

FIRST FINANCIAL CORP /TX/  
Form 10KSB  
April 15, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-KSB**

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

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

**Commission File Number: 0-5559**

**FIRST FINANCIAL CORPORATION**

(Name of small business issuer as specified in its charter)

**Texas**  
(State or other jurisdiction of  
incorporation or organization)

**74-1502313**  
(I.R.S. Employer  
Identification No.)

**800 Washington Avenue, Waco, Texas**  
(Address of principal executive offices)

**76701**  
(Zip Code)

Issuer's telephone number: (254) 757-2424

**Securities registered pursuant to Section 12(b) of the Act:**

None

**Securities registered pursuant to Section 12(g) of the Act:**

Common Stock (no par value per share)

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB.

Issuer's revenues for the fiscal year ended December 31, 2004, were \$7,688,340.

There is no established trading market for the Issuer's class of voting stock, therefore, the Issuer cannot determine the aggregate value of voting stock held by non-affiliates.

Number of shares of the Issuer's Common Stock outstanding on March 31, 2005, was 173,528.

**DOCUMENTS INCORPORATED BY REFERENCE**

None.

Transitional Small Business Disclosure Format (check one): Yes \_\_\_\_\_ No X

Total number of pages, including cover pages - 62

## **PART I**

### **Item 1. Description of Business**

#### **GENERAL**

First Financial Corporation (the "Company") was incorporated in the State of Texas in 1964 and its principal place of business is in Waco, Texas. During the last three years, the primary business of the Company, through its subsidiaries, has been originating and servicing residential mortgage loans, engaging in insurance activities, providing consulting and data processing services to related companies and servicing a decreasing portfolio of manufactured home loans.

The Company originates and services residential mortgage loans through its subsidiary, First Preference Mortgage Corp. ("FPMC"). FPMC originates and services residential mortgage loans and is an approved seller/servicer for the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Veterans Administration and Federal Housing Administration. FPMC currently operates retail branch offices in Waco and Victoria, Texas and has operations centers in Houston and Hurst, Texas. Each retail branch office is staffed with loan originators who actively solicit residential mortgage loans in their respective markets. FPMC also originates loans received from approximately 600 FPMC-approved independent mortgage loan brokers located throughout Texas. Substantially all of the loans originated by FPMC are sold to governmental or private investors. During 2002, 2003, and 2004, FPMC originated approximately \$673 million, \$706 million and \$347 million, respectively, in new residential mortgage loans.

FPMC funds the loans it originates prior to the sale of such loans to investors. The source of money to fund these loans is a warehouse line of credit with a financial institution under which the financial institution advances up to 99% of the amount of each loan that is to be paid by the investor, but not to exceed the unpaid principal of the loan. The advance is repaid when the loan is sold to the investor. Additionally, in August 2002, the Company entered into a Loan Participation Agreement with another financial institution. Under this agreement, the financial institution underwrites selected loans originated by FPMC and has the option to purchase a 99% undivided interest in each loan approved for the program. When a subject mortgage loan is sold in the secondary market, the financial institution recoups its investment plus a specified yield on its investment.

Apex Lloyds Insurance Company ("Apex Lloyds"), which, prior to March 31, 2005, was a wholly-owned subsidiary of the Company, underwrites hazard and credit risks on residential home loans financed by the Company or by others. Hazard insurance on residential homes not financed by the Company or any related company is also written by Apex Lloyds through fronting and reinsurance agreements with unrelated third parties. Under the fronting agreements, Apex Lloyds issues the insurance policies and reinsures substantially all of the risks on the insurance to another insurance entity for a fee. The reinsurance agreements provides that the insurer assumes all or part of the risk undertaken by Apex Lloyds for a fee. Prior to December 29, 2004, through First Apex Re, Inc. ("FAR"), the Company provided reinsurance coverage for mortgage guaranty insurance placed on loans originated by related and affiliated entities.

There are a large number of competitors in the origination and servicing of residential mortgage loans, including other mortgage companies, banks and financial institutions. Compared to its competitors, FPMC is a small company. The loan products offered by FPMC are similar to loan products offered by its competitors.

(continued)



**Item 1. Description of Business** (Continued)

**GENERAL** (Continued)

First Advisory Services, Inc., a wholly owned subsidiary of the Company, provides accounting, personnel, general and administrative, and information technology services to entities that are affiliated through common ownership.

The Company and its consolidated subsidiaries employed 74 employees as of December 31, 2004, of whom 58 are full-time employees. Fifty of these employees work for FPMC, of whom 42 are full-time employees.

The Company does not spend any significant amounts on research and development or compliance with environmental laws.

**SALE OF FIRST APEX RE AND APEX LLOYDS INSURANCE COMPANY**

On December 29, 2004, (i) Apex Lloyds Insurance Company ("Apex Lloyds") sold its 48% ownership interest in First Apex, Re., Inc., a Vermont corporation ("FAR"), to Security Bancshares, Inc., ("SBI"), a Delaware corporation and (ii) First Preference Mortgage Corp., a Texas corporation and a wholly-owned subsidiary of the Company ("FPMC"), sold its 52% ownership interest in FAR to SBI.

As consideration for the shares of FAR common stock sold to SBI, Apex Lloyds received (i) cash in the amount of \$2,374 and (ii) marketable securities with a market value on the date of sale of \$532,283, and FPMC received cash in the amount of \$579,211. This purchase price was the fair market value of FAR as determined by an independent appraiser. Prior to approving the sale to SBI, the Board of Directors of the Company received an opinion from an independent business valuation advisor regarding the fairness of the transaction to the Company's shareholders.

Through an agreement with a third party, FAR provides reinsurance coverage for mortgage guaranty insurance placed on certain loans originated by FPMC. The Company expects that this relationship will continue in the future whenever it is commercially reasonable for the Company.

On March 31, 2005, the Company sold its 100% ownership interest in (i) Apex Lloyds, a Texas Lloyds Plan insurance company, and (ii) Texas Apex, Inc., a Texas corporation ("Texas Apex"), to ("SBI").

Apex Lloyds underwrites hazard insurance on residential mortgage loans financed by the Company, and subsidiaries, and by unrelated third parties. Apex Lloyds also writes hazard insurance on residential homes not financed by the Company or its affiliates through fronting and reinsurance agreements with unrelated third parties. The Company expects that the sale of the Apex Lloyds ownership to SBI will have no effect on the currently existing contractual relationships between the Company and Apex Lloyds. It also expects that it will continue to conduct business with Apex Lloyds in the future whenever it is commercially reasonable for it to do so.

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**Item 1. Description of Business** (Continued)

**SALE OF FIRST APEX RE AND APEX LLOYDS INSURANCE COMPANY** (Continued)

Texas Apex holds a certificate of authority from the Texas Commissioner of Insurance to act as attorney-in-fact for Apex Lloyds to transact insurance business in Texas and conducts no other business.

As consideration for the shares of Texas Apex and Apex Lloyds common stock sold to SBI, the Company received (i) cash in the amount of \$1,640,963 and (ii) marketable securities with a market value on the date of sale of \$498,686. This purchase price was the fair market value of Texas Apex and Apex Lloyds as determined by an independent appraiser. Prior to approving the sale to SBI, the Board of Directors of the Company received an opinion from an independent business valuation advisor regarding the fairness of the transaction to the Company's shareholders.

David W. Mann, Chief Executive Officer, Chief Financial Officer and a director of FFC, is a director and executive officer of SBI. In addition, through entities that he controls, Mr. Mann beneficially owns approximately 72.67% of the outstanding common stock of SBI.

**KEY GROUP TRANSACTIONS**

Prior to July 31, 2002, (i) the Company owned, directly, approximately 53% of Key Group, Ltd., a Texas limited partnership, (ii) Key Group Ltd. owned all of the capital stock of First Preference Holdings, Inc. ("FPHI"), a Texas corporation; (iii) FPHI owned all of the capital stock of Security Washington Avenue Corporation ("Security"), a Delaware corporation; and (iv) Security owned all of the capital stock of First Preference Mortgage Company ("FPMC"), a significant operating subsidiary of the Company, the primary business of which is the originating and servicing of residential mortgage loans through retail and wholesale broker relationships throughout Texas. The remaining interest in Key Group, Ltd. (approximately 47%) was owned by Bluebonnet Investments, Ltd., a Texas limited partnership ("Bluebonnet"), which is controlled, in part, by David W. Mann (the President and a director of the Company). Substantially all of Bluebonnet is owned, indirectly, by Mr. Mann and his siblings, Mary Hyden Hunter and Allen B. Mann, both of whom were directors of the Company at the time of the transactions.

On or shortly after July 31, 2002, the following transactions occurred:

1. Key Group, Ltd. was dissolved and distributed all of its assets to its partners, as a result of which the Company received approximately 53% and Bluebonnet received approximately 47% of the capital stock of FPHI.

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5

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**Item 1. Description of Business** (Continued)

**KEY GROUP TRANSACTIONS** (Continued)

2. The Company purchased from Bluebonnet all of the capital stock of FPHI owned by Bluebonnet (valued at \$478,361) in exchange for (i) the Company's 24% limited partner interest (valued at \$290,699) in Vidor, Ltd., a Texas limited partnership, the business of which consists of the ownership and development of approximately 1.8 acres of real estate located in eastern Texas, (ii) the Company's 25% membership interest (valued at \$10,465) in Vidor Whispering Pines, L.C., a Texas limited liability company, the business of which consists of the ownership of approximately 160.5 acres of unimproved real estate, and (iii) the Company's promissory note (the "Promissory Note") in the principal amount of \$177,197 payable in full in three years, bearing interest at 7.25% per year payable quarterly, and secured by approximately 78.471 acres of unimproved real estate owned by the Company located in Robinson, Texas (the "Robinson Real Estate"). As a result of this purchase from Bluebonnet, the Company became the sole owner of all of the outstanding capital stock of FPHI. For purposes of determining the purchase price of the assets exchanged in these transactions, the Promissory Note was evaluated at its principal amount and all other non-cash assets were evaluated at the valuations determined in recent appraisals received from independent, expert appraisers.

3. Security merged with and into FPHI, after which FPHI merged with and into FPMC, with FPMC being the surviving corporation.

4. The Promissory Note was assumed by FPMC and the Robinson Real Estate was transferred by the Company to FPMC as a capital contribution.

5. Real estate owned by FPMC at 800 Washington Avenue in Waco, Texas, was sold to FVI Acquisition, L.C. ("FVI") for \$750,000, of which \$525,000 was paid in cash at closing and \$225,000 was paid in the form of FVI's 3-year promissory note secured by the Washington Avenue property and bearing interest at 5.25% ( $\frac{1}{2}\%$  over Wells Fargo Bank, N.A. prime rate). The Washington Avenue property was leased back by FVI to FPMC pursuant to a triple-net lease calling for monthly rental payments of \$9,382 for a primary term of three years. FVI was a Texas limited liability company the manager of which was David W. Mann and all of the membership interests which were owned by the trusts for the benefit of Mr. Mann's children. During 2003, FVI was converted, under Texas law, into JRPM Investments, Ltd., a Texas limited partnership ("JRPM") controlled by Mr. Mann and owned by Mr. Mann and trusts for his children.

As a result of these transactions, Key Group, Ltd., FPHI and Security have been eliminated and FPMC became wholly owned, directly, by the Company.

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**Item 1. Description of Business** (Continued)

**DEBT SWAP WITH BLUEBONNET**

On November 22, 2002, the \$225,000 promissory note issued by FVI to the Company and the security interest in the Washington Avenue property serving as collateral for that note were assigned by the Company to Bluebonnet in exchange for (i) the cancellation of the \$177,197 Promissory Note issued by the Company to Bluebonnet, (ii) the relinquishment by Bluebonnet of its security interest in the Robinson Real Estate and (iii) the payment by Bluebonnet to FPMC of cash in the amount of the difference between the principal balances due on the two notes (\$39,649).

**Item 2. Description of Properties**

First Preference Mortgage Corp. ("FPMC") owned an office building containing approximately 13,500 square feet of office space at 800 Washington Avenue, Waco, Texas. On August 1, 2002, this building was sold to FVI Acquisition, L.C. ("FVI") and leased back by FVI, now JRPM Investments, Ltd., to FPMC pursuant to a triple-net lease for a term of three years (see Certain Relationships and Related Transactions). This office building has served as the Company's principal office since August 1991.

FPMC currently leases approximately 1,750 square feet of office space located at 919 N. Valley Mills Drive, Waco, Texas as a retail branch office. This lease expired and FPMC renewed the lease for a term of 36 months expiring June 30, 2005.

FPMC leases approximately 1,620 square feet of office space located at 464 Mid Cities Boulevard, Hurst, Texas as an area operations center. This lease expired in May 2003 and was renewed for an additional two-year term to expire June 30, 2005.

In February 2002, FPMC leased approximately 550 square feet of office space located at 5620 Old Bullard Road, Tyler, Texas for a term of 12 months. In February 2003, FPMC leased an additional 279 square feet of space and extended the lease on the 550 square feet of office space until February 2006. This location was a retail branch office. This office was closed in February 2004 and FPMC bought out the remaining term of the lease.

FPMC leases approximately 1,693 square feet of office space located at 5700 Northwest Central Drive, Houston, Texas as an area operations center. This lease expired in April 2003 and FPMC renewed the lease for a term of 36 months.

In March 2000, FPMC assumed a lease of approximately 1,811 square feet of office space located at 6224 Colleyville Boulevard, Colleyville, Texas as a retail branch. This lease expired November 30, 2001, and FPMC renewed the lease for a term of 36 months. This lease expired in November 2004 and the office was closed.

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**Item 2. Description of Properties** (Continued)

In April 2003, FPMC leased approximately 750 square feet of office space located at 5003 John Stockbauer Drive, Victoria, Texas for a term of 12 months. In February 2004, this lease was extended for an additional 12 months to expire March 31, 2005. In March, the lease was extended for an additional 12 months. This location is a retail branch office.

In May 2001, FPMC leased approximately 1,000 square feet of office space at 203 Crossroads Shopping Center, Waco, Texas for a lease term of three years. In May 2004, this lease was extended for an additional 24 months to expire April 30, 2006. This office serves as a satellite retail office.

In May 2002, FPMC leased approximately 264 square feet of office space located at 1723 E. Cherry Street, Rockport, Texas on a month-to-month basis. This office served as a satellite retail office. This office was closed in September 2003.

In September 2002, FPMC leased approximately 1,470 square feet of office space located at 4923 Franklin Avenue, Waco, Texas for a lease term of 36 months. This office was closed in June 2004 and FPMC bought out the remaining term of the lease. This office was a retail branch office.

In November 2004, FPMC leased approximately 2,000 square feet of office space located at 111 West Arkansas Lane, Arlington, Texas for a term of 24 months. This location was a retail branch office. In February 2005, FPMC sold this branch and the purchaser assumed the remaining term of the lease.

In October 2004, FPMC leased an executive office located at 17304 Preston Road, Suite 800, Dallas, Texas for a period of 6 months to expire April 2005. In November 2004, FPMC leased an additional executive office on a month to month basis. This location was a retail branch office. In February 2005, FPMC sold this branch and the purchaser assumed the remaining term of the lease.

On April 30, 1993, Apex Lloyds, a subsidiary of the Company, purchased an office building containing approximately 14,475 square feet of office space located at 825 Washington Avenue, Waco, Texas. The building is presently being used to store records and was purchased with the intent that it will be used as the home office of Apex Lloyds in the future. On March 31, 2005, Shelter Resources, Inc., a wholly-owned subsidiary of the Company purchased the building from Apex Lloyds.

**Item 3. Legal Proceedings**

Neither the Company nor any of its subsidiaries are currently involved in any legal proceeding where the amount involved exceeds 10% of the current assets of the Company.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

## **PART II**

### **Item 5. Market for the Registrants' Common Equity and Related Stockholder Matters**

There is no established public trading market for the Company's no par value common stock. On March 31, 2005, the Company had approximately 463 holders of record of its common stock.

The Company did not pay any cash dividends during the last two fiscal years. Other than restrictions applicable to Texas corporations in general, there are no restrictions that limit the ability to pay dividends on common equity or that are likely to do so in the future.

The Company has not sold any securities within the past three years.

### **Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

#### **MORTGAGE OPERATIONS**

The mortgage banking business continues to be a primary source of the Company's revenues and earnings. Consequently, a primary influence on the Company's operating results is the demand for mortgage loans in Texas. The demand for mortgage loans is affected by such external factors as prevailing mortgage rates and the strength of the Texas housing market.

In 2004, total U.S. residential mortgage loan production declined significantly from 2003's record setting market to an estimated \$2.9 trillion. This decline was largely attributable to a decline in mortgage refinance activity caused by interest rates rising from the historical low levels reached in 2003. Driven by this mortgage market, the Company originated approximately \$346.6 million in new residential mortgage loans in 2004, compared to approximately \$706.1 in 2003. The Company earns revenue from loan origination fees, interest on the mortgage loan until it is sold to investors and revenue on the sale of its mortgage loans to investors.

For 2005, forecasters predict a continued reduction in the total mortgage loan production due to an expected continuation in the decline in mortgage refinance activity. In response to this anticipated decline, the Company has increased its efforts to recruit experienced sales personnel, implemented a new client management system and is evaluating staffing levels.

#### **INSURANCE OPERATIONS**

During 2004, the Company's insurance operations generated approximately \$781,000 in revenue compared to approximately \$1.6 million in 2003. Net income from insurance operations decreased to approximately \$60,000 from approximately \$684,000 in 2003. As previously discussed, on December 29, 2004, the Company sold First Apex Re and on March 31, 2005, sold Apex Lloyds Insurance Company (see Item 1 under the heading "Sale of First Apex Re and Apex Lloyds Insurance Company"). As a result, the Company will have minimal revenue from insurance operations in 2005 and in future years.

(continued)

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

(Continued)

**RESULTS OF OPERATIONS**

The Company had a net loss of \$(3,064,481) for 2004, compared to net income of \$1,343,672 for 2003. In general, substantially all of the Company's revenue is derived from the Company's subsidiaries involved in residential mortgage loan operations and insurance operations.

Loan administration and production revenue for 2004 was \$3,275,504 compared to \$5,530,288 for 2003. During 2004, FPMC originated approximately \$80.5 million in new residential mortgage loans by its retail branches and approximately \$266.1 million was originated through it's network of approved independent mortgage brokers compared to \$106.8 and \$599.3, respectively in 2003.

Interest income for 2004 amounted to \$1,230,348 compared to \$2,367,188 in 2003. During 2004, the interest income earned by the Company on investments increased by approximately \$35,000 or 46%. This increase is primarily the result of improved cash and investment management. Interest income earned on mortgages held-for-sale decreased by approximately \$1,172,000 during 2004. This decrease is primarily due to the \$359.5 million decrease in loan originations from 2004 to 2003, as discussed above. FPMC earns interest from the date the mortgage is closed until the date the mortgage loan is sold to investors.

Interest expense for the year ended December 31, 2004, amounted to \$962,589 compared to \$2,012,836 for the same period in 2003. During 2004, the weighted average interest rate on the Company's financing of its mortgage lending activities was 4.63% compared to 4.69% for 2003. The difference between interest income and interest expense in 2004 was approximately \$267,759 compared to approximately \$354,352 in 2003. The decrease in the spread between interest income and interest expense was primarily due to residential mortgage rates increasing at a slower rate than the interest paid on the borrowed funds (see Liquidity and Capital Resources).

As previously discussed, effective October 31, 2004, the Company sold the outstanding stock of First Apex Re ("FAR") which resulted in the Company realizing a loss of \$(7,990) on the sale. The Company's consolidated statements of income include the revenue and expense of FAR for the period January 1, 2004 to October 31, 2004.

For the ten months ended October 31, 2004, First Apex Re ("FAR") had net mortgage insurance premium revenues of \$116,418 compared to \$283,886 for the year 2003. The revenues of FAR are generated as a result of loans made by FPMC and the premiums generated by these policies renew annually until the loan is paid off or the loan to value is less than 80%.

(continued)

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

(Continued)

**RESULTS OF OPERATIONS** (Continued)

Fees earned under fronting arrangements amounted to \$148,659 in 2004 compared to \$319,049 in 2003. During 2004, premiums earned and losses paid under reinsurance agreements amounted to \$761,572 and \$186,992, respectively compared to \$724,798 and \$369,381, respectively in 2003. The Company entered into a new Property Quota Share Reinsurance Contract, with the existing managing general agent, effective January 1, 2003. Under this contract, the Company earns liability insurance premiums in addition to assumed reinsurance premiums and fronting fees.

Effective December 30, 2003, the Company entered into a Commutation and Mutual Release Agreement under which the Company assumed all of a reinsurer's past, present and future obligations and liabilities under certain reinsurance agreements in exchange for cash amounting to \$1,913,970. The Company accounted for the cash as negative ceded loss and recorded a loss reserve based on data provided by an independent actuary to reduce the gross proceeds. Based on the difference in gross proceeds received and the actuarial loss exposure associated with past, present, and future obligations related to this agreement, net of associated commissions, the Company realized a net gain of approximately \$590,000 under this agreement in 2003. At December 31, 2004, the Company has an approximate \$455,000 reinsurance loss reserve compared to approximately \$1.4 million at December 31, 2003. Based on the independent actuarial study, it is the Company's belief that its reserve for losses under insurance policies is adequate to absorb potential losses associated with reinsurance.

Consulting fees for the year ended December 31, 2004, amounted to \$315,215 compared to \$399,625 for the same period in 2003. Effective in March 2003, the Company evaluated its billings for consulting fees and decreased the fees to reflect the current cost of providing these services.

During the years ended December 31, 2004 and 2003, the Company did not originate any manufactured home loans. The Company only originates new manufactured home loans to finance the resale of its inventory of repossessed mobile homes that were originally financed through the Company.

For the year ended December 31, 2004, the Company realized gain on sales of loans of \$2,007,812 compared to \$6,041,152 in 2003. During 2004, the volume of new residential mortgage loans sold by FPMC to governmental and private investors amounted to approximately \$336.7 million compared to \$734.1 in 2003 and the net margin realized on the sale of these mortgage loans decreased by approximately 32% due to the competitive conditions that prevailed during the year. During 2004, the Company also realized gains of approximately \$24,000 on the sale of certain of its marketable investment securities compared to realized gains of approximately \$14,000 in 2003.

Salaries and related expenses for 2004 were \$4,733,490 compared to \$6,610,807 in 2003. This decrease is primarily due to the overall decrease in the volume on new residential mortgages originated in 2004 compared to 2003 as previously discussed.

(continued)

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

(Continued)

**RESULTS OF OPERATIONS** (Continued)

During 2004, the Company recorded a provision for loan losses of \$2,071,465 compared to \$1,082,572 for 2003. At December 31, 2004, the reserve for loan losses amounted to \$1,969,296 compared to \$634,254 at December 31, 2003. The Company is at risk under certain of its agreements with private investors for credit losses and cost of foreclosure on default of the borrower. During 2004 and 2003, the Company experienced an increase in the delinquency and default rate on the mortgage loans it originated and sold to investors. The Company has analyzed certain attributes of the mortgage loans that it has sold to investors, including delinquencies, credit quality, credit insurance, loss experience and insurance coverage. Based on this review, the Company believes that its reserve for loan losses is adequate for potential loan losses.

Operating expenses for 2004 were \$3,283,364 compared to \$5,110,004 in 2003. As discussed above, this decrease is primarily due to the decrease in loan origination volume for 2004 compared to 2003.

The Company made no provision for losses under servicing agreements in either 2004 or 2003 and the reserve for losses under servicing agreements amounted to \$234,595 at December 31, 2004 and December 31, 2003. Under the terms of certain of its servicing agreements, the Company is at risk for any credit losses and costs of foreclosure, net of insurance proceeds, if any, sustained on default of the borrower. The Company has analyzed its servicing portfolio characteristics, including the servicing portfolio balance, loss experience, maturity and aging of the loans and the credit insurance coverage on the loans. Based on this analysis, it is the Company's belief that its reserve for losses under servicing agreements is adequate for potential losses attributable to the servicing agreements.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company's primary sources of liquidity are proceeds from the sale of mortgage loans, net interest income, fees earned from originating mortgage loans, premiums written from insurance operations and borrowing under the Company's warehouse credit facilities. The Company's use of cash includes the funding of mortgage loans prior to their sale, payment of interest, repayment of amounts borrowed pursuant to warehouse lines of credit, operating and administrative expenses and capital expenditures.

On a consolidated basis, cash and cash equivalents (including restricted cash) were \$2,154,960 at December 31, 2004. Included therein were cash and cash equivalents for Apex Lloyds of \$1,141,914. The cash flow of Apex Lloyds is only available to the Company as allowed by state insurance regulations.

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**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

(Continued)

**LIQUIDITY AND CAPITAL RESOURCES** (Continued)

FPMC has a mortgage warehouse line of credit with an unrelated financial institution that expires on March 31, 2005. The maximum principal amount under the line of credit was \$25,000,000 at December 31, 2004, and \$35,000,000 at December 31, 2003. Under this agreement, the financial institution advances up to ninety-nine percent (99%) of the amount paid by the investor, but not to exceed the unpaid principal of the loan. When the subject mortgage loan is sold in the secondary market, the financial institution advance is repaid. Advances bear interest based on the 30 day LIBOR (London Interbank Offered Rate) plus 1.90% to 2.65% depending on the advance rate. As of December 31, 2004 and 2003, the principal amount outstanding on the line of credit was \$22,733,529 and \$23,389,011, respectively. This agreement includes certain financial covenants including requirements to maintain adjusted tangible net worth above \$3,500,000. Also, FPMC's total liabilities to adjusted tangible net worth may never exceed 15 to 1. On December 31, 2004, FPMC was in violation of certain covenants related to this agreement. The financial institution has waived the violation of the covenants as of December 31, 2004. In March 2005, the agreement was amended to extend the maturity date to June 30, 2005, and reduce the adjusted tangible net worth requirement to \$2,500,000. In addition, the Company contributed \$1,500,000 in equity to FPMC. The obligations under this agreement are guaranteed under an Unlimited Continuing Guaranty Agreement executed by David W. Mann. Management expects to renew this agreement or possibly seek an alternate funding source for its financing of operations, and therefore, management does not believe that this matter will have a material adverse effect on the financial position of FPMC, however, the ability to provide adequate funding sources for its financing of operations has a direct impact on maintaining the level of operations.

On June 9, 2003, FPMC entered into a loan participation agreement in the amount of \$10,000,000 with its line of credit lender. Under this agreement, the financial institution has the option to purchase an undivided interest in the residential mortgage loans originated by FPMC. When the subject mortgage is sold in the secondary market, the financial institution recoups its investment plus a specified yield on its investment. At December 31, 2004, the participations outstanding under this agreement amounted to \$1,850,227. There were no participations outstanding at December 31, 2003.

In addition, FPMC has a loan participation agreement with Citizens State Bank of Woodville, Texas, of which David W. Mann is president, chief executive officer and a principal shareholder, under which Citizens State Bank has the option to purchase an undivided interest in the residential mortgage loans originated by FPMC. When a subject mortgage loan is sold in the secondary market, the financial institution recoups its investment plus a specified yield on its investment. At December 31, 2004, no participations were outstanding under this agreement.

(continued)

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

(Continued)

**LIQUIDITY AND CAPITAL RESOURCES** (Continued)

On July 1, 2004, FPMC executed a Real Estate Lien Note with Citizens State Bank in the amount of \$825,000. During the first three months the interest rate on the note was 6 1/2%. Thereafter, during each succeeding three-month period, the rate is equal to the prime rate on the first day of each succeeding three month period, plus one and one-half percent. The note is payable in monthly installments of \$10,000 and is due on June 15, 2011. The note is secured by approximately 78.471 acres of unimproved real estate owned by FPMC located in Robinson, Texas. The note is also guaranteed by the Company. In connection with execution of this note, FPMC paid Citizens State Bank \$5,770 in loan fees. During 2004, FPMC paid \$35,901 in principal and \$25,921 in interest to Citizens State Bank. On December 29, 2004, Bluebonnet Investments Ltd., a Texas limited partnership which is controlled, in part, by Mr. Mann, purchased this Real Estate Lien Note from Citizens State Bank.

In July 2002, as a result of FPMC's sale and leaseback of real estate in Waco, Texas, as described under "Key Group Transactions" in Item 1, above, the Company's liquidity was improved by the receipt of \$525,000 in cash and a secured three-year promissory note in the amount of \$225,000. In November 2002, that promissory note was exchanged for the cancellation of a note made by the Company and cash in the amount of the difference between the principal balances due on the two notes (\$39,649).

The Company had no material commitments for capital expenditures at December 31, 2004. As reflected in the attached financial statements, the stockholder's equity of the Company was \$3,143,441 at December 31, 2004, and the stockholders' equity was \$6,217,556 at December 31, 2003.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Company has off-balance sheet interest rate risk on mortgage loans in its pipeline and its outstanding commitments to extend mortgage loans, at predetermined locked-in rates, to homeowners. Management does not believe that any of its off-balance sheet arrangements have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**Item 7. Financial Statements**

The consolidated financial statements of the Company and its subsidiaries and the independent auditor's report appear on pages 15 through 19 herein.

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of  
First Financial Corporation and Subsidiaries

We have audited the accompanying consolidated balance sheet of First Financial Corporation (a Texas corporation) and Subsidiaries as of December 31, 2004, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years ended December 31, 2004 and 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Financial Corporation and Subsidiaries as of December 31, 2004, and the results of their operations and their cash flows for the years ended December 31, 2004 and 2003, in conformity with accounting principles generally accepted in the United States of America.

April 11, 2005

401 WEST HIGHWAY 6 P. O. BOX 20725 WACO, TX 76702-0725 (254) 772-4901 FAX: (254) 772-4920 [www.pbhcpa.com](http://www.pbhcpa.com)  
AFFILIATE OFFICES: BROWNSVILLE, TX (956) 544-7778 HILLSBORO, TX (254) 582-2583  
TEMPLE, TX (254) 791-3460 ALBUQUERQUE, NM (505) 266-5904 RIO RANCHO, NM (505) 898-3516

## FIRST FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEET

AS OF DECEMBER 31, 2004

## ASSETS

|  |        |                |
|--|--------|----------------|
| Cash and cash equivalents                | \$     | 1,675,465      |
| Restricted cash                          |        | 479,495        |
| Accounts receivable                      |        | 625,958        |
| Receivables from related parties         |        | 94,939         |
| Marketable investment securities         |        | 1,346,470      |
| Real estate held-for-investment, at cost |        | 553,836        |
| Mortgage loans held-for-investment       |        | 53,521         |
| Mortgage loans held-for-sale             |        | 23,146,726     |
| Property and equipment                   |        | 1,602,192      |
| Deferred tax asset                       |        | 298,087        |
| Other assets                             |        | 803,074        |
| <br>Total Assets                         | <br>\$ | <br>30,679,763 |

## LIABILITIES AND STOCKHOLDERS' EQUITY

|   |        |                |
|---|--------|----------------|
| Liabilities   |        |                |
| Estimated reserve for indemnifications and early payment default losses   | \$     | 1,969,296      |
| Estimated reserve for losses under servicing agreements   |        | 234,595        |
| Estimated reserve for losses under insurance policies   |        | 455,226        |
| Accounts payable  |        | 536,950        |
| Accrued expenses and other liabilities  |        | 656,773        |
| Payables to related parties   |        | 15,175         |
| Note on line of credit  |        | 22,733,529     |
| Note payable  |        | 839,099        |
| Interest payable  |        | 95,679         |
| Total Liabilities   |        | 27,536,322     |
| Stockholders' Equity  |        |                |
| Common stock - no par value; authorized 500,000 shares; issued 183,750 shares, of which 10,222 shares are held in treasury shares |        | 1,000          |
| Additional paid-in capital  |        | 518,702        |
| Retained earnings   |        | 2,620,625      |
| Accumulated other comprehensive income:   |        |                |
| Unrealized gain on marketable securities, net of tax  |        | 38,423         |
|   |        | 3,178,750      |
| Less: Treasury stock - at cost  |        | 35,309         |
| Total Stockholders' Equity  |        | 3,143,441      |
| <br>Total Liabilities and Stockholders' Equity  | <br>\$ | <br>30,679,763 |

See accompanying notes to consolidated financial statements.

## FIRST FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
YEARS ENDED DECEMBER 31, 2004 AND 2003

|   | 2004           | 2003         |
|---|----------------|--------------|
| <b>REVENUE</b>  |                |              |
| Loan administration and production  | \$ 3,275,504   | \$ 5,530,288 |
| Interest income   | 1,230,348      | 2,367,188    |
| Insurance premiums and commissions  | 781,051        | 1,586,966    |
| Consulting fees   | 315,215        | 399,625      |
| Realized gain on sale of mortgage loans   | 2,007,812      | 6,041,152    |
| Other   | 78,410         | 233,758      |
| Total Revenue   | 7,688,340      | 16,158,977   |
| <b>COST AND EXPENSES</b>  |                |              |
| Salaries and related expenses   | 4,733,490      | 6,610,807    |
| Interest expense  | 962,589        | 2,012,836    |
| Provision for losses under servicing agreements and other                                 | 2,071,465      | 1,082,572    |
| Operating expenses:   |                |              |
| Professional fees   | 462,242        | 717,667      |
| Depreciation and amortization   | 122,630        | 356,390      |
| General and administrative  | 2,698,492      | 4,035,947    |
| Total Cost and Expenses   | 11,050,908     | 14,816,219   |
| <b>INCOME BEFORE INCOME TAXES, MINORITY INTEREST<br/>AND EQUITY IN LOSS OF AFFILIATES</b> | ( 3,362,568)   | 1,342,758    |
| <b>INCOME TAXES</b>   |                |              |
| Current   | ( 298,087)     | ( 914)       |
| Total Income Taxes  | ( 298,087)     | ( 914)       |
| <b>INCOME BEFORE MINORITY INTEREST AND EQUITY<br/>IN LOSS OF AFFILIATES</b>               | ( 3,064,481)   | 1,343,672    |
| <b>NET INCOME (LOSS)</b>  | ( 3,064,481)   | 1,343,672    |
| <b>OTHER COMPREHENSIVE INCOME (LOSS)</b>  |                |              |
| Unrealized gain (loss) on marketable securities, net of tax                               | ( 9,634)       | 22,260       |
| <b>COMPREHENSIVE INCOME (LOSS)</b>  | \$( 3,074,115) | \$ 1,365,932 |
| <b>INCOME (LOSS) PER COMMON SHARE</b>   | \$( 17.66)     | \$ 7.74      |

See accompanying notes to consolidated financial statements.

## FIRST FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

## YEARS ENDED DECEMBER 31, 2004 AND 2003

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Unrealized<br>Gain (Loss) | Treasury<br>Stock | Total        |
|---|-----------------|----------------------------------|----------------------|--|-------------------|--------------|
| <b>BALANCE, DECEMBER 31, 2002</b>                           | \$ 1,000        | \$ 518,702                       | \$ 4,341,434         | \$ 25,797                                | \$ ( 35,309)      | \$ 4,851,624 |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                          |                 |                                  |                      |  |                   |              |
| Net income (loss)   | -               | -                                | 1,343,672            | -  | -                 | 1,343,672    |
| Other comprehensive income (loss):                          |                 |                                  |                      |  |                   |              |
| Unrealized gain (loss) on marketable securities, net of tax | -               | -                                | -                    | 22,260                                   | -                 | 22,260       |
| Total Comprehensive Income (Loss)                           |                 |                                  |                      |  |                   | 1,365,932    |
| <b>BALANCE, DECEMBER 31, 2003</b>                           | 1,000           | 518,702                          | 5,685,106            | 48,057                                   | ( 35,309)         | 6,217,556    |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                          |                 |                                  |                      |  |                   |              |
| Net income (loss)   | -               | -                                | ( 3,064,481)         | -  | -                 | ( 3,064,481) |
| Other comprehensive income (loss):                          |                 |                                  |                      |  |                   |              |
| Unrealized gain (loss) on marketable securities, net of tax | -               | -                                | -                    | ( 9,634)                                 | -                 | ( 9,634)     |
| Total Comprehensive Income (Loss)                           |                 |                                  |                      |  |                   | ( 3,074,115) |
| <b>BALANCE, DECEMBER 31, 2004</b>                           | \$ 1,000        | \$ 518,702                       | \$ 2,620,625         | \$ 38,423                                | \$ ( 35,309)      | \$ 3,143,441 |

The accompanying notes to consolidated financial statements.

## FIRST FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOW

YEARS ENDED DECEMBER 31, 2004 AND 2003

|   | 2004           | 2003           |
|---|----------------|----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                |                |
| Net income  | \$( 3,064,481) | \$ 1,343,672   |
| Adjustments to reconcile net income to<br>net cash provided (used) by operating activities: |                |                |
| Depreciation and amortization   | 122,630        | 356,390        |
| Realized gain on sale of mortgage loans   | ( 2,007,812)   | ( 6,041,152)   |
| Gain on sale of property and equipment  | -              | ( 689)         |
| Provision for losses  | ( 678,724)     | 2,404,113      |
| (Increase) decrease in restricted cash  | 288,484        | ( 62,305)      |
| (Increase) decrease in accounts receivable  | 2,027,498      | ( 1,476,682)   |
| Increase (decrease) in accounts payable and other accrued                                   | 25,616         | ( 951,033)     |
| Mortgage loans funded   | ( 346,913,596) | ( 709,609,656) |
| Mortgage loans sold   | 346,999,459    | 734,054,507    |
| Change in mortgage loan participations sold   | 1,850,227      | -              |
| Increase (decrease) in other assets   | 66,621         | 478,963        |
| <b>NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES</b>                                     | ( 1,284,078)   | 20,496,128     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                |                |
| (Gain) loss on sale of marketable investment securities, available-for-sale                 | -              | -              |
| Proceeds from sale of marketable investment securities, available-for-sale                  | -              | 597,919        |
| Purchases of marketable investment securities, available-for-sale                           | ( 620,493)     | ( 655,543)     |
| Principal received on mortgage loans  | 23,041         | 41,961         |
| Principal received on real estate   | ( 4,500)       | ( 105,336)     |
| Purchases of property and equipment   | ( 801,454)     | ( 845,331)     |
| Disposition of property and equipment   | -              | 230,582        |
| Unrealized holding gain (loss)  | ( 9,634)       | 15,918         |
| <b>NET CASH USED BY INVESTING ACTIVITIES</b>  | ( 1,413,040)   | ( 719,830)     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                |                |
| Net change in short-term borrowings   | ( 655,482)     | ( 18,774,082)  |
| Proceeds from note payable  | 2,639,326      | -              |
| <b>NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES</b>                                     | 1,983,844      | ( 18,774,082)  |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                                 | ( 713,274)     | 1,002,216      |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>   | 2,388,739      | 1,386,523      |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>   | \$ 1,675,465   | \$ 2,388,739   |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>                                     |                |                |
| Interest paid   | \$ 958,511     | \$ 2,182,503   |
| Federal income taxes paid   | \$ -           | \$ -           |

See accompanying notes to consolidated financial statements.





**FIRST FINANCIAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 2004**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Description of Business**

First Financial Corporation ("the Company") was incorporated in the State of Texas in 1964. During the last three years, the primary business of the Company, either directly or through its subsidiaries, has been originating and servicing a portfolio of residential mortgage and manufactured home loans, engaging in insurance activities, and providing consulting and data processing services to related companies.

**Basis for Financial Presentation**

The Company's financial statements have been prepared in conformity with generally accepted accounting principles. In preparing those financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenue and expenses for the period. Actual results could differ significantly from those estimates. Operating results for the year ended December 31, 2004, are not necessarily indicative of the results for any future period.

**Insurance Related Activities**

The Company owns 100% of a property and casualty insurance company and indirectly a mortgage guarantee insurance company which are included in the consolidated financial statements. The policies below relate specifically to the insurance activities of the companies.

*Premium Revenues* - Premiums on property and casualty contracts are recognized as earned primarily on a prorata basis over the contract period.

*Unpaid Losses and Loss Expenses* - Unpaid losses and loss expenses are based on cash-basis estimates for reported claims, and on estimates, based on experience, for unreported claims and loss expenses. The provisions for unpaid losses and loss expenses at December 31, 2004 and 2003, have been established to cover the estimated net cost of insured losses. The amounts are necessarily based on estimates and, accordingly, there can be no assurance that the ultimate liability will not exceed such estimates.

*Acquisition Cost* - Acquisition cost includes such things as commissions, premium taxes and other items, which are charged to current operations as incurred. Amounts are deferred based upon the capitalization and unearned premium rates. Deferred costs are amortized over the contract period on a prorata basis.

**(continued)**



1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

**Insurance Related Activities** (Continued)

*Reinsurance* - The Company cedes 100% of the insurance written on residential homes to a reinsurer under a fronting and reinsurance agreement. This reinsurance arrangement provided greater diversification of business and minimized the Company's losses arising from large risks or from hazards of an unusual nature. Although the ceding of insurance does not discharge the original insurer from its primary liability to its policyholder, the insurance company that assumes the coverage assumes the related liability, and it is the practice of insurers for accounting purposes to treat insured risks, to the extent of the reinsurance ceded, as though they were risks for which the original insurer is not liable. During 2004, substantially all of the Company's insurance was written under this fronting and reinsurance agreement.

Subsequent to December 31, 2004, the Company sold the capital stock of the insurance company to Security Bancshares, Inc. a related party by common ownership. The purchase price of \$2,139,649 was based on the fair market value of the capital stock of the insurance company as of December 31, 2004, as determined by a Valuation of Capital Stock prepared by ATI Capital Group, Inc., dated February 20, 2005.

**Principles of Consolidation**

The accompanying consolidated financial statements include the financial statements of First Financial Corporation, and all of its wholly owned and majority owned subsidiaries. All significant intercompany transactions and balances have been eliminated in the consolidation. For the year ended December 31, 2004, all subsidiaries are wholly-owned; therefore, no minority interest is reported.

**Cash Equivalents**

For the purposes of the 2004 and 2003 consolidated statements of cash flows, the Company considers all highly liquid instruments with original maturities of three months or less to be cash equivalents.

**Investment Securities**

Investment securities classified as available-for-sale are adjusted to market value at year-end. The unrealized gain (loss) is recorded net of income taxes as a component of comprehensive income. Realized gains or losses on sale of securities are calculated based on the specific identification method.

**Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed using accelerated and straight-line methods over the estimated useful lives of the assets.

(continued)

1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Real Estate Held-for-Investment**

Real estate held-for-investment is carried at the lower of cost or market in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." As of year-end, no permanent impairments to this property had occurred.

**Mortgage Loans Held-for-Sale**

Mortgage loans held-for-sale are carried at the lower of aggregate cost or market as determined by outstanding commitments from investors or current investment yield requirements calculated on the aggregate loan basis. Mortgage loans held-for-sale are reported net of any participations sold to investors.

**Mortgage Loans Held-for-Investment**

Mortgage loans held-for-investment are carried at historical cost unless otherwise permanently impaired.

**Estimated Reserve for Indemnifications and Early Payment Default Losses**

The Company uses the reserve method of providing for estimated losses for indemnifications and early payment defaults. The reserve is increased by provisions charged to operating expense and reduced by net charge-offs. The provision for estimated losses charged to operating expense, among other factors, is based on the Company's historical loan repurchases and indemnifications of investors for losses sustained, net of any expected third party recoveries.

The reserve for estimated losses for indemnifications and early payment defaults is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loans sold. The amount of the reserve is based on management's evaluation of loans with contingent liability, including the nature of trends in historical loss experience, specific impaired loans, economic conditions, and other risks inherent in the sale of loans. Although management uses available information to recognize estimated losses for indemnifications and early payment defaults, because of uncertainties associated with economic conditions, collateral values, and future cash flows on impaired loans, it is reasonably possible that a material change could occur in the estimate of losses for indemnifications and early payment defaults in the near term.

(continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Estimated Reserve for Losses Under Insurance Policies**

The reserve for losses under insurance policies is based on estimates for reported claims, and on estimates, based on experience, for unreported claims and potential loss exposure as calculated by an independent actuary. The reserve for losses under insurance policies has been established to cover the estimated net cost of insured losses. As this reserve is based on significant actuarial assumptions, it is reasonably possible that a material change could occur in the near future.

**Income Taxes**

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of the loan loss reserve for financial and income tax reporting. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred taxes also are recognized for operating losses that are available to offset future taxable income and tax credits that are available to offset future federal income taxes.

**Foreclosed Manufactured Homes and Claims Receivable**

Foreclosed manufactured homes and claims receivable, which consists of manufactured homes acquired by foreclosures, are held-for-sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

**Loan Administration Revenue**

Loan administration revenue represents net fees earned for servicing manufactured home loans owned by institutional investors. The fees are generally calculated on the outstanding principal balances of the loans serviced and are recorded as income when earned. Loan production revenue, representing fees earned for originating residential mortgage loans, is also included in loan administration revenue.

(continued)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Hedging Anticipated Transactions**

The Company's wholly owned subsidiary, First Preference Mortgage Corporation ("FPMC"), has off-balance sheet interest rate risk on mortgage loans in its pipeline. In order to decrease the interest rate risk associated with the market, FPMC is hedging anticipated transactions by purchasing mortgage-backed securities against its pipeline. These mortgage-backed securities are designed as fair value hedging instruments in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." FPMC accounts for the hedging of these anticipated transactions by recording the funded loan using the interest rate of the hedge, instead of the stated rate on the loan. Since FPMC holds these loans short-term, the gain or loss on the loan, due to the hedge, is recognized when it is sold to the investor.

**Earnings Per Common Share**

Earnings per common share were computed by dividing net income by the weighted average number of shares outstanding.

**Mortgage Loan Servicing Rights**

In the normal course of business, the Company does not retain the right to service mortgage loans. Servicing rights are sold to investors with the mortgage loans.

**Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue 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 valuation of the estimated losses for loan indemnifications and early payment defaults, valuation of investment securities, valuation of mortgage loans held-for-sale, and reserve for losses under insurance policies.

**Reclassifications**

Certain reclassifications have been made to prior periods' financial statements to conform to current year classifications. Such reclassifications had no effect on previously reported net income.

## 2. CONTINGENCIES AND THE CURRENT OPERATING ENVIRONMENT

The Company participated in the Government National Mortgage Association (GNMA) Mortgage-Backed Securities (GNMA-MBS) program for manufactured homes through 1987. Under the GNMA-MBS program, the Company collected monthly principal and interest payments from the mortgagor and remitted the payment to the security holder, after deducting a service fee. The security holder of a GNMA-MBS was guaranteed monthly payment of principal and interest regardless of whether the Company collected the necessary amount from the mortgagor. Therefore, the Company made advances to security holders using its own funds for scheduled principal and interest payments due that were delinquent or in the process of repossession. Substantially all loans were originated with some credit risk protection; however, a portion of the loss remained uninsured and had to be sustained by the Company.

The declining economies and increased unemployment rates of the Southwest in 1986 and 1987 caused delinquent loans and loans in repossession status to increase significantly. These high levels of delinquent loans and loans in repossession status placed a serious strain on the Company's liquidity. Beginning in 1986 and on numerous occasions throughout 1987, management met and discussed with and made various proposals to representatives of GNMA in an effort to reduce the losses being sustained by the Company on the loans serviced under the GNMA-MBS Program.

None of the proposals were accepted by GNMA. In September 1987, the Company advised GNMA that it would not be able to meet the scheduled payments to security holders on September 15, 1987, and made application requesting funds to meet the payments. The advance of funds by GNMA constitutes default under the guaranty agreements between the Company and GNMA. As a result of the default, the Company's rights, title and interests in mortgages pooled under its GNMA-MBS Program were extinguished.

Subsequent to its extinguishment, the Company entered into an Interim Servicing Agreement with GNMA with respect to the mortgages pooled under the GNMA-MBS Program. Under the agreement, the Company continued to service the mortgages on behalf of GNMA through March 1, 1988.

Between September 15, 1987 and March 1, 1988, GNMA made advances of approximately \$15,100,000 to the Company in order to meet scheduled payments to security holders. On September 12, 1988, GNMA made demand on the Company for approximately \$21,129,000 in losses incurred by GNMA as a result of the default and GNMA assuming the issuer obligations of the Company. Further, GNMA anticipated that it would incur additional losses in connection with assuming the Company's issuer responsibilities. There has been no reassertion of these claims since that time.

The Company's management and legal counsel are not aware of any facts which would lead them to believe that it is probable GNMA will or intends to assert or reassert any claims against FFC. The Company's position is it has no liability to GNMA. Legal counsel has advised FFC that if GNMA does assert or reassert any claims, FFC should in addition to its defense it has no liability, raise other defenses such as the expiration of the statute of limitations and laches. It is not possible to determine, at this time, the ultimate outcome of these matters and the effects, if any, on the accompanying consolidated financial statements since the final resolution depends on circumstances which cannot currently be evaluated with certainty.

### 3. LOAN ADMINISTRATION

The Company was servicing loans owned by institutional investors aggregating approximately \$180,000 at December 31, 2004. The Company was also servicing loans owned by the Company's wholly owned subsidiary, First Preference Mortgage Corporation, aggregating approximately \$53,000 at December 31, 2004. Related trust funds of approximately \$5,278 at December 31, 2004, on deposit in special bank accounts are not included in the consolidated financial statements.

First Preference Mortgage Company also holds trust funds of approximately \$43,134 at December 31, 2004. These trust funds are on deposit at special bank accounts and are not included in the consolidated financial statements. These trust funds include monies that are related to the administration of loans.

### 4. MARKETABLE INVESTMENT SECURITIES

Marketable investment securities at December 31, 2004, consist of:

| December 31, 2004           | Amortized<br>Cost | Gross<br>Unrealized<br>Gain/(Loss) | Fair<br>Value |
|-----------------------------|-------------------|------------------------------------|---------------|
| Available-for-sale:         |                   |                                    |               |
| Equity securities           | \$ 1,095,643      | \$ 26,844                          | \$ 1,122,487  |
| Bonds and notes, restricted | 223,983           | -                                  | 223,983       |
| Total Investment Securities | \$ 1,319,626      | \$ 26,844                          | \$ 1,346,470  |

The gross unrealized gain for 2004 relating to investment securities available-for-sale is \$26,844.

### 5. RESERVE FOR POSSIBLE LOAN INDEMNIFICATION AND EARLY PAYMENT DEFAULT LOSSES

Changes in the reserve for possible loan indemnification and early payment default losses are as follows:

|                              | 2004         | 2003       |
|------------------------------|--------------|------------|
| Balance, beginning of period | \$ 634,254   | \$ 102,189 |
| Provision charged to income  | 2,071,465    | 1,082,572  |
| Loans charged-off            | ( 744,882)   | ( 555,468) |
| Recoveries                   | 8,459        | 4,961      |
| Balance, end of period       | \$ 1,969,296 | \$ 634,254 |



**6. RESERVE FOR LOSSES UNDER INSURANCE POLICIES**

Effective December 30, 2003, the Company entered into a Commutation and Mutual Release Agreement under which the Company assumed all of a reinsurer's past, present and future obligations under certain reinsurance agreements in exchange for cash. The Company accounted for the cash as negative ceded loss and recorded a loss reserve based on data provided by an independent actuary to reduce the gross proceeds. Details of the reserve are as follows:

|  |              |              |
|--|--------------|--------------|
| Reserve, December 31, 2003                     |              | \$ 1,355,188 |
| Negative ceded loss from commutation agreement | 387,963      |              |
| Reserve adjustment based on actuarial study    | ( 1,287,925) |              |
| 2004 Provision                                 |              | ( 899,962)   |
| Reserve, December 31, 2004                     |              | \$ 455,226   |

The \$1,287,925 net gain is included in insurance premiums and commissions on the accompanying statement of income.

**7. PROPERTY AND EQUIPMENT**

Property and equipment consist of the following at December 31, 2004:

|                                   |              | Estimated<br>Useful Lives |
|-----------------------------------|--------------|---------------------------|
| Buildings and improvements        | \$ 357,918   | 10 to 40 years            |
| Equipment, furniture and fixtures | 3,237,449    | 3 to 10 years             |
|                                   | 3,595,367    |                           |
| Less accumulated depreciation     | ( 1,993,175) |                           |
|                                   | \$ 1,602,192 |                           |

**8. ESTIMATED RESERVE FOR LOSSES UNDER SERVICING AGREEMENTS**

Under the terms of certain of its existing servicing agreements, the Company is at risk for any credit losses and costs of foreclosure, net of credit insurance proceeds, sustained on default of the borrower. During 1988 and 1987, as a result of the declining economies and other matters discussed in Note 2, the Company made substantial loss provisions to raise the estimated reserve for losses under servicing agreements to levels that adequately reflect management's estimate of future losses that may be incurred under the Company's current and prior servicing agreements. Beginning in 1990, the Company changed its reserve estimate for losses under servicing agreements as a result of decreases in the amount of serviced loans outstanding. An analysis of the reserve follows:

(continued)

**8. ESTIMATED RESERVE FOR LOSSES UNDER SERVICING AGREEMENTS (Continued)**

|                    | December 31 |            |
|--------------------|-------------|------------|
|                    | 2004        | 2003       |
| Balance, beginning | \$ 234,595  | \$ 236,926 |
| Recoveries - net   | -           | ( 2,331)   |
| Balance, ending    | \$ 234,595  | \$ 234,595 |

The losses incurred above are shown net of credit insurance proceeds and other payments received as further discussed in Note 2.

**9. LEASES**

The Company maintains various equipment under long-term operating leases. Future minimum rental payments required under these leases are approximately:

|       |        |
|-------|--------|
|       | \$     |
| 2005  | 55,591 |
| 2006  | 11,420 |
| 2007  | 3,672  |
| 2008  | 754    |
|       | \$     |
| Total | 71,437 |

The rental expense for equipment leases was \$67,371 and \$73,808 for December 31, 2004 and 2003, respectively.

The Company also leases office space for its locations under various operating leases. The future minimum rental payments required are approximately:

|       |    |         |
|-------|----|---------|
| 2005  | \$ | 142,004 |
| 2006  |    | 7,935   |
| 2007  |    | -       |
| Total | \$ | 149,939 |

The rental expense for office space was \$312,021 and \$314,492 for 2004 and 2003, respectively.

## 10. FINANCING AGREEMENTS

In December 2000, FPMC entered into a mortgage warehouse line of credit not to exceed \$25,000,000. This warehouse line of credit replaced a master loan participation agreement that FPMC had with another financial institution. Under the new agreement, the financial institution advances up to ninety-nine percent (99%) of the amount to be paid by the investor, but not to exceed the unpaid principal of the loan. When the subject mortgage loan is sold in the secondary market, the financial institution advance is repaid. Advances bear interest based on the 30-day LIBOR (London Interbank Offered Rate) plus 1.75% to 2.25% depending on the sublimit category. Borrowings under the agreement are collateralized by mortgage loans held-for-sale. At December 31, 2004, approximately \$22,733,529 in advances were outstanding under this agreement. On February 20, 2001, this line of credit was amended to increase the maximum amount to \$35,000,000 and on April 10, 2001, it was amended to a maximum amount of \$50,000,000. On August 29, 2001, the line of credit was reduced to a maximum of \$45,000,000. This line of credit was amended on October 31, 2002, with a scheduled maturity date of April 30, 2003.

On April 30, 2003, the mortgage warehouse line of credit was amended, extending the maturity date to August 29, 2003. On August 29, 2003, the maturity date was once again extended. On December 11, 2003, the Company amended the mortgage warehouse line of credit to a \$35,000,000 maximum principal amount and extended the maturity date to June 30, 2004. The line of credit was temporarily extended by letter agreements dated June 9, 2004, September 28, 2004, October 18, 2004, November 30, 2004, and December 15, 2004. On December 29, 2004, FPMC executed the Eighth Amendment to the Mortgage Warehouse Loan, reducing the maximum principal amount to \$25 million and extending the maturity date to March 31, 2005.

The line of credit agreement includes certain financial covenants. As of December 31, 2004 and 2003, the Company is in compliance with these covenants.

During the year 2002, the Company entered into a loan participation agreement with a financial institution related through common ownership amounting to \$17,500,000. Under this agreement, this financial institution has the option to purchase an undivided interest in the residential mortgage loans originated by the Company. When a subject mortgage loan is sold in the secondary market, the financial institution recoups its investment plus a specified yield on its investment. No loan participations were sold under this agreement during 2004.

During 2003, FPMC entered into a loan participation agreement with an unrelated financial institution amounting to \$10 million. Under this agreement, the financial institution owns a participation interest in new loans originated by the Company that meet certain underwriting criteria. When a participated loan is sold in the secondary market, the financial institution is paid its participation amount plus a specified yield on its investment. As of December 31, 2004, \$1,850,227 in participations were outstanding under this agreement.

In 2004, FPMC borrowed \$825,000 from Citizens State Bank, a related party through common ownership. Prior to December 31, 2004, Citizens Bank sold the loan to Bluebonnet Investments, Ltd., another related party through common ownership. The balance of the loan on December 31, 2004, was \$789,099.

## 11. RELATED PARTY TRANSACTIONS

On September 30, 1991, the Company executed a Limited Partnership Agreement (the "Agreement") to form a limited partnership with the name "Key Group, Ltd." A certificate of Limited Partnership for Key Group, Ltd. ("Key Group") was filed with and approved by the Secretary of State of Texas on October 2, 1991. The limited partners in Key Group were the Company and Bluebonnet Investments, Ltd. ("Bluebonnet"). The general partners were Robert A. Mann and First Key Holdings.

Pursuant to the Agreement, on September 30, 1991, the Company, as a limited partner in Key Group, contributed to Key Group certain mobile home notes payable to and held by the Company having an aggregate unpaid balance of approximately \$1,750,000, plus an amount of cash on hand equal to the difference between \$2,249,780 and the unpaid balance of such notes as of the date transferred to Key Group. In exchange for its contribution, the Company received 52,936 partnership Units ("Units") out of a total of 100,000 Units representing approximately 52.94% of Key Group.

Bluebonnet, a Texas limited partnership in which Robert A. Mann and David W. Mann had direct and indirect interest (as described below), contributed cash or cash equivalents equal to \$1,999,795 in exchange for 47,054 Units representing approximately 47.05% of Key Group.

Robert A. Mann, individually, and First Key Holdings, Inc., a Texas corporation which was owned by the David W. Mann 1990 Trust, of which Robert A. Mann was trustee and David W. Mann is a beneficiary, each contributed \$212.50 for 5 Units each in Key Group. In November 2000, Citizens Land Corporation ("Citizens") purchased the .005% general partnership interest owned by Robert A. Mann and Shelter Resources, Inc. ("Shelter") purchased the general partnership interest owned by First Key Holdings, Inc. Citizens is directly and indirectly controlled by members of the Mann Family and Shelter is a wholly-owned subsidiary of the Company.

Key Group executed a Servicing Agreement with the Company pursuant to which the Company will continue to service the notes the Company contributed to Key Group.

Key Group conducts business through its wholly-owned subsidiary, First Preference Holdings, Inc. ("First Preference Holdings"). First Preference Holdings owns two wholly-owned subsidiaries: First Preference Financial Corp. and Security Washington Avenue Corp. First Preference Mortgage Corp. originates and services residential mortgage loans and is an approved Seller/Servicer for Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("Freddie Mac"), Veterans Administration ("VA") and Federal Housing Administration ("FHA"). During 1997, First Preference Holdings, Inc. transferred 100% of First Preference Mortgage Corp.'s stock to Security Washington Avenue Corp. in exchange for 100% of the outstanding stock of Security Washington Avenue Corp.

First Preference Financial Corp. was formed to be an originator and servicer of consumer loans, primarily in the manufactured home market. At the present time, First Preference Financial Corp. has not obtained any government licenses to originate and service consumer loans. First Financial Information Services, Inc. provides data processing services for the Company and its subsidiaries. On June 1, 1992, the Company sold 100% of the issued and outstanding common stock of First Financial Information Services, Inc. to First Preference Holdings for a purchase price equal to its investment in First Financial Information Services, Inc.

(continued)



**11. RELATED PARTY TRANSACTIONS (Continued)**

Prior to July 31, 2002, (i) First Financial Corporation owned directly, approximately 53% of Key Group, Ltd., a Texas limited partnership, and approximately 47% of Key Group, Ltd. was owned directly by Bluebonnet Investments, Ltd., a Texas limited partnership ("Bluebonnet"); (ii) Key Group, Ltd. owned all of the capital stock of First Preference Holdings, Inc. ("FPHI"), a Texas corporation; (iii) FPHI owned all of the capital stock of Security Washington Avenue Corporation ("Security"), a Delaware corporation; and (iv) Security owned all of the capital stock of First Preference Mortgage Corporation ("FPMC").

On or shortly after July 31, 2002, several transactions took place which resulted in the elimination of Key Group, FPHI and Security. FPMC became a wholly owned subsidiary of the Company. Additionally, the Company contributed 52% ownership of First Apex Re, Inc. to FPMC as contributed capital.

On December 29, 2004, FPMC and Apex Lloyds sold their respective interest in First Apex Re, Inc. ("FAR") to Security Bancshares, Inc. a Texas bank holding company related by common ownership. The purchase price of \$1,113,868 was based on the fair market value of the capital stock of FAR as of October 31, 2004, as determined by a Valuation of Capital Stock prepared by ATI Capital Group, Inc., dated November 23, 2004. Bernstein, Conklin & Balcomb, business valuation advisors, reviewed the Stock Purchase Agreement and indicated the valuation of the capital stock of FAR was fair from a financial point of view.

The Company also provides accounting, personnel, general and administrative, and information technology services to entities that are related through common ownership. The Company billed approximately \$315,000 and \$400,000 to these entities in 2004 and 2003, respectively.

**12. INCOME TAXES**

The provision for income taxes consists of the following components at December 31, 2004 and 2003:

|   | 2004           | 2003       |
|---|----------------|------------|
| Income tax expense computed               |                |            |
| at corporate Federal rate                 | \$( 1,143,273) | \$ 456,538 |
| Change in reserve for deferred tax asset  | 829,252        | -          |
| Nondeductible income and expenses         | 15,934         | 10,282     |
| Utilization of reserve deferred tax asset | -              | ( 467,734) |
|   | \$( 298,087)   | \$( 914)   |

**(continued)**

**12. INCOME TAXES (Continued)**

The deferred tax benefit in the accompanying balance sheet at December 31, 2004, includes the following components:

|   |              |
|---|--------------|
| Deferred tax benefit attributable to net operating loss carryforwards                                       | \$ 2,312,627 |
| Deferred tax benefit attributable to reserve for losses under servicing agreements, marketing and insurance | 904,100      |
| Deferred tax benefit applicable to unrealized gain on investment securities                                 | 13,064       |
| Deferred tax asset valuation allowance  |              |
| Net deferred tax asset  | \$ 298,087   |

The valuation allowance increased due primarily to change in the amount deferred relating to reserve for losses under servicing and insurance, difference between net operating loss carryforward recorded on the books and actual benefit from the tax return for 2003, and the amount of net operating loss carryforward realized for book purposes in 2004.

A valuation allowance has been provided for substantially all future benefits available for tax purposes due to the trend of historical losses of the Company and the unlikely possibility of future realization. The net deferred tax asset relates to benefits available at a subsidiary level where an unconsolidated return is filed.

At December 31, 2004, for federal income tax purposes, the Company has consolidated unused net operating loss carryforwards of approximately \$6.8 million which expire in 2006 and 2018 through 2020.

**13. COMMITMENTS AND CONTINGENCIES****Servicing**

Substantially all of the conventional pools of manufactured home loans serviced by the Company, approximating \$408,000 and \$440,000 at December 31, 2004 and 2003, respectively, were sold to investors with recourse. The recourse provisions typically require the Company to repurchase delinquent loans at the unpaid principal balances plus accrued interest, or replace delinquent loans with another loan which is current. Further, several of the agreements require the Company to establish and maintain cash reserve accounts. Deposits are periodically made to the accounts equal to a specified percent of the outstanding loans. The accounts may be used to cover deficiencies from foreclosure and liquidation of delinquent pooled mortgage loans. Such cash reserve accounts totaled \$4,495 and are included in restricted cash at December 31, 2004.

(continued)

**13. COMMITMENTS AND CONTINGENCIES (Continued)**

**Indemnification of Mortgage Loans Sold**

In the ordinary course of business, the Company sells loans without recourse that may have to be subsequently repurchased due to defects that occurred during the origination of the loan. The potential defects are categorized as documentation errors, underwriting errors and fraud. In addition, mortgage loans sold to investors are subject to repurchase or indemnification if the loans become a specified number of months delinquent within a specified period of time after the loans are sold (e.g., early payment default). When a loan sold to an investor without recourse fails to perform, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no defects, the Company has no commitment to repurchase the loan.

At December 31, 2004, estimated losses for indemnifications and early payment defaults on loans sold of \$1,969,296 are reported in the accompanying balance sheet.

**HUD Requirements**

FPMC is required to maintain a certain specified level of minimum net worth and liquidity to maintain its approved status with HUD. As December 31, 2004, the minimum net worth requirement was \$660,970 and the minimum liquidity requirement was \$100,000.

**Loss Reserves for Ceded Reinsurance**

The Company entered into a Commutation and Mutual Release Agreement effective December 30, 2003, under which the Company assumed all of the reinsurer's past, present, and future obligations and liabilities under certain reinsurance agreements. A reserve of approximately \$455,000 million is included in the balance sheet as of December 31, 2004.

**Other**

The Company is involved in various other claims and legal actions arising in the ordinary course of business. Historically, the ultimate disposition of these matters has not had a material adverse effect on the Company's financial condition. It is not possible to determine, at this time, the ultimate outcome of these matters and the effects, if any, on the accompanying consolidated financial statements since the final resolution depends on circumstances which cannot currently be evaluated with certainty. Certain accruals for loss contingencies have been recorded in the financial statements of the Company.



**14. SEGMENT REPORTING**

The Company operates principally in two segments, mortgage banking and commission sales and underwriting of hazard insurance for manufactured housing primarily in the Central and Southeast region of Texas. Other segments include underwriting credit insurance, and consulting services through the Company's wholly owned subsidiaries.

Information concerning the Company's operations in different segments follows:

|                             | Mortgage<br>Banking | Insurance<br>Sales | Corporate<br>and Other | Consolidated  |
|-----------------------------|---------------------|--------------------|------------------------|---------------|
| For the Year Ended 12/31/04 |                     |                    |                        |               |
| Revenue                     | \$ 6,513,664        | \$ 781,051         | \$ 393,625             | \$ 7,688,340  |
| Operating profit (loss)     | ( 3,197,535)        | 112,644            | ( 277,677)             | ( 3,362,568)  |
| Identifiable assets         | 28,345,616          | 2,808,981          | ( 474,834)             | 30,679,763    |
| Depreciation                | 105,218             | 7,987              | 9,425                  | 122,630       |
| Capital expenditures        | 736,685             | 6,943              | -                      | 743,628       |
| For the Year Ended 12/31/03 |                     |                    |                        |               |
| Revenue                     | \$ 13,938,628       | \$ 1,586,966       | \$ 633,383             | \$ 16,158,977 |
| Operating profit (loss)     | 190,249             | 1,159,599          | ( 7,090)               | 1,342,758     |
| Identifiable assets         | 28,770,989          | 4,206,071          | 178,427                | 33,155,487    |
| Depreciation                | 339,999             | 12,542             | 3,849                  | 356,390       |
| Capital expenditures        | 843,480             | -                  | 1,851                  | 845,331       |

**15. FAIR VALUE OF FINANCIAL INSTRUMENTS****Cash and Cash Equivalents**

The fair value of cash and cash equivalents approximates the carrying value because of the short time until realization of these amounts.

**Accounts Receivable and Payable**

The fair value of accounts receivable and accounts payable approximates the carrying value because of the short time until realization of those balances.

**Mortgage Loans Held-for-Sale**

Mortgage loans held-for-sale are recorded net of participations sold to investors. The fair value of mortgage loans held-for-sale is based upon the estimated price the investor is willing to pay. The value of these loans are:

|                                      | Carrying<br>Value | Market<br>Value |
|--------------------------------------|-------------------|-----------------|
| Mortgage Loans Held-for-Sale (gross) | \$ 24,996,953     | \$ 25,638,408   |

(continued)

**15. FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

**Mortgage Loans Held-for-Investment**

Mortgage loans held-for-investment are net of any discounts. The fair value of the balance is based upon discounted cash flows at the market rate of interest for similar loans. The value of these loans are:

|                                    | Carrying<br>Value | Market<br>Value |
|------------------------------------|-------------------|-----------------|
| Mortgage Loans Held-for-Investment | \$ 53,521         | \$ 53,521       |

**16. CONCENTRATIONS OF CREDIT RISK**

The Company maintains cash balances at several depository institutions. Cash accounts at these institutions are insured by the FDIC for up to \$100,000 for each account. Amounts in excess of insured limits were approximately \$3.2 million at December 31, 2004. Of that balance, approximately \$182,000 relates to funds on deposit in the settlement account with a depository institution. The primary function of this account is to receive payment on loans sold which were financed by the depository institution. When payments are received, the balance is distributed to the depository institution and the Company, based upon the financing agreement.

**17. RETIREMENT PLANS**

The Company maintains a 401(k) profit sharing plan for the benefit of all employees who have attained the age of 21 and have completed one year of service. The calendar year plan provides for voluntary employee contributions as a deduction from wages with a required matching contribution by the employer. During 2003, the Company made matching contributions equal to 50% of the amount of the salary reduction up to 2% plus 25% for reductions in excess of 2% to a maximum of 4%. During 2004, the Company ceased making matching contributions for FPMC employees. For the year ended December 31, 2004, the Company incurred a total contribution expense of \$27,836.

**PART II**  
(Continued)

**Item 8. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

Not Applicable

**Item 8A. Controls and Procedures**

As of December 31, 2004, the Company carried out an evaluation under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rule 13a-14 under the Securities and Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to date the Company carried out its evaluation.

**PART III****Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act**

| Name and Principal Occupation<br>for the Last Five Years   | Age | Director<br>Since | Positions<br>With Company  |
|--|-----|-------------------|--|
| <b>David W. Mann</b><br>President, First Financial Corporation since October 29, 1985; Chairman of the Board, First Financial Corporation since May 15, 2001, Director since 1980; President, First Preference Mortgage Corp. since October 1991; Chairman of the Board, First Preference Mortgage Corp. since May 15, 2001; President, Chief Executive Officer and Vice Chairman of the Board, Citizens State Bank, Woodville, Texas since January 28, 1997; Mr. Mann is also an officer and director of certain insurance agencies and companies and holds positions with several other family-owned entities. | 48  | 4-27-79           | President, Chief Financial Officer, Chairman of the Board and Director |
| <b>James Lee Motheral</b><br>Since January 1, 1996, Mr. Motheral has been employed in the field of print management as President of Motheral Printing Company.   | 47  | 2-6-01            | Director   |
| <b>Dr. Raymond A. Parker</b><br>Dr. Parker is a retired minister.  | 75  | 11-15-01          | Director   |
| <b>Walter J. Rusek</b><br>Chairman of the Board, Citizens State Bank, Woodville since March 27, 2001; Vice Chairman of the Board, Citizens State Bank, Woodville from February 1, 1993 to March 27, 2001; President and Chief Executive Officer, Citizens State Bank, Woodville from July 1, 1994 to December 31, 1996; Trust Officer, Citizens State Bank, Woodville from August 1996 until December 31, 1998.  | 72  | 2-26-70           | Director   |
| <b>Joseph Edward Walker</b><br>Since January 1, 1996, Mr. Walker has been employed by Video Productions and Impact Productions.  | 73  | 2-06-01           | Director   |

(continued)

**Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act** (Continued)

The Company has adopted a Code of Ethics applicable to its Chief Executive Officer and Senior Financial Officers, which is being filed with the SEC as Exhibit 14.1 to this annual report.

No shares of the Company's common stock were sold or transferred during fiscal year 2004. Therefore, the Company's officers and directors were in full compliance with Section 16(a) if the Securities Exchange Act of 1934 during 2004.

**Item 10. Executive Compensation**

The following table sets forth information regarding executive compensation paid to or for the Company's chief executive officer and each of the most highly compensated executive officers whose cash compensation exceeded \$100,000 during any of the last three fiscal years.

| Name and Principal<br>Position                                 | Year | Annual Compensation |            |   |
|--|------|---------------------|------------|---|
|  |      | Salary(\$)          | Bonus(\$)  | All Other<br>Compensation <sup>(1)</sup> (\$) |
| David W. Mann<br>President                                     | 2002 | \$ 216,250          | \$ 11,265  | \$ 2,766                                      |
|  | 2003 | \$ 255,000          | \$ 201,000 | \$ 3,660                                      |
|  | 2004 | \$ 243,750          | \$ -0-     | \$ 6,325                                      |
| Annie Laurie Miller <sup>(2)</sup><br>Executive Vice President | 2002 | \$ 134,667          | \$ 25,500  | \$ 4,040                                      |
|  | 2003 | \$ 73,349           | \$ -0-     | \$ -0-  |
|  | 2004 | \$ -0-              | \$ -0-     | \$ -0-  |

(1) All amounts reported in this column consist of contributions made by the Company to the 401(k) retirement plans of the identified executive officers.

(2) Ms. Miller resigned her positions with the Company in July 2003. During 2002 and 2003, she served as executive vice president and during 2002, she also served as chief financial officer.

Each non-employee director of the Company (all directors other than David W. Mann) was paid a fee of \$1,000 for each regular meeting of the Board of Directors that such director attended. The Company does not have any standard arrangements or other arrangements pursuant to which any director of the Company was compensated during the last completed fiscal year for any service as a director, including committee participation and special assignments.

**Item 11. Security Ownership of Certain Beneficial Owners and Management**

The following table presents certain information, to the extent known to the Company, regarding the number and percentage of shares of common stock beneficially owned by each person who beneficially owns more than 5% of the Company's common stock, by each director and each nominee for election as a director, by each executive officer, and by all directors and executive officers as a group, as of March 31, 2005. Except as otherwise indicated, the parties named below have sole voting and investment power with respect to the shares beneficially owned by them.

**(continued)**

**Item 11. Security Ownership of Certain Beneficial Owners and Management** (Continued)

| <u>Name and Address<br/>of Beneficial Owner</u>   | <u>Number of Shares<br/>Beneficially Owned</u> | <u>Percentage of All<br/>Outstanding Shares</u> |
|---|--|---|
| First Financial Holdings, Ltd. <sup>(1)</sup><br>800 Washington Ave.<br>Waco, Texas 76701 | 102,477  | 59.06%  |
| Harold E. Allison, III <sup>(2)</sup><br>102 West Bluff Street<br>Woodville, Texas 75979  | 102,477  | 59.06%  |
| David W. Mann<br>800 Washington Ave.<br>Waco, Texas 76701                                 | 102,898 <sup>(3)</sup>                         | 59.30%  |
| James Lee Motheral<br>4416 Overton Crest<br>Ft. Worth, Texas 76109                        | -0-  | -0-   |
| Dr. Raymond A. Parker<br>Hwy., 256N-509 CR 2080<br>Woodville, Texas 75979                 | -0-  | -0-   |
| Walter J. Rusek<br>2121 Lake James<br>Waco, Texas 76710                                   | -0-  | -0-   |
| Joseph Edward Walker<br>12566 Chapel Road<br>Lorena, Texas 75566                          | -0-  | -0-   |
| All directors and executive<br>officers as a group  | 102,898  | 59.30%  |

(1) First Financial Holdings, Ltd. ("Holdings") is a Texas limited partnership the general partners of which are David W. Mann and FFC Holdings, Inc., a Texas corporation ("FFCH"). Mr. Mann is president and a director of FFCH; the other directors are Dr. Raymond Parker, Walter J. Rusek and Joseph E. Walker, all of whom are directors of the Company. The sole shareholder of FFCH is the David W. Mann 1990 Trust (the "1990 Trust"). Mr. Mann is the sole current beneficiary of the 1990 Trust.

(2) Mr. Allison is the sole trustee of the 1990 Trust. He is an executive officer of Citizens State Bank, Woodville, of which David W. Mann is president, chief executive officer and a director. All of the shares shown as beneficially owned by Mr. Allison consist of the 102,477 held directly by Holdings (see footnote 1 above).

(3) Consists of the 102,477 shares owned directly by Holdings (see footnote 1 above) and 421 shares owned directly by a limited partnership the general partners of which are David W. Mann and a corporation wholly owned and controlled by him.

(continued)

**Item 11. Security Ownership of Certain Beneficial Owners and Management** (Continued)

**SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's directors, executive officers, controller, and beneficial owners of more than 10% of the Company's common stock to file certain beneficial ownership reports with the Securities and Exchange Commission. The Company is not aware of the failure by any of such persons to file timely any such report during 2004 or with respect to transactions occurring during 2004.

**Item 12. Certain Relationships and Related Transactions**

**KEY GROUP TRANSACTIONS**

The discussion in Item 1 under the heading "Key Group Transactions" is incorporated into this Item 12 by reference.

**DEBT SWAP WITH BLUEBONNET**

The disclosure in Item 1 under the heading "Debt Swap With Bluebonnet" is incorporated into this Item 12 by reference.

**GUARANTEE OF FPMC LINE OF CREDIT**

The obligations of FPMC under its mortgage warehouse line of credit with an unrelated commercial bank have been guaranteed by David W. Mann under an unlimited continuing guaranty agreement that was entered into when the mortgage warehouse line of credit was established in December 2000. As compensation for this guarantee Mr. Mann receives an annual fee equal to 0.25% of the lender's total commitment under the line of credit, which has varied between \$25 million and \$50 million and, since December 2003, the commitment has varied between \$35 million and \$25 million.. Guarantee fees paid to Mr. Mann during 2003 aggregated \$231,050. For the period January 2004 to September 2004 the guarantee fee were paid in monthly installments and aggregated \$65,685. Mr. Mann waived and forgave the obligation to pay the guarantee fees for the period October 2004 to December 2004.

**FPMC LOAN PARTICIPATION AGREEMENT**

In August 2002, FPMC entered into a Loan Participation Agreement with Citizens State Bank of Woodville, Texas, of which David W. Mann is a director, the chief executive officer and a principal shareholder and of which Walter J. Rusek is chairman of the board of directors. Under this agreement, Citizens State Bank has the option to purchase an undivided 99% interest in residential mortgage loans originated by FPMC and made available by FPMC for purchase by Citizens State Bank. When a participated mortgage loan is sold in the secondary market, Citizens State Bank recoups its investment plus a specified yield equal to the interest rate on the participated loan less 0.9375% for the period during which the loan was held. During 2003 and 2004, Citizens State Bank paid to FPMC an aggregate of \$166,182,058 and \$0, respectively, for the purchase of such participations and received back an aggregate of \$179,696,746 and \$0 plus an aggregate yield of \$655,305 and \$0, respectively, upon the sale of participated loans. At December 31, 2004 and 2003, there were no participations outstanding under this agreement.

(continued)



**Item 12. Certain Relationships and Related Transactions** (Continued)

**MANAGERIAL AND ACCOUNTING SERVICES PROVIDED BY FIRST ADVISOR SERVICES, INC.**

During 2003 and 2004, Bluebonnet and other entities directly or indirectly owned or controlled by David W. Mann and other members of the Mann family paid First Advisory Services, Inc., a subsidiary of the Company, an aggregate amount \$415,346 and \$309,145, respectively, in fees for accounting and managerial services provided by First Advisory Services, Inc. to such entities.

**EXPENSE SHARING AGREEMENT WITH UW INSURANCE GROUP, INC.**

During 2003 and 2004, the Company and certain subsidiaries of the Company had expense sharing arrangements with UW Service Corporation, Inc. ("UWSC"), which is wholly owned by Bluebonnet, pursuant to which UWSC provided certain personnel, facilities, equipment and supplies to the Company and its subsidiaries and allocated to the Company and its subsidiaries the costs incurred by UWSC for such personnel, facilities, equipment and supplies. During 2003 and 2004, the Company and its subsidiaries paid a total of \$168,351 and \$444,272, respectively, to UWSC pursuant to these expense sharing arrangements. It is the intention of the parties to these expense sharing arrangements that no party realize a profit nor incur a loss as a result of the cost sharing covered by these arrangements.

**LEASE OF 800 WASHINGTON AVE. PROPERTY**

800 Washington Ave., Waco, Texas, is the principal office of the Company and its subsidiaries (including FPMC) and is owned by JRPM Investments, Ltd., a Texas limited partnership ("JRPM") controlled by Mr. Mann and owned by Mr. Mann and trusts for his children. JRPM leases the building to FPMC, and FPMC subleases a portion of the building to Bluebonnet, UWSC, Citizens State Bank, and other entities directly or indirectly owned or controlled by David W. Mann. During 2003 and 2004, those sublessees paid \$49,200 and \$43,800, respectively, in rent to FPMC. During 2003 and 2004, FPMC paid \$112,584 per year in rent to JRPM.

**REAL ESTATE NOTE WITH CITIZENS STATE BANK**

On July 1, 2004, FPMC executed a Real Estate Lien Note with Citizens State Bank in the amount of \$825,000. During the first three months the interest rate on the note was 6 1/2%. Thereafter, during each succeeding three-month period, the rate is equal to the prime rate on the first day of each succeeding three month period, plus one and one-half percent. The note is payable in monthly installments of \$10,000 and is due on June 15, 2011. The note is secured by approximately 78.471 acres of unimproved real estate owned by FPMC located in Robinson, Texas. The note is also guaranteed by the Company. In connection with execution of this note, FPMC paid Citizens State Bank \$5,770 in loan fees. During 2004, FPMC paid \$35,901 in principal and \$25,921 in interest to Citizens State Bank. On December 29, 2004, Bluebonnet Investments Ltd., a Texas limited partnership which is controlled, in part, by Mr. Mann, purchased this Real Estate Lien Note from Citizens State Bank.

**SALE OF FIRST APEX RE AND APEX LLOYDS INSURANCE COMPANY**

The disclosure in Item 1 under the heading "Sale of First Apex Re and Apex Lloyds Insurance Company" is incorporated into this Item 12 by reference.



**Item 13. Exhibits and Reports on Form 8-K**

(a) Exhibits. Reference is made to the Exhibit Index beginning on page E-1 hereof.

(b) Reports on Form 8-K.

No Form 8-K was filed during the quarter ended December 31, 2004.

**Item 14. Principal Accountant Fees and Services**

The following table discloses the audit fees that Pattillo, Brown & Hill, L.L.P. billed the Company for audit services rendered for each of the last two fiscal years, as well as the fees for other professional services billed by Pattillo, Brown & Hill, L.L.P. in each of the last two fiscal years:

|                         | <u>2004</u> | <u>2003</u> |
|-------------------------|-------------|-------------|
| Audit Fees.....         | \$ 87,781   | \$97,516    |
| Audit Related Fees..... | --          | --          |
| Tax Fees (1).....       | 19,240      | 34,695      |
| All Other Fees.....     | --          | --          |

(1) Consists of, in 2004 and 2003, the preparation of federal and state tax returns.

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, First Financial Corporation has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized:

**FIRST FINANCIAL CORPORATION**

/s/ David W. Mann

By: David W. Mann  
President and Principal  
Financial Officer

/s/ Robert L. Harris

By: Robert L. Harris  
Vice President and Principal  
Accounting Officer

Date: April 14, 2005

Date: April 14, 2005

In accordance with requirements of the Exchange Act, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

/s/ David W. Mann

David W. Mann, Director and Chairman  
of the Board and President

Date: April 14, 2005

/s/ Walter J. Rusek

Walter J. Rusek, Director

Date: April 14, 2005

/s/ Jim Motherall

Jim Motherall, Director

Date: April 14, 2005

/s/ Joe Walker

Joe Walker, Director

Date: April 14, 2005

/s/ Dr. Raymond Parker

Dr. Raymond Parker, Director

Date: April 14, 2005

**EXHIBIT INDEX**

- 3.1 Restated Articles of Incorporation of First Financial Corporation (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2002).
- 3.2 Amended and Restated Bylaws of First Financial Corporation (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2002).
- 10.1 Limited Partnership Agreement between the Company and Key Group, Ltd dated September 30, 1991 (incorporated by reference to the Company's Form 8-K dated September 30, 1991).
- 10.2 Mortgage Warehouse Line of Credit in the amount of \$25 million dated December 12, 2000, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2000).
- 10.3 Second Amendment to Mortgage Warehouse Loan and Security Agreement dated April 10, 2001, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2001).
- 10.4 Third Amendment to Mortgage Warehouse Loan and Security Agreement dated August 29, 2001, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2001).
- 10.5 Fourth Amendment to Mortgage Warehouse Loan and Security Agreement dated October 31, 2002, between First Preference Mortgage Corporation and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2002).
- 10.6 Loan Participation Agreement dated August 16, 2002, between First Preference Mortgage Corp. and Citizens State Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2002).
- 10.7 Triparty Agreement dated August 16, 2002, among First Preference Mortgage Corp. and Citizens State Bank and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2002).
- 10.8 Fifth Amendment to Mortgage Warehouse Loan and Security Agreement dated April 30, 2003, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2003).
- 10.9 Sixth Amendment to Mortgage Warehouse Loan and Security Agreement dated August 29, 2003, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2003).
- 10.10 Seventh Amendment to Mortgage Warehouse Loan and Security Agreement dated December 29, 2003, between First Preference Mortgage Corp. and Colonial Bank (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2003).

**(continued)**

**EXHIBIT INDEX**

(Continued)

- 10.11 Eight Amendment to Mortgage Warehouse Loan and Security Agreement dated December 31, 2004, between First Preference Mortgage Corp. and Colonial Bank.
- 10.12 Stock Purchase Agreement by and between Security Bancshares and Apex Lloyds Insurance Company and First Preference Mortgage Corp. dated December 29, 2004 and effective as of October 31, 2004 (incorporated by reference to the Company's current report on Form 8-k dated April 6, 2005).
- 10.13 Stock Purchase Agreement by and between Security Bancshares and First Financial Corporation dated March 31, 2005 (incorporated by reference to the Company's current report on Form 8-k dated April 6, 2005).
- 14.1 Code of Ethics (incorporated by reference to the Company's Annual Report on Form 10-KSB for fiscal year ended December 31, 2003).
- 21.1 Subsidiaries of the Registrant.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification.
- 32.1 Section 906 Certification furnished pursuant to 18 U.S.C. Section 1350. This certification is "furnished" and not "filed" for purposes of liability in Section 18 of the Securities Exchange Act of 1934.