
Payments	(61,527,218)	(56,000,000)
Proceeds from the issuance of subordinated debt	20,619,000	20,619,000
Exercise of common stock warrants	55,000	-

Exercise of common stock options		947,773		143,570
Excess tax benefit from stock compensation arrangements		110,244		-
Costs incurred in connection with registration of common stock issued in merger		(187,609)		-
Net cash provided by financing activities		238,984,384		245,387,216
Net increase in cash and cash equivalents		54,345,282		70,325,564
Cash and cash equivalents, beginning of period		58,654,270		26,745,787
Cash and cash equivalents, end of period	$	112,999,552	$	97,071,351

See accompanying notes to consolidated financial statements.

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

Note 1. Summary of Significant Accounting Policies

Nature of Business — Pinnacle Financial Partners, Inc. (Pinnacle Financial) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, Pinnacle National Bank (Pinnacle National). Pinnacle National is a commercial bank located in Nashville, Tennessee. Pinnacle National provides a full range of banking services in its primary market areas of Davidson, Rutherford, Williamson, Sumner and Bedford Counties. Pinnacle Financial and Pinnacle National have formed several subsidiaries for various purposes as follows:

- PFP Title Company is a wholly-owned subsidiary of Pinnacle National. PFP Title Company is licensed to sell title insurance policies to Pinnacle National customers and others.
- PNFP Holdings, Inc. is a wholly-owned subsidiary of PFP Title Company and is the parent of PNFP Properties, Inc., which was established as a Real Estate Investment Trust pursuant to Internal Revenue Service regulations.
- Pinnacle Community Development, Inc. is a wholly-owned subsidiary of Pinnacle National and is certified as a Community Development Entity by the Community Development Financial Institutions Fund of the United States Department of the Treasury.
- PNFP Statutory Trust I, PNFP Statutory Trust II and PNFP Statutory Trust III, wholly-owned subsidiaries of Pinnacle Financial, were created for the exclusive purpose of issuing capital trust preferred securities.
- Pinnacle Advisory Services, Inc. is a wholly-owned subsidiary of Pinnacle Financial and was established as a registered investment advisor pursuant to regulations promulgated by the Board of Governors of the Federal Reserve System.
- Miller and Loughry Insurance and Services, Inc. is a wholly-owned subsidiary of Pinnacle National. Miller and Loughry is a general insurance agency located in Murfreesboro, Tennessee and is licensed to sell various commercial and consumer insurance products.
- Pinnacle Credit Enhancement Holdings, Inc. is a wholly-owned subsidiary of Pinnacle Financial and was established to own a 24.5% membership interest in Collateral Plus, LLC. Collateral Plus, LLC serves as an intermediary between investors and borrowers in certain financial transactions whereby the borrowers require enhanced collateral in the form of letters of credit issued by the investors for the benefit of banks and other financial institutions.

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

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

Impairment— Long-lived assets, including purchased intangible assets subject to amortization, such as Pinnacle Financial's core deposit intangible asset, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill and intangible assets that have indefinite useful lives are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. Pinnacle Financial's annual assessment date will be as of September 30 such that the assessment will be completed during the fourth quarter of each year. Accordingly, should we determine in a future period that the goodwill recorded in connection with our acquisition of Cavalry has been impaired, then a charge to our earnings will be recorded in the period such determination is made.

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

Cash and Cash Flows — Cash on hand, cash items in process of collection, amounts due from banks, Federal funds sold and securities purchased under agreements to resell, with original maturities within ninety days, are included in cash and cash equivalents. The following supplemental cash flow information addresses certain cash payments and noncash transactions for the nine months ended September 30, 2006 and 2005 as follows:

	For the nine months ended September 30,	
	2006	***2005***
Cash Payments:		
Interest	$ 34,444,269	$ 10,692,618
Income taxes	6,380,000	2,660,133
Noncash Transactions:		
Loans charged-off to the allowance for loan losses	627,838	125,449
Loans foreclosed upon with repossessions transferred to other assets	-	34,750
Common stock and options issued to acquire Cavalry Bancorp, Inc.	171,087,572	-

Income Per Common Share — Basic earnings per share ("EPS") is computed by dividing net income by the weighted average common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding was attributable to common stock options and warrants. The dilutive effect of outstanding options and warrants is reflected in diluted earnings per share by application of the treasury stock method, which in 2006 includes consideration of stock-based compensation attributable to future services resulting from the adoption of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS No.123(R)").

As of September 30, 2006 and 2005, there were common stock options outstanding to purchase up to 1.6 million and 1.2 million common shares, respectively. Most of these options have exercise prices (and in 2006, compensation costs attributable to current services), which when considered in relation to the average market price of Pinnacle Financial's common stock, are considered dilutive and are considered in Pinnacle Financial's diluted income per share calculation for each of the three and nine month periods ended September 30, 2006 and 2005. There were common stock options of 177,000 and 8,000 outstanding as of September 30, 2006 and 2005, respectively, which were considered anti-dilutive and thus have not been considered in the fully-diluted share calculations below. Additionally, as of September 30, 2006 and 2005, Pinnacle Financial had outstanding warrants to purchase 395,000 and 406,000, respectively, of common shares which have been considered in the calculation of Pinnacle Financial's diluted income per share for the three and nine months ended September 30, 2006 and 2005.

The following is a summary of the basic and diluted earnings per share calculation for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	***2005***	***2006***	***2005***
Basic earnings per share calculation:				
Numerator - Net income	$ 5,346,774	$ 2,078,243	$ 12,281,140	$ 5,817,165

Denominator - Average common shares outstanding		15,393,735		8,417,980		13,450,282		8,402,916
Basic net income per share	$	0.35	$	0.25	$	0.91	$	0.69
Diluted earnings per share calculation:								
Numerator - Net income	$	5,346,774	$	2,078,243	$	12,281,140	$	5,817,165
Denominator - Average common shares outstanding		15,393,735		8,417,980		13,450,282		8,402,916
Dilutive shares contingently issuable		1,261,614		1,077,207		1,199,136		1,052,840
Average diluted common shares outstanding		16,655,349		9,495,187		14,649,418		9,455,756
Diluted net income per share	$	0.32	$	0.22	$	0.84	$	0.62

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

Stock-Based Compensation — On January 1, 2006, Pinnacle Financial adopted SFAS No. 123(R), that addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for equity instruments. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions, as Pinnacle Financial formerly did, using the intrinsic value method as prescribed by Accounting Principles Board, (“APB”), Opinion No. 25, “Accounting for Stock Issued to Employees,” and generally requires that such transactions be accounted for using a fair-value-based method and recognized as expense in the accompanying consolidated statement of income.

Pinnacle Financial adopted SFAS No. 123(R) using the modified prospective method which requires the application of the accounting standard as of January 1, 2006. The accompanying consolidated financial statements as of and for the first nine months of 2006 reflect the impact of adopting SFAS No. 123(R). In accordance with the modified prospective method, consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). See Note 7 for further details.

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the accompanying consolidated statement of income during 2006 included compensation expense for stock-based payment awards granted prior to, but not yet vested, as of January 1, 2006 and for the stock-based awards granted after January 1, 2006, based on the grant date fair value estimated in accordance with SFAS No. 123(R). As stock-based compensation expense recognized in the accompanying statement of income for 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information for 2005, which is also detailed in Note 7, we accounted for forfeitures as they occurred.

Comprehensive Income (Loss) —SFAS No. 130, “Reporting Comprehensive Income” describes comprehensive income as the total of all components of comprehensive income including net income. Other comprehensive income refers to revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. Currently, Pinnacle Financial’s other comprehensive income (loss) consists of unrealized gains and losses, net of deferred income taxes, on available-for-sale securities.

Recent Accounting Pronouncements — FASB Staff Position on SFAS No. 115-1 and SFAS No. 124-1 (the “FSP”), “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” was issued in November 2005 and addresses the determination of when an investment is considered impaired; whether the impairment is other-than-temporary; and how to measure an impairment loss. The FSP also addresses accounting considerations subsequent to the recognition of an other-than-temporary impairment on a debt security, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The FSP replaces the impairment guidance on Emerging Issues Task Force (“EITF”) Issue No. 03-1 with references to existing authoritative literature concerning other-than-temporary determinations. Under the FSP, losses arising from impairment deemed to be other-than-temporary, must be recognized in earnings at an amount equal to the entire difference between the securities cost and its fair value at the financial statement date, without considering partial recoveries subsequent to that date. The FSP also requires that an investor recognize an other-than-temporary impairment loss when a decision to sell a security has been made and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale. The FSP was effective for reporting periods beginning after December 15, 2005. The initial adoption of this statement did not have a material impact on Pinnacle Financial’s consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3” (“SFAS No. 154”). This statement changes the requirements for the accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This statement does not change the guidance for reporting the correction of an error in previously issued financial statements or the change in an accounting estimate. SFAS 154 was effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

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SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes a contractual obligation to service a financial asset in certain circumstances. All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value. Subsequent measurement methods include the amortization method, whereby servicing assets or servicing liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss, or the fair value method, whereby servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value are reported in earnings in the period in which they occur. If the amortization method is used, an entity must assess servicing assets or servicing liabilities for impairment or increased obligation based on the fair value at each reporting date. SFAS No. 156 is effective for fiscal years beginning after December 15, 2006. Pinnacle Financial is currently evaluating the impact of SFAS No. 156 on its consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation 48, "Accounting for Income Tax Uncertainties" ("FIN 48"). FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority. The recently issued literature also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. FIN 48 is effective for fiscal years beginning after December 15, 2006. The differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption will be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. Pinnacle Financial is currently evaluating the impact of FIN 48 on its consolidated financial statements.

In June 2006, the Emerging Issues Task Force issued EITF No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefits Aspects of Endorsement Split-Dollar Life Insurance Arrangements." The EITF concluded that deferred compensation or postretirement benefit aspects of an endorsement split-dollar life insurance arrangement should be recognized as a liability by the employer and the obligation is not effectively settled by the purchase of a life insurance policy. The effective date is for fiscal years beginning after December 15, 2007. Pinnacle Financial is currently evaluating the impact of EITF No. 06-4 on its consolidated financial statements.

In June 2006, the Emerging Issues Task Force issued EITF No. 06-5, "Accounting for Purchases of Life Insurance - Determining the Amount that Could Be Realized in Accordance with FASB Tech Bulletin 85-4." The EITF concluded that a policyholder should consider any additional amounts included in the contractual terms of the life insurance policy in determining the "amount that could be realized under the insurance contract." For group policies with multiple certificates or multiple policies with a group rider, the EITF also concluded that the amount that could be realized should be determined at the individual policy or certificate level, i.e., amounts that would be realized only upon surrendering all of the policies or certificates would not be included when measuring the assets. The effective date is for fiscal years beginning after December 15, 2006. Pinnacle Financial is currently evaluating the impact of EITF No. 06-5 on its consolidated financial statements.

SFAS No. 157, "Fair Value Measurements" - SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 applies only to fair-value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The effective date for SFAS No. 157 is for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Pinnacle Financial is currently evaluating the impact of EITF 06-5 on its consolidated financial statements.

FASB Statement No. 158, “An Amendment to Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans” was issued September 29, 2006. SFAS No. 158 requires the recognition on the balance sheet of the overfunded or underfunded status of a defined benefit postretirement obligation measured as the difference between the fair value of plan assets and the benefit obligation. Recognition of “delayed” items should be considered in other comprehensive income. The effective date of SFAS No. 158 for public entities is for fiscal years ending after December 15, 2006. Pinnacle Financial does not anticipate that SFAS No. 158 will have a material impact on Pinnacle Financial’s consolidated financial statements.

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In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both the balance sheet and income statement approach when quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for Pinnacle Financial's fiscal year ending December 31, 2006. Pinnacle Financial is currently evaluating the impact of SAB 108 on the Company's consolidated financial statements.

Note 2. Merger with Cavalry Bancorp, Inc.

On March 15, 2006, Pinnacle Financial consummated its merger with Cavalry Bancorp, Inc. ("Cavalry"), a one-bank holding company located in Murfreesboro, Tennessee. Pursuant to the merger agreement, Pinnacle acquired all Cavalry common stock via a tax-free exchange whereby Cavalry shareholders received a fixed exchange ratio of 0.95 shares of Pinnacle Financial common stock for each share of Cavalry common stock, or approximately 6.9 million Pinnacle Financial shares. The accompanying consolidated financial statements include the activities of the former Cavalry since March 15, 2006.

In accordance with SFAS No. 141, "Accounting for Business Combinations" ("SFAS No. 141"), SFAS No. 142, "Goodwill and Intangible Assets" ("SFAS No. 142") and SFAS No. 147, "Acquisition of Certain Financial Institutions" ("SFAS No. 147"), Pinnacle Financial recorded at fair value the following assets and liabilities of Cavalry as of March 15, 2006:

Cash and cash equivalents	$ 37,420,210
Investment securities - available-for-sale	39,476,178
Loans, net of an allowance for loan losses of $5,102,296	545,598,367
Goodwill	115,064,500
Core deposit intangible	13,168,236
Other assets	47,933,728
Total assets acquired	798,661,219
Deposits	583,640,043
Federal Home Loan Bank advances	17,766,661
Other liabilities	24,977,272
Total liabilities assumed	626,383,976
Total consideration paid for Cavalry	$ 172,277,243

As discussed more fully below, total consideration is comprised of $171.1 million in Pinnacle Financial common shares issued to former Cavalry shareholders and options issued to former Cavalry option holders and $1.2 million in acquisition costs. Pinnacle Financial is in the process of finalizing the allocation of the purchase price to the acquired net assets noted above. Accordingly, the above allocations should be considered preliminary as of September 30, 2006.

As noted above, total consideration for Cavalry approximates $172.3 million of which $171.1 million was in the form of Pinnacle Financial common shares and options to acquire Pinnacle Financial common shares and $1.2 million in investment banking fees, attorney's fees and other costs related to the acquisition which have been accounted for as a component of the purchase price. Pinnacle Financial issued 6,856,298 shares of Pinnacle Financial common stock to the former Cavalry shareholders. In accordance with EITF No. 99-12, “Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination”, the consideration shares were valued at $24.53 per common share which represents the average closing price of Pinnacle Financial common stock from the two days prior to the merger announcement on September 30, 2005 through the two days after the merger announcement. Aggregate consideration for the common stock issued was approximately $168.2 million. Additionally, Pinnacle Financial also has assumed the Cavalry Bancorp, Inc. 1999 Stock Incentive Plan (the “Cavalry Plan”) pursuant to which Pinnacle is obligated to issue 195,551 shares of Pinnacle Financial common stock upon exercise of stock options awarded to certain former Cavalry employees who held outstanding options as of March 15, 2006. All of these options were fully vested prior to the merger announcement date and expire at various dates between 2011 and 2012. The exercise prices for these stock options range between $10.26 per share and $13.68 per share. In accordance with SFAS No. 141, Pinnacle Financial has considered the fair value of these options in determining the acquisition cost of Cavalry. The fair value of these vested options approximated $2.9 million which has been included as a component of the aggregate purchase price.

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In accordance with SFAS Nos. 141 and 142, Pinnacle Financial has recognized $13.2 million as a core deposit intangible. This identified intangible is being amortized over seven years using an accelerated method which anticipates the life of the underlying deposits to which the intangible is attributable. For the three and nine months ended September 30, 2006, approximately $535,000 and $1,248,000, respectively, was recognized in the accompanying statement of income as other noninterest expense. Amortization expense associated with this identified intangible will approximate $1.8 million to $2.1 million per year for the next five years with lesser amounts for the remaining two years.

Pinnacle Financial also recorded other adjustments to the carrying value of Cavalry’s assets and liabilities in order to reflect the fair value of those net assets in accordance with generally accepted accounting principles, including a $4.8 million discount associated with the loan portfolio, a $2.6 million premium for Cavalry’s certificates of deposit and a $4.6 million premium for Cavalry’s land and buildings. Pinnacle Financial also recorded the corresponding deferred tax asset or liability associated with these adjustments. The discounts and premiums related to financial assets and liabilities will be amortized into our statements of income in future periods using a method that approximates the level yield method over the anticipated lives of the underlying financial assets or liabilities. For the three and nine months ended September 30, 2006, the accretion of the fair value discounts related to the acquired loans and certificates of deposit increased net interest income by approximately $950,000 and $2.38 million, respectively. Based on the estimated useful lives of the acquired loans and deposits, Pinnacle Financial expects to recognize increases in net interest income related to accretion of these purchase accounting adjustments of $850,000 for the remainder of fiscal year 2006 and $4.1 million in subsequent years.

Statement of Position 03-03, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (“SOP 03-03”) addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. The SOP does not apply to loans originated by the entity. The preliminary purchase accounting adjustments reflect a reduction in loans and the allowance for loan losses of $1.0 million related to Cavalry’s impaired loans.

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The following pro forma income statements assume the merger was consummated on January 1, 2005. The pro forma information does not reflect Pinnacle Financial's results of operations that would have actually occurred had the merger been consummated on such date (dollars in thousands).

	Nine Months Ended September 30, 2006		2005(1)	
Pro Forma Income Statements:				
Net interest income	$	48,512	$	40,674
Provision for loan losses		3,662		1,661
Noninterest income		13,249		13,051
Noninterest expense (2):				
Compensation		22,095		19,158
Other noninterest expense		15,094		13,984
Net income before taxes		20,910		18,922
Income tax expense		7,809		6,092
Net income	$	13,101	$	12,830
Pro Forma Per Share Information:				
Basic net income per common share	$	0.86	$	0.84
Diluted net income per common share	$	0.79	$	0.78
Weighted average shares outstanding:				
Basic		15,308,766		15,259,603
Diluted		16,507,901		16,417,195

(1) In the first quarter of 2005, Cavalry recorded a tax benefit of $427,000 due to a cash distribution of dividends to the participants in their employee stock ownership plan. Excluding this benefit would have lowered pro forma net income for the nine months ended September 30, 2005 by $427,000 resulting in pro forma net income of $12,404,000 or $0.81 per basic share and $0.76 per fully-diluted share.

(2) In preparation and as a result of the merger during 2006, Cavalry and Pinnacle Financial incurred significant merger related charges of approximately $11.6 million in the aggregate primarily for severance benefits, accelerated vesting of defined compensation agreements, investment banker fees, etc. Including these charges would have decreased pro forma net income for the nine months ended September 30, 2006 by $7.05 million resulting in net income of $6,051,000 and a basic and fully diluted pro forma net income per share of $0.40 and $0.37, respectively.

During the three and nine months ended September 30, 2006, Pinnacle Financial incurred merger integration expense related to the merger with Cavalry of $218,000 and $1,583,000, respectively. These expenses were directly related to the merger, recognized as incurred and reflected on the accompanying consolidated statement of income as merger related expense.

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Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2006 and December 31, 2005 are summarized as follows:

	September 30, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$ -	$ -	$ -	$ -
U.S. government agency securities	32,071,059	10,369	515,196	31,566,232
Mortgage-backed securities	222,272,968	326,785	3,610,267	218,989,486
State and municipal securities	51,166,848	77,279	534,778	50,709,349
Corporate notes and other	2,289,519	-	71,362	2,218,157
	$ 307,800,394	$ 414,433	$ 4,731,603	$ 303,483,224
Securities held-to-maturity:				
U.S. government agency securities	$ 17,747,119	$ -	$ 416,594	$ 17,330,525
State and municipal securities	9,528,532	-	327,910	9,200,622
	$ 27,275,651	$ -	$ 744,504	$ 26,531,147

	December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury securities	$ -	$ -	$ -	$ -
U.S. government agency securities	31,054,469	-	534,899	30,519,570
Mortgage-backed securities	190,708,007	44,378	3,866,210	186,886,175
State and municipal securities	32,583,283	19,044	464,984	32,137,343
Corporate notes	2,300,442	-	94,436	2,206,006
	$ 256,646,201	$ 63,422	$ 4,960,529	$ 251,749,094
Securities held-to-maturity:				
U.S. government agency securities	$ 17,746,883	$ -	$ 441,208	$ 17,305,675
State and municipal securities	9,584,368	-	343,746	9,240,622
	$ 27,331,251	$ -	$ 784,954	$ 26,546,297

On March 31, 2004, Pinnacle National transferred approximately $27,656,000 of available-for-sale securities to held-to-maturity at fair value. The transfer consisted of substantially all of Pinnacle National’s holdings of Tennessee municipal securities and several of its longer-term agency securities. The net unrealized gain on such securities as of the date of transfer was approximately $325,000. This amount is reflected in the accumulated other comprehensive income, net of tax, and is being amortized over the remaining lives of the respective held-to-maturity securities. At September 30, 2006, the unamortized amount approximated $191,000.

Pinnacle Financial realized approximately $114,000 in gains from the sale of $6,792,000 of available-for-sale securities during the nine months ended September 30, 2005. There were no sales of securities during the three months ended September 30, 2005 or during the three and nine months ended September 30, 2006.

At September 30, 2006, approximately $306,331,000 of Pinnacle Financial's securities were pledged to secure public funds and other deposits and securities sold under agreements to repurchase.

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At September 30, 2006 and December 31, 2005, included in securities were the following investments with unrealized losses. The information below classifies these investments according to the term of the unrealized loss of less than twelve months or twelve months or longer:

	Investments With an Unrealized Loss of Less than 12 months		Investments With an Unrealized Loss of 12 months or longer		Total Investments With an Unrealized Loss	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At September 30, 2006:						
U.S. government agency securities	$ 7,761,607	$ 49,142	$ 40,125,251	$ 882,647	$ 47,886,858	$ 931,789
Mortgage-backed securities	48,077,830	447,709	129,662,420	3,162,559	177,740,250	3,610,268
State and municipal securities	22,638,865	209,771	24,237,720	652,917	46,876,585	862,688
Corporate notes	-	-	2,218,157	71,362	2,218,157	71,362
Total temporarily-impaired securities	$ 78,478,302	$ 706,622	$ 196,243,548	$ 4,769,485	$ 274,721,850	$ 5,476,107
At December 31, 2005:						
U.S. government agency securities	$ 28,605,270	$ 463,534	$ 19,219,975	$ 512,573	$ 47,825,245	$ 976,107
Mortgage-backed securities	110,636,351	1,586,394	69,512,865	2,279,816	180,149,216	3,866,210
State and municipal securities	22,692,062	341,869	14,074,344	466,861	36,766,406	808,730
Corporate notes	-	-	2,206,006	94,436	2,206,006	94,436
Total temporarily-impaired securities	$ 161,933,683	$ 2,391,797	$ 105,013,190	$ 3,353,686	$ 266,946,873	$ 5,745,483

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

Note 4. Loans and Allowance for Loan Losses

The composition of loans at September 30, 2006 and December 31, 2005 is summarized as follows:

	At September 30, 2006	***At December 31, 2005***
Commercial real estate - Mortgage	$ 265,173,969	$ 148,102,053
Commercial real estate - Construction	152,627,475	30,295,106
Commercial - Other	554,617,009	239,128,969
Total Commercial	972,418,453	417,526,128
Consumer real estate - Mortgage	292,206,262	169,952,860
Consumer real estate - Construction	87,890,024	37,371,834
Consumer - Other	52,886,690	23,173,210
Total Consumer	432,982,976	230,497,904
Total Loans	1,405,401,429	648,024,032
Allowance for loan losses	(15,172,446)	(7,857,774)
Loans, net	$ 1,390,228,983	$ 640,166,258

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Changes in the allowance for loan losses for the nine months ended September 30, 2006 and for the year ended December 31, 2005 are as follows:

	2006	2005
Balance at beginning of period	$ 7,857,774	$ 5,650,014
Charged-off loans	(627,838)	(207,647)
Recovery of previously charged-off loans	159,576	263,441
Allowance from Cavalry acquisition (see note 2)	5,102,296	-
Provision for loan losses	2,680,638	2,151,966
Balance at end of period	$ 15,172,446	$ 7,857,774

At September 30, 2006 and 2005, Pinnacle Financial had certain impaired loans on nonaccruing interest status. The principal balance of these nonaccrual loans amounted to $3,477,000 and $61,000 at September 30, 2006 and 2005, respectively. In each case, at the date such loans were placed on nonaccrual, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Had these loans been on accruing status, interest income would have been higher by $202,000 and $32,000 for the nine months ended September 30, 2006 and 2005, respectively.

At September 30, 2006, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately $18,392,000 to certain directors, executive officers, and their related entities, of which approximately $11,778,000 had been drawn upon. At December 31, 2005, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately $13,223,000 to certain directors, executive officers, and their related entities, of which $6,958,000 had been drawn upon. The terms on these loans and extensions are on substantially the same terms customary for other persons for the type of loan involved.

During the three and nine months ended September 30, 2006 and 2005, Pinnacle Financial sold participations in certain loans to correspondent banks at an interest rate that was less than that of the borrower's rate of interest. In accordance with generally accepted accounting principles, Pinnacle Financial has reflected a net gain on the sale of these participated loans for the three months ended September 30, 2006 of approximately $102,000 and a net loss of $26,000 for the three months ended September 30, 2005, and, for the nine months ended September 30, 2006 and 2005, Pinnacle Financial reflected a net gain on the sale of participated loans of $224,000 and $111,000, respectively, which is attributable to the present value of the future net cash flows of the difference between the interest payments the borrower is projected to pay Pinnacle Financial and the amount of interest that will be owed the correspondent banks based on their participation in the loan.

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Note 5. Income Taxes

Income tax expense attributable to income from continuing operations for the three and nine months ended September 30, 2006 and 2005 consists of the following:

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Current tax expense:				
Federal	$ 2,404,721	$ 742,824	$ 6,644,857	$ 2,678,092
State	118,652	822	428,745	93,472
Total current tax expense	2,523,373	743,646	7,073,602	2,771,564
Deferred tax benefit:				
Federal	57,292	37,534	(949,171)	(382,960)
State	14,800	8,201	(161,319)	(77,149)
Total deferred tax expense (benefit)	72,092	45,736	(1,110,490)	(460,109)
	$ 2,595,465	$ 789,382	$ 5,963,112	$ 2,311,455

Pinnacle Financial's income tax expense (benefit) differs from the amounts computed by applying the Federal income tax statutory rates of 35% in 2006 and 34% in 2005 to income before income taxes. A reconciliation of the differences for the three and nine months ended September 30, 2006 and 2005 is as follows:

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Income taxes at statutory rate	$ 2,779,782	$ 974,994	$ 6,385,488	$ 2,763,731
State tax expense, net of federal tax effect	86,743	(12,622)	173,827	10,773
Federal tax credits	(75,000)	(75,000)	(225,000)	(225,000)
Tax-exempt securities	(155,154)	(116,739)	(425,766)	(232,716)
Other items	(40,906)	18,749	54,563	(5,333)
Income tax expense	$ 2,595,465	$ 789,382	$ 5,963,112	$ 2,311,455

The effective tax rate for 2006 and 2005 is impacted by Federal tax credits related to the New Markets Tax Credit program whereby a subsidiary of Pinnacle National has been awarded approximately $2.3 million in future Federal tax credits which are available thru 2010. Tax benefits related to these credits will be recognized for financial reporting purposes in the same periods that the credits are recognized in the Company’s income tax returns. The credit that is available for each of the years ended December 31, 2006 and 2005 is $300,000. Pinnacle Financial believes that it will comply with the various regulatory provisions of the New Markets Tax Credit program in fiscal 2006, and therefore has reflected the impact of the credits in its estimated annual effective tax rate for 2006. During 2004, Pinnacle National formed a real estate investment trust which provides Pinnacle Financial with an alternative vehicle for raising capital. Additionally, the ownership structure of this real estate investment trust provides certain state income tax benefits to Pinnacle National and Pinnacle Financial.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that Pinnacle Financial will realize the benefit of these deductible differences. However, the amount of the deferred tax asset considered realizable could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

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The components of deferred income taxes included in other assets in the accompanying consolidated balance sheets at September 30, 2006 and December 31, 2005 are as follows:

	September 30, 2006	December 31, 2005
Deferred tax assets:		
Loans and loan loss allowance	$ 7,808,264	$ 3,019,094
Securities	1,568,024	1,773,521
Merger related deferred deductions	1,447,810	-
Accrued liability for salaried executive retirement plan	1,486,314	-
Other deferred tax assets	192,024	174,816
	12,502,436	4,967,431
Deferred tax liabilities:		
Depreciation and amortization	1,805,264	417,207
Deposits	4,051,911	-
FHLB dividends	724,633	-
Other deferred tax liabilities	499,272	139,602
	7,081,080	556,809
Net deferred tax assets	$ 5,421,356	$ 4,410,622

Note 6. Commitments and Contingent Liabilities

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

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from Pinnacle Financial under certain prescribed circumstances. Subsequently, Pinnacle Financial would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

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

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

A summary of Pinnacle Financial's total contractual amount for all off-balance sheet commitments at September 30, 2006 is as follows:

Commitments to extend credit	$ 502,295,000
Standby letters of credit	$ 56,439,000

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At September 30, 2006, the fair value of Pinnacle Financial's standby letters of credit was $163,000. This amount represents the unamortized fee associated with these standby letters of credit and is included in the consolidated balance sheet of Pinnacle Financial. This fair value will decrease over time as the existing standby letters of credit approach their expiration dates.

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of claims outstanding at September 30, 2006 will not have a material effect on Pinnacle Financial's consolidated financial statements.

Note 7. Stock Option Plan and Restricted Shares

Pinnacle Financial has two equity incentive plans under which it has granted stock options to its employees to purchase common stock at or above the fair market value on the date of grant and granted restricted share awards to employees and directors. During the first quarter of 2006 and in connection with its merger with Cavalry, Pinnacle Financial assumed a third equity incentive plan, (the "Cavalry Plan"). All options granted under the Cavalry Plan were fully vested prior to Pinnacle Financial's merger with Cavalry and expire at various dates between January 2011 and June 2012. In connection with the merger, all options to acquire Cavalry common stock were converted to options to acquire Pinnacle Financial common stock at the 0.95 exchange ratio. The exercise price of the outstanding options under the Cavalry Plan was adjusted using the same conversion ratio. All other terms of the Cavalry options were unchanged. There were 195,551 Pinnacle shares which could be acquired by the participants in the Cavalry Plan at exercise prices that ranged between $10.26 per share and $13.68 per share.

As of September 30, 2006, of the 1,649,000 stock options outstanding, 1,341,000 options were granted with the intention to be incentive stock options qualifying under Section 422 of the Internal Revenue Code for favorable tax treatment to the option holder while 308,000 options would be deemed non-qualified stock options and thus not subject to favorable tax treatment to the option holder. All stock options under the plans vest in equal increments over five years from the date of grant and are exercisable over a period of ten years from the date of grant.

A summary of the activity within the three equity incentive plans during the nine months ended September 30, 2006 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters was as follows:

	Number	Weighted-Average Exercise Price	Weighted-Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value (1) (000's)
Outstanding at December 31, 2005	**1,242,393**	**$ 9.78**		
Additional stock option grants resulting from assumption of the Cavalry Plan	195,551	10.80		
Granted	310,569	28.24		
Exercised	(93,435)	10.15		
Forfeited	(5,832)	12.65		
Outstanding at September 30, 2006	**1,649,246**	**$ 13.31**	**6.53**	**$ 37,123**
	1,623,405	**$ 13.16**	**6.50**	**$ 36,749**

Outstanding and expected to vest at September 30, 2006				
Options exercisable at September 30, 2006	**954,346**	**$ 7.39**	**5.17**	**$ 27,117**

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of Pinnacle Financial common stock of $35.80 per common share for the 1.65 million options that were in-the-money at September 30, 2006.

During the nine months ended September 30, 2006, 149,491 option awards vested at an average exercise price of $12.35 and an intrinsic value of approximately $5.35 million.

During the nine months ended September 30, 2006 and 2005, the aggregate intrinsic value of options exercised under our equity incentive plans was $1,553,000 and $314,000, respectively, determined as of the date of option exercise. As of September 30, 2006, there was approximately $4.15 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under our equity incentive plans. That cost is expected to be recognized over a weighted-average period of 3.42 years.

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Pinnacle Financial adopted SFAS No. 123(R) using the modified prospective transition method on January 1, 2006. Accordingly, during the nine month period ended September 30, 2006, we recorded stock-based compensation expense using the Black-Scholes valuation model for awards granted prior to, but not yet vested, as of January 1, 2006 and for stock-based awards granted after January 1, 2006, based on fair value estimated using the Black-Scholes valuation model. For these awards, we have recognized compensation expense using a straight-line amortization method. As SFAS No. 123(R) requires that stock-based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the nine month period ended September 30, 2006 has been reduced for estimated forfeitures. The impact on our results of operations (compensation and employee benefits expense) and earnings per share of recording stock-based compensation in accordance with SFAS No. 123(R) (related to stock option awards) for the nine month period ended September 30, 2006 was as follows:

	Awards granted with the intention to be classified as incentive stock options	Non-qualified stock option awards	Totals
Stock-based compensation expense	$ 437,911	$ 252,232	$ 690,143
Deferred income tax benefit	-	98,951	98,951
Impact of stock-based compensation expense after deferred income tax benefit	$ 437,911	$ 153,281	$ 591,192
Impact on earnings per share:			
Basic - 13,450,282 weighted average shares outstanding	$ 0.033	$ 0.011	$ 0.044
Fully diluted - 14,649,418 weighted average shares outstanding	$ 0.030	$ 0.010	$ 0.040

For purposes of these calculations, the fair value of options granted for each of the nine months ended September 30, 2006 and 2005 was estimated using the Black-Scholes option pricing model and the following assumptions:

	For the nine months ended September 30, 2006	2005
Risk free interest rate	4.66%	2.89%
Expected life of options	6.50 years	6.50 years
Expected dividend yield	0.00%	0.00%
Expected volatility	23.5%	23.9%
Weighted average fair value	$10.29	$7.43

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

Additionally, Pinnacle Financial's 2004 Equity Incentive Plan provides for the granting of restricted share awards and other performance or market-based awards, such as stock appreciation rights. There were no market-based awards or stock appreciation rights outstanding as of September 30, 2006. During 2005 and 2004, Pinnacle Financial awarded 16,366 shares and 3,846 shares, respectively, of restricted common stock to certain executives of Pinnacle Financial. The fair value of these awards as of the date of grant was $24.98 and $22.62 per share, respectively. The forfeiture restrictions on the restricted shares lapse in three separate traunches should Pinnacle Financial achieve certain earnings and soundness targets over the subsequent three year period, excluding the impact of merger related expense in 2006. Compensation expense associated with the restricted share awards is recognized over the time period that the restrictions associated with the awards lapse based on a graded vesting schedule such that each traunche is amortized separately. Earnings and soundness targets for the 2005 and 2004 fiscal years were achieved and the restrictions related to 6,734 shares and 1,282 shares, respectively, were released.

For the nine months ended September 30, 2006 and 2005, Pinnacle Financial recognized approximately $130,000 and $129,000, respectively, in compensation costs attributable to these awards. Accumulated compensation costs since the date these shares were awarded have amounted to approximately $460,000 through September 30, 2006.

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During the three months ended September 30, 2006, Pinnacle Financial awarded 18,057 restricted shares to certain executives of Pinnacle Financial. The fair value of these awards as of the date of grant was $34.96. The forfeiture restrictions on the restricted shares lapse in three separate traunches should Pinnacle Financial achieve certain earnings and soundness targets over the subsequent three year period, excluding the impact of merger related expense in 2006. Compensation expense associated with the restricted share awards is recognized over the time period that the restrictions associated with the awards lapse based on a vesting schedule such that all traunches are amortized separately. For the three months ended September 30, 2006, Pinnacle Financial recognized approximately $105,000 in compensation costs attributable to these awards.

During the first and second quarters of 2006, the Board of Directors of Pinnacle Financial awarded 4,400 shares of restricted common stock to the outside members of the board in accordance with their 2006 board compensation package. Each board member received an award of 400 shares. The restrictions on these shares will lapse on the one year anniversary date of the award provided the individual board member meets attendance goals for the various board and board committee meetings to which such member is scheduled to attend during the fiscal year ending December 31, 2006. During the third quarter, one outside board member resigned his board seat and forfeited his restricted share award. The weighted average fair value of all restricted share awards granted to our directors as of the date of grant was $26.05 per share. For the nine months ended September 30, 2006, Pinnacle Financial recognized approximately $76,000, in compensation costs attributable to these awards. Pinnacle Financial anticipates that should the remaining restrictions on these shares lapse, Pinnacle Financial will incur an additional $29,000 in compensation costs.

A summary of activity for restricted share awards for the nine months ended September 30, 2006 follows:

	Executive Management Awards			***Board of Director Awards***		
(number of share awards)	***Vested***	***Unvested***	***Totals***	***Vested***	***Unvested***	***Totals***
Balances at Dec. 31, 2005	8,014	12,198	20,212	-	-	-
Granted	-	18,057	18,057	-	4,400	4,400
Forfeited	-	-	-	-	(400)	(400)
Vested	-	-	-	-	-	-
Balances at September 30, 2006	8,014	30,255	38,269	-	4,000	4,000

Prior to January 1, 2006, Pinnacle Financial applied APB Opinion No. 25 and related interpretations in accounting for its stock option plans. All option grants carry exercise prices equal to or above the fair value of the common stock on the date of grant. Accordingly, no compensation cost had been recognized for such periods. Had compensation cost for Pinnacle Financial's equity incentive plans been determined based on the fair value at the grant dates for awards under the plans consistent with the method prescribed in SFAS No. 123(R), Pinnacle Financial's net income and net income per share would have been adjusted to the pro forma amounts indicated below for the three and nine months ended September 30, 2005:

	For the three months ended September 30, 2005	***For the nine months ended September 30, 2005***

Net income, as reported		$	2,078,243	$	5,817,165
Add: Compensation expense recognized in the accompanying consolidated statement of income, net of related tax effects			69,235		78,351
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of related tax effects			(212,547)		(564,912)
Pro forma net income		$	1,934,931	$	5,330,604
Per share information:					
Basic net income	As reported	$	0.25	$	0.69
	Pro forma		0.23		0.63
Diluted net income	As reported	$	0.22	$	0.62
	Pro forma		0.20		0.56

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Note 8. Regulatory Matters

Pinnacle National is subject to restrictions on the payment of dividends to Pinnacle Financial under federal banking laws and the regulations of the Office of the Comptroller of the Currency. Pinnacle Financial is also subject to limits on payment of dividends to its shareholders by the rules, regulations and policies of federal banking authorities. Pinnacle Financial has not paid any cash dividends since inception, and it does not anticipate that it will consider paying dividends until Pinnacle National generates sufficient capital from operations to support both anticipated asset growth and dividend payments.

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

Quantitative measures established by regulation to ensure capital adequacy require Pinnacle Financial and Pinnacle National to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average assets. Management believes, as of September 30, 2006 and December 31, 2005, that Pinnacle Financial and Pinnacle National met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized, Pinnacle National must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. Pinnacle Financial and Pinnacle National's actual capital amounts and ratios are presented in the following table (dollars in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
At September 30, 2006						
Total capital to risk weighted assets:						
Pinnacle Financial	$ 194,427	12.0%	$ 130,154	8.0%		