

PROSPERITY BANCSHARES INC

Form 10-K/A

October 28, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K/A**

AMENDMENT NO. 1

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(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934

For The Fiscal Year Ended December 31, 2004

OR

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

For the transition period from            to

Commission File Number 0-25051

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**PROSPERITY BANCSHARES, INC. ®**

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(Exact name of registrant as specified in its charter)

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

**74-2331986**  
(I.R.S. Employer  
Identification No.)

**PROSPERITY BANK PLAZA**

**4295 SAN FELIPE**

**HOUSTON, TEXAS**  
(Address of principal executive offices)

**77027**  
(Zip Code)

**Registrant's Telephone Number, Including Area Code: (713) 693-9300**

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**Securities registered pursuant to Section 12(b) of the Act: None**

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

**Common Stock, par value**

**\$1.00 per share**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment of this Form 10-K.

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The aggregate market value of the shares of Common Stock held by non-affiliates, based on the closing price of the Common Stock on the Nasdaq National Market System on June 30, 2004 was approximately \$380.3 million.

As of March 1, 2005, the number of outstanding shares of Common Stock was 27,471,396.

### **Documents Incorporated by Reference:**

Portions of the Company's Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2004, are incorporated by reference into Part III, Items 10-14 of this Form 10-K.

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**Explanatory Note**

The purpose of this Amendment No. 1 on Form 10-K/A to the Annual Report on Form 10-K of Prosperity Bancshares, Inc. (the Company) for the year ended December 31, 2004 (the Original Form 10-K) is to restate the Company's consolidated financial statements as of December 31, 2004 and 2003 and for the years ended December 31, 2004, 2003 and 2002 to correct amounts on the Company's consolidated statements of cash flows related to acquisitions as more fully discussed in Note 21 to the accompanying consolidated financial statements. Specifically, the amounts presented in the Company's consolidated statements of cash flows for the years ended December 31, 2004, 2003 and 2002 reflect a correction in the presentation of the Company's common stock issued in connection with acquisitions to present this activity as a non-cash activity rather than it being presented as cash flows in the financing and investing activities sections of the consolidated statements of cash flows. The Company also corrected other immaterial miscellaneous items in the consolidated statements of cash flows for the years ended December 31, 2004, 2003 and 2002. There was no change in the net increase in cash and cash equivalents. Further, these changes had no effect on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.

In addition, the Company has amended Item 9A and Management's Annual Report on Internal Control Over Financial Reporting to update the disclosure regarding disclosure controls and procedures and internal control over financial reporting.

As a result of the restatement, the Company has determined it to be necessary to amend the Original Form 10-K. This Amendment No. 1 amends and restates in its entirety Part II, Items 8 and 9A and Part IV, Item 15 of the Original Form 10-K. This Amendment No. 1 continues to reflect circumstances as of the date of the filing of the Original Form 10-K and does not reflect events occurring after the filing of the Original Form 10-K, or modify or update those disclosures in any way, except as required to reflect the effects of the restatement as described in Note 21 to the accompanying consolidated financial statements and to correct certain other immaterial miscellaneous items.

PROSPERITY BANCSHARES, INC. ®

2004 ANNUAL REPORT ON FORM 10-K/A

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements, the reports thereon, the notes thereto and supplementary data commence at page 8 of this Amendment No. 1 to the Annual Report on Form 10-K/A.

The following table presents certain unaudited quarterly financial information concerning the Company's results of operations for each of the two years indicated below. The information should be read in conjunction with the historical consolidated financial statements of the Company and the notes thereto appearing elsewhere in this Amendment No. 1 to the Annual Report on Form 10-K/A.

CONSOLIDATED QUARTERLY FINANCIAL DATA OF THE COMPANY

	Quarter Ended 2004			
	(unaudited) (As previously reported)			
	December 31	September 30	June 30	March 31
	(Dollars in thousands, except per share data)			
Interest income	\$ 30,308	\$ 28,763	\$ 26,313	\$ 26,372
Interest expense	8,106	7,696	6,962	7,025
Net interest income	22,202	21,067	19,351	19,347
Provision for credit losses	220	420	120	120
Net interest income after provision	21,982	20,647	19,231	19,227
Noninterest income	6,233	6,111	5,455	5,272
Noninterest expense	13,987	13,194	12,067	12,459
Income before income taxes	14,228	13,564	12,619	12,040
Provision for income taxes	4,892	4,618	4,257	3,977
Net income	\$ 9,336	\$ 8,946	\$ 8,362	\$ 8,063
Earnings per share:				
Basic	\$ 0.417	\$ 0.410	\$ 0.399	\$ 0.385
Diluted	\$ 0.412	\$ 0.405	\$ 0.394	\$ 0.380

Quarter Ended 2003

(unaudited) (As previously reported)

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	<u>December 31</u>	<u>September 30</u>	<u>June 30</u>	<u>March 31</u>
	(Dollars in thousands, except per share data)			
Interest income	\$ 25,054	\$ 21,365	\$ 22,214	\$ 22,212
Interest expense	6,650	6,375	6,653	6,668
Net interest income	18,404	14,990	15,561	15,544
Provision for credit losses	123	120	120	120
Net interest income after provision	18,281	14,870	15,441	15,424
Noninterest income	4,796	4,326	4,005	3,839
Noninterest expense	12,458	9,707	9,925	9,931
Income before income taxes	10,619	9,489	9,521	9,332
Provision for income taxes	3,427	3,019	3,024	2,943
Net income	\$ 7,192	\$ 6,470	\$ 6,497	\$ 6,389
Earnings per share:				
Basic	\$ 0.359	\$ 0.341	\$ 0.343	\$ 0.338
Diluted	\$ 0.353	\$ 0.336	\$ 0.338	\$ 0.333

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### **ITEM 9A. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its SEC filings is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e) and 15d-15(e) promulgated under the Exchange Act. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply judgment in evaluating its controls and procedures.

Management, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. Subsequent to the date of that evaluation, management considered the restatement of the Company's consolidated financial statements and concluded that such restatement was the result of a material weakness related to controls over the preparation and review of its consolidated statement of cash flows. Based on such considerations, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of December 31, 2004, the Company's disclosure controls and procedures were not effective solely because of the material weakness described below. Specifically, the Company did not maintain effective controls to appropriately classify the presentation of the Company's common stock issued in connection with acquisitions. The amounts presented in the Company's statements of cash flows for the year ended December 31, 2004, 2003 and 2002 reflect a change in the presentation for Company common stock issued in connection with acquisitions to present this activity as a non-cash activity rather than being presented as cash flows in the financing and investing activities section of the statements of cash flows. The Company also corrected other immaterial miscellaneous items. There was no change in the net increase in cash and cash equivalents. Further, these changes had no impact on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.

In an effort to remediate the material weakness in the Company's internal control over the preparation and review of its consolidated statements of cash flows described above, management has implemented a process to aid in correctly classifying amounts related to acquisitions reflected in the consolidated statement of cash flows, including a more detailed cash flow statement preparation checklist. Accordingly, management believes this process will remediate the material weakness discussed above. There were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) Securities Exchange Act of 1934) in the fourth quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### *Management's Report on Internal Control Over Financial Reporting*

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with generally accepted accounting principles.

As of December 31, 2004, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in the Internal Control - Integrated Framework, issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. This assessment included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the Consolidated Financial Statements for Bank Holding Companies (Form FRY-9C) to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act.

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Based on management's consideration of the restatement of the Company's consolidated financial statements subsequent to the date of such assessment, management determined that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, solely because of the material weakness related to controls over the preparation and review of its consolidated statements of cash flows described above.

Deloitte & Touche, LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Amendment No. 1 to the Annual Report on Form 10-K/A, has issued an attestation report on management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. The report is included in this Item under the heading Report of Independent Registered Public Accounting Firm.



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Prosperity Bancshares, Inc. and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions for the *Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C)*. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our report dated March 8, 2005, we expressed an unqualified opinion on management's assessment that the Company maintained effective internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting. As described in the following paragraph, the Company subsequently identified material misstatements in its 2004, 2003 and 2002 annual financial statements

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and 2005 and 2004 interim financial statements, which caused such annual and interim financial statements to be restated. Management subsequently revised its assessment due to the identification of a material weakness, described in the following paragraph, in connection with the financial statement restatement. Accordingly, our opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 expressed herein is different from that expressed in our previous report.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's revised assessments: The amounts presented in the Company's statements of cash flows for the years ended December 31, 2004, 2003 and 2002 reflect a correction in the presentation for stock issued in connection with acquisitions to present this activity as a non-cash activity rather than being presented as cash flows in the financing and investing activities sections of the consolidated statements of cash flows. The Company also corrected other immaterial miscellaneous items. There was no change in the total net increase in cash and cash equivalents. These changes had no effect on the Company's statements of income, balance sheets or statements of shareholders equity. This material weakness resulted in the restatement of the Company's previously issued annual financial statements as described more fully in Note 21 to the consolidated financial statements. This material weakness was considered in determining the nature, timing and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2004 (as restated), of the Company and this report does not affect our report on such restated financial statements.

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In our opinion, management's revised assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2004, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2004 (as restated) of the Company and our report dated March 8, 2005 (October 26, 2005 as to the effects of the restatement described in Note 21 to the financial statements) expresses an unqualified opinion on those financial statements and includes explanatory paragraphs relating to the restatement described in Note 21 to the financial statements.

Houston, Texas

March 8, 2005 (October 26, 2005 as to the effect of

the material weakness described in Management's

Report on Internal Control over Financial Reporting,

as revised)

**PART IV.**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

**Consolidated Financial Statements and Schedules**

Reference is made to the Consolidated Financial Statements, the reports thereon, the notes thereto and supplementary data commencing at page 8 of this Amendment No. 1 to the Annual Report on Form 10-K/A. Set forth below is a list of such Consolidated Financial Statements:

Report of Independent Registered Public Accounting Firm

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Consolidated Balance Sheets as of December 31, 2004 and 2003

Consolidated Statements of Income for the Years Ended December 31, 2004, 2003 and 2002

Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2004, 2003 and 2002

Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002 (as Restated)

Notes to Consolidated Financial Statements

## Financial Statement Schedules

All supplemental schedules are omitted as inapplicable or because the required information is included in the Consolidated Financial Statements or notes thereto.

## Exhibits

Each exhibit marked with an asterisk is filed with this Annual Report on Form 10-K/A.

### Exhibit

<u>Number</u> <sup>(1)</sup>	<u>Description</u>
2.1	- Agreement and Plan of Reorganization, dated as of October 25, 2004, by and between the Company and First Capital Bankers, Inc. (incorporated herein by reference to Exhibit 2.1 to the Company's Registration Statement on Form S-4 (Registration No. 333-121767)).
2.2	- Agreement and Plan of Reorganization dated as of May 1, 2002 by and between Prosperity Bancshares, Inc. and Paradigm Bancorporation, Inc. (incorporated herein by reference to Exhibit 2.1 to the Company's Registration Statement on Form S-4 (Registration No. 333-91248))

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- 2.3 - Stock Purchase Agreement dated as of February 22, 2002 by and between Prosperity Bancshares, Inc. and American Bancorp of Oklahoma, Inc. (incorporated herein by reference to Exhibit 2.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002)
- 2.4 - Agreement and Plan of Reorganization dated as of April 26, 2002 by and among Prosperity Bancshares, Inc., Prosperity Bank and The First State Bank (incorporated herein by reference to Exhibit 2.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002)
- 2.5 - Agreement and Plan of Reorganization by and between the Prosperity Bancshares, Inc and Commercial Bancshares, Inc. dated November 8, 2000 (incorporated herein by reference to Exhibit 2.1 to the Company's Registration Statement on Form S-4 (Registration No. 333-52342))
- 2.6 - Agreement and Plan of Reorganization by and between Prosperity Bancshares, Inc. and South Texas Bancshares, Inc. dated June 17, 1999 (incorporated herein by reference to Exhibit 2.1 to the Company's Form 10-Q for the quarter ended June 30, 1999)
- 2.7 - Agreement and Plan of Reorganization dated June 5, 1998 by and among Prosperity, Prosperity Bank and Union State Bank (incorporated herein by reference to Exhibit 10.4 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
- 3.1 - Amended and Restated Articles of Incorporation of Prosperity (incorporated herein by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
- 3.2 - Amended and Restated Bylaws of Prosperity (incorporated herein by reference to Exhibit 3.1 to the Company's Form 10-Q for the quarter ended March 31, 2001)
- 4.1 - Form of certificate representing shares of Prosperity common stock (incorporated herein by reference to Exhibit 4 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
- 4.2 - Indenture dated as of July 31, 2001 by and between Prosperity Bancshares, Inc., as Issuer, and State Street Bank and Trust Company of Connecticut, National Association, with respect to the Floating Rate Junior Subordinated Deferrable Interest Debentures of Prosperity Bancshares, Inc. (incorporated herein by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
- 4.3 - Amended and Restated Declaration of Trust of Prosperity Statutory Trust II dated as of July 31, 2001 (incorporated herein by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
- 4.4 - Guarantee Agreement dated as of July 31, 2001 by and between Prosperity Bancshares, Inc. and State Street Bank and Trust Company of Connecticut, National Association (incorporated herein by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001)
- 10.1 - Prosperity Bancshares, Inc. 1995 Stock Option Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
- 10.2 - Prosperity Bancshares, Inc. 1998 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1 (Registration No. 333-63267))
- 10.3 - Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-4 (Registration No. 333-121767))
- 10.4 - Amended and Restated Employment Agreement by and between Prosperity Bank and David Zalman (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated January 18, 2005)

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- 10.5 - Amended and Restated Employment Agreement by and between Prosperity Bank and H. E. Timanus, Jr. (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K dated January 18, 2005)
- 10.6 - Employment Agreement between the Company, Prosperity Bank and D. Michael Hunter (incorporated herein by reference to Exhibit 10.4 to the Company's Registration Statement on Form S-4 (Registration No. 333-121767))
- 10.7 - Commercial Bancshares, Inc. Incentive Stock Option Plan for Key Employees (incorporated herein by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-8 (Registration No. 333-57238))
- 10.8 - Form of Stock Option Agreement under the Commercial Bancshares, Inc. Incentive Stock Option Plan for Key Employees (incorporated herein by reference to Exhibit 4.6 to the Company's Registration Statement on Form S-8 (Registration No. 333-57238))
- 10.9 - Paradigm Bancorporation, Inc. 1999 Stock Incentive Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-100815))
- 10.10 - MainBancorp, Inc. 1996 Employee Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-110755))
- 10.11 - Form of MainBancorp, Inc. Non-Qualified Stock Option Agreement (incorporated herein by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (Registration No. 333-110755))
- 10.12 \*\* - First Capital Bankers, Inc. 1996 Executive Stock Option Plan
- 10.13 \*\* - First Capital Bankers, Inc. Amended and Restated 1998 Stock Option Plan
- 21.1\*\* - Subsidiaries of Prosperity Bancshares, Inc.
- 23.1\* - Consent of Deloitte & Touche LLP
- 31.1\* - Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
- 31.2\* - Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
- 32.1\* - Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* - Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Management contract or compensatory plan or arrangement.

- (1) The Company has other long-term debt agreements that meet the exclusion set forth in Section 601(b)(4)(iii)(A) of Regulation S-K. The Company hereby agrees to furnish a copy of such agreements to the Commission upon request.

\* Filed herewith.

\*\* Previously filed.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Prosperity Bancshares, Inc., has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Houston and State of Texas on October 28, 2005.

**PROSPERITY BANCSHARES, INC.®**

**By: /s/ DAVID ZALMAN**

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**David Zalman  
President and Chief Executive Officer**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed by the following persons on behalf of the registrant in the indicated capacities on October 28, 2005.

<u>Signature</u>	<u>Positions</u>
<u>/s/ DAVID ZALMAN</u>	President and Chief Executive Officer (principal executive officer); Director
David Zalman	
<u>/s/ NED S. HOLMES</u>	Chairman of the Board; Director
Ned S. Holmes	
<u>/s/ DAVID HOLLOWAY</u>	Chief Financial Officer (principal financial officer and principal accounting officer)
David Hollaway	
<u>/s/ H.E. TIMANUS, JR.</u>	Executive Vice President and Chief Operating Officer; Director
H.E. Timanus, Jr.	
<u>/s/ JAMES A. BOULIGNY</u>	Director
James A. Bouligny	
<u>/s/ CHARLES A. DAVIS, JR.</u>	Director
Charles A. Davis, Jr.	
<u>/s/ WILLIAM H. FAGAN, M.D.</u>	Director
William Fagan, M.D.	

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*/s/ CHARLES J. HOWARD, M.D.* Director

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Charles Howard, M.D.

*/s/ D. MICHAEL HUNTER* Director

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D. Michael Hunter

*/s/ S. REED MORIAN* Director

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S. Reed Morian

*/s/ PERRY MUELLER, JR., D.D.S.* Director

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Perry Mueller, Jr., D.D.S.

*/s/ TRACY T. RUDOLPH* Director

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Tracy T. Rudolph

*/s/ HARRISON STAFFORD II* Director

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Harrison Stafford II

*/s/ ROBERT STEELHAMMER* Director

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Robert Steelhammer



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Prosperity Bancshares, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Prosperity Bancshares Inc. and subsidiaries (the Company) as of December 31, 2004 and 2003, and the related statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. These 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, such financial statements present fairly, in all material respects, the financial position of Prosperity Bancshares, Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 8, 2005 (October 26, 2005 as to the effect of the material weakness described in Management's Report on Internal Control Over Financial Reporting (as revised)), expresses an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting.

As discussed in Note 21, the consolidated statements of cash flows for each of the three fiscal years in the period ended December 31, 2004 have been restated.

Houston, Texas

March 8, 2005 (October 26, 2005 as to the

effects of the restatement described in Note 21)

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2004	2003
	(Dollars in thousands)	
<b>ASSETS</b>		
Cash and due from banks	\$ 58,760	\$ 71,983
Federal funds sold	79,150	11,730
Total cash and cash equivalents	137,910	83,713
Interest bearing deposits in financial institutions	200	262
Available for sale securities, at fair value	177,683	263,648
Held to maturity securities, at cost	1,125,109	1,113,232
Loans	1,035,513	770,053
Less allowance for credit losses	(13,105)	(10,345)
Loans, net	1,022,408	759,708
Accrued interest receivable	10,171	10,119
Goodwill	153,180	118,012
Core deposit intangibles, net of accumulated amortization of \$2.8 million and \$1.0 million, respectively	11,492	6,743
Bank premises and equipment, net	35,793	34,299
Other real estate owned	341	246
Other assets	22,941	10,505
<b>TOTAL ASSETS</b>	<b>\$ 2,697,228</b>	<b>\$ 2,400,487</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 518,358	\$ 467,389
Interest-bearing	1,798,718	1,616,359
Total deposits	2,317,076	2,083,748
Other borrowings	13,116	11,929
Securities sold under repurchase agreements	25,058	19,007
Accrued interest payable	3,102	2,522
Other liabilities	15,805	3,889
Junior subordinated debentures	47,424	59,804
Total liabilities	2,421,581	2,180,899
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, \$1 par value; 20,000,000 shares authorized; none issued or outstanding		
Common stock, \$1 par value; 50,000,000 shares authorized; 22,418,128 and 20,966,706 shares issued at December 31, 2004 and 2003, respectively; 22,381,040 and 20,929,618 shares outstanding at December 31, 2004 and 2003, respectively	22,418	20,967
Capital surplus	134,288	102,594
Retained earnings	122,647	94,610
Accumulated other comprehensive (loss) income net unrealized (loss) gain on available for sale securities, net of tax benefit of \$1,669 and tax of \$1,090, respectively	(3,099)	2,024

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Less treasury stock, at cost, 37,088 shares	(607)	(607)
Total shareholders' equity	275,647	219,588
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 2,697,228</b>	<b>\$ 2,400,487</b>

See notes to consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

	For the Years Ended		
	December 31,		
	2004	2003	2002
	(Dollars in thousands, except per share data)		
<b>INTEREST INCOME:</b>			
Loans, including fees	\$ 55,779	\$ 46,686	\$ 38,330
Securities:			
Taxable.	52,771	40,507	39,289
Nontaxable	1,461	1,625	1,599
70% nontaxable preferred dividends	1,009	1,779	1,216
Federal funds sold	556	232	285
Deposits in financial institutions	180	16	23
<b>Total interest income</b>	<b>111,756</b>	<b>90,845</b>	<b>80,742</b>
<b>INTEREST EXPENSE:</b>			
Deposits	24,586	22,633	24,976
Junior subordinated debentures	4,046	2,630	2,170
Note payable and other borrowings	1,157	1,083	955
<b>Total interest expense</b>	<b>29,789</b>	<b>26,346</b>	<b>28,101</b>
<b>NET INTEREST INCOME</b>	<b>81,967</b>	<b>64,499</b>	<b>52,641</b>
<b>PROVISION FOR CREDIT LOSSES</b>	<b>880</b>	<b>483</b>	<b>1,010</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b>	<b>81,087</b>	<b>64,016</b>	<b>51,631</b>
<b>NONINTEREST INCOME:</b>			
Service charges on deposit accounts	20,215	14,236	9,764
Gain on sale of securities	78		
Other	2,778	2,730	1,830
<b>Total noninterest income</b>	<b>23,071</b>	<b>16,966</b>	<b>11,594</b>
<b>NONINTEREST EXPENSE:</b>			
Salaries and employee benefits	27,861	22,422	16,379
Net occupancy expense	4,814	4,492	3,439
Data processing	2,036	2,128	2,131
Core deposit intangibles amortization	1,781	818	192
Depreciation expense	2,843	2,535	1,830
Other	12,372	9,626	8,378
<b>Total noninterest expense</b>	<b>51,707</b>	<b>42,021</b>	<b>32,349</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>52,451</b>	<b>38,961</b>	<b>30,876</b>

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PROVISION FOR INCOME TAXES	17,744	12,413	9,555
NET INCOME	\$ 34,707	\$ 26,548	\$ 21,321
EARNINGS PER SHARE:			
Basic	\$ 1.61	\$ 1.38	\$ 1.25
Diluted	\$ 1.59	\$ 1.36	\$ 1.22

See notes to consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

	Common Stock		Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total Shareholders Equity
	Shares	Amount					
(Dollars in thousands, except share data)							
BALANCE AT JANUARY 1, 2002	16,218,022	\$ 16,218	\$ 16,865	\$ 55,462	\$ 217	\$ (37)	\$ 88,725
Net income				21,321			21,321
Net change in unrealized gain (loss) on available for sale securities					2,427		2,427
Total comprehensive income							23,748
Issuance of common stock in connection with the exercise of stock options	104,504	105	155				260
Common stock issued in connection with Paradigm acquisition	2,580,502	2,580	43,295				45,875
Cash paid in lieu of fractional shares in connection with the Paradigm acquisition			(3)				(3)
Cash dividends declared, \$0.22 per share				(3,866)			(3,866)
BALANCE AT DECEMBER 31, 2002	18,903,028	18,903	60,312	72,917	2,644	(37)	154,739
Net income				26,548			26,548
Net change in unrealized (loss) gain on available for sale securities					(620)		(620)
Total comprehensive income							25,928
Issuance of common stock in connection with the exercise of stock options	170,638	171	824				995
Refund of escrow shares in connection with the Paradigm acquisition						(570)	(570)
Common stock issued in connection with the Mainbancorp acquisition	1,499,966	1,500	33,149				34,649
Common stock issued in connection with the FSBNT acquisition	393,074	393	8,538				8,931
Stock option compensation			25				25
Junior subordinated debentures issuance costs			(254)				(254)
Cash dividends declared, \$0.25 per share				(4,855)			(4,855)
BALANCE AT DECEMBER 31, 2003	20,966,706	20,967	102,594	94,610	2,024	(607)	219,588
Net income				34,707			34,707
Net change in unrealized (loss) gain on available for sale securities					(5,123)		(5,123)
Total comprehensive income							29,584
Issuance of common stock in connection with the exercise of stock options	206,321	206	840				1,046



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Common stock issued in connection with the Liberty acquisition	1,245,191	1,245	30,713				31,958
Stock option compensation			141				141
Cash dividends declared, \$0.31 per share				(6,670)			(6,670)
<b>BALANCE AT DECEMBER 31, 2004</b>	<b>22,418,218</b>	<b>\$ 22,418</b>	<b>\$ 134,288</b>	<b>\$ 122,647</b>	<b>\$ (3,099)</b>	<b>\$ (607)</b>	<b>\$ 275,647</b>

See notes to consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Years Ended		
	December 31,		
	2004	2003	2002
	(Dollars in thousands) (As restated, see note 21)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 34,707	\$ 26,548	\$ 21,321
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,122	3,353	2,022
Provision for credit losses	880	483	1,010
Net amortization of premium on investments	4,869	9,707	4,317
Gain on sale of premises, equipment and other real estate	(389)	(378)	(39)
Stock option compensation expense	141	25	
(Increase) decrease in accrued interest receivable and other assets	(4,056)	4,871	(1,525)
Increase (decrease) in accrued interest payable and other liabilities	7,649	(3,995)	(2,567)
<b>Total adjustments</b>	<b>14,216</b>	<b>14,066</b>	<b>3,218</b>
<b>Net cash provided by operating activities</b>	<b>48,923</b>	<b>40,614</b>	<b>24,539</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from maturities and principal paydowns of held to maturity securities	257,501	505,733	211,467
Purchase of held to maturity securities	(270,855)	(973,480)	(300,816)
Proceeds from maturities and principal paydowns of available for sale securities	67,201	144,821	128,906
Proceeds from the sales of available for sale securities	20,000		
Purchase of available for sale securities	(299)	(11,951)	(119,527)
Net (increase) decrease in loans	(68,254)	38,001	36,838
Purchase of bank premises and equipment	(895)	(3,485)	(2,171)
Net proceeds from sale of bank premises, equipment and other real estate	3,297	3,243	1,229
Purchase of Liberty Bancshares, Inc. and Village Bank & Trust, ssb	(28,282)		
Cash and cash equivalents acquired in the purchase of Liberty Bancshares, Inc. and Village Bank & Trust, ssb	62,719		
Purchase of Abrams Centre Bancshares, Dallas Bancshares, MainBancorp and FSBNT		(45,665)	
Cash and cash equivalents acquired in the purchase of Abrams Centre Bancshares, Dallas Bancshares, MainBancorp and FSBNT		158,902	
Purchase of Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Bank Holding Company			(40,785)
Cash and cash equivalents acquired in the purchase of Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Bank Holding Company			52,206
Net decrease in interest-bearing deposits in financial institutions	762	399	397
<b>Net cash provided by (used in) investing activities</b>	<b>42,895</b>	<b>(183,482)</b>	<b>(32,256)</b>

(Table continued on following page)



**Table of Contents****PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Years Ended		
	December 31,		
	2004	2003	2002
	(Dollars in thousands)		
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net (decrease) increase in noninterest-bearing deposits	\$ (9,892)	\$ 23,579	\$ 10,118
Net (decrease) increase in interest-bearing deposits	(14,727)	125,657	26,228
Proceeds (repayments) of other borrowings and securities sold under repurchase agreements (net)	4,622	(24,340)	14,059
Proceeds from issuance of junior subordinated debentures		25,000	
Junior subordinated debentures issuance costs		(254)	
Cash paid in lieu of fractional shares			(3)
Redemption of junior subordinated debentures issued to Prosperity Capital Trust I (net)	(12,000)		
Proceeds from stock option exercises	1,046	995	260
Payments of cash dividends	(6,670)	(4,855)	(3,866)
	<u>(37,621)</u>	<u>145,782</u>	<u>46,796</u>
<b>Net cash (used in) provided by financing activities</b>	<b>(37,621)</b>	<b>145,782</b>	<b>46,796</b>
	<u>(37,621)</u>	<u>145,782</u>	<u>46,796</u>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$ 54,197</b>	<b>\$ 2,914</b>	<b>\$ 39,079</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>83,713</b>	<b>80,799</b>	<b>41,720</b>
	<u>83,713</u>	<u>80,799</u>	<u>41,720</u>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 137,910</b>	<b>\$ 83,713</b>	<b>\$ 80,799</b>
	<u>\$ 137,910</u>	<u>\$ 83,713</u>	<u>\$ 80,799</u>
<b>NONCASH ACTIVITIES:</b>			
Stock issued in connection with the Liberty acquisition	31,958		
Stock issued in connection with the MainBancorp and FSBNT acquisitions		43,580	
Stock issued in connection with the Paradigm Bancorporation acquisition			49,184
<b>INCOME TAXES PAID</b>	<b>\$ 19,464</b>	<b>\$ 14,397</b>	<b>\$ 9,182</b>
	<u>\$ 19,464</u>	<u>\$ 14,397</u>	<u>\$ 9,182</u>
<b>INTEREST PAID</b>	<b>\$ 29,368</b>	<b>\$ 26,215</b>	<b>\$ 26,250</b>
	<u>\$ 29,368</u>	<u>\$ 26,215</u>	<u>\$ 26,250</u>
<b>TRANSFER OF AVAILABLE FOR SALE SECURITIES TO HELD TO MATURITY SECURITIES</b>	<b>\$</b>	<b>\$</b>	<b>\$ 241,756</b>
	<u>\$</u>	<u>\$</u>	<u>\$ 241,756</u>

See notes to consolidated financial statements.

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**PROSPERITY BANCSHARES, INC.<sup>®</sup> AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES**

**Nature of Operations** Prosperity Bancshares, Inc.<sup>®</sup> ( Bancshares ) and its subsidiaries, Prosperity Holdings of Delaware, LLC ( Holdings ) and Prosperity Bank<sup>®</sup> (the Bank ), and together with Bancshares and Holdings, collectively referred to as the Company ) provide retail and commercial banking services.

The Bank operates fifty-eight (58) full-service banking locations; with twenty-nine (29) in the Greater Houston Consolidated Metropolitan Statistical Area ( CMSA ), eleven (11) in eight contiguous counties situated south and southwest of Houston and extending into South Texas, eleven (11) in the Dallas/Fort Worth area and seven (7) in the Austin, Texas area with locations in Dallas-Abrams Centre, Houston-Aldine, Austin-Allandale, Angleton, Bay City, Beeville, Blooming Grove, Houston-Bellaire, Dallas-Camp Wisdom, Dallas-Cedar Hill, Houston-City West, Houston-Clear Lake, Cleveland, Austin-Congress, Corsicana, Houston-Copperfield, Cuero, Cypress, Dayton, Houston-Downtown, East Bernard, Edna, El Campo, Ennis, Fairfield, Galveston, Houston-Gladebrook, Goliad, Houston-Highway 6, Hitchcock, Dallas-Kiest, Austin-Lakeway, Liberty, Magnolia, Mathis, Houston-Medical Center, Houston-Memorial, Mont Belvieu, Needville, Palacios, Oakhill, Houston-Post Oak, Dallas-Preston Road, Dallas-Red Oak, Austin-Research Boulevard, Houston-River Oaks, Austin-Riverside, Sweeny, Houston-Tanglewood, Dallas-Turtle Creek, Victoria, Houston-Waugh Drive, West Columbia, Dallas-Westmoreland, Wharton, Austin-William Cannon, Winnie and Houston-Woodcreek.

**Principles of Consolidation** The consolidated financial statements include the accounts of Bancshares and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America ( GAAP ) and the prevailing practices within the banking industry. A summary of significant accounting and reporting policies is as follows:

**Use of Estimates** The preparation of financial statements in conformity with GAAP 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 revenues and expenses during the reporting period. Actual results could differ from these estimates.

**Securities** Securities held to maturity are carried at cost, adjusted for the amortization of premiums and the accretion of discounts. Management has the positive intent and the Company has the ability to hold these assets as long-term securities until their estimated maturities.

Securities available for sale are carried at fair value. Unrealized gains and losses are excluded from earnings and reported, net of tax, as a separate component of shareholders' equity until realized. Securities within the available for sale portfolio may be used as part of the Company's asset/liability strategy and may be sold in response to changes in interest risk, prepayment risk or other similar economic factors.

Declines in the fair value of individual held to maturity and available for sale securities below their cost that are other than temporary would result in write-downs of the individual securities to their fair value. The related write-downs would be included in earnings as realized losses.

Premiums and discounts are amortized and accreted to operations using the level-yield method of accounting, adjusted for prepayments as applicable. The specific identification method of accounting is used to compute gains or losses on the sales of these assets. Interest earned on these assets is included in interest income.

**Loans** Loans are stated at the principal amount outstanding, net of unearned discount and fees. Unearned discount relates principally to consumer installment loans. The related interest income for multipayment loans is recognized principally by the sum of the digits method which records interest in proportion to the declining outstanding balances of the loans; for single payment loans, such income is recognized using the straight-line method.

**Nonrefundable Fees and Costs Associated with Lending Activities** - Loan origination fees in excess of the associated costs are recognized over the life of the related loan as an adjustment to yield using the interest method.

Generally, loan commitment fees are deferred, except for certain retrospectively determined fees, and recognized as an adjustment of yield by the interest method over the related loan life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

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PROSPERITY BANCSHARES, INC.® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Nonperforming and Past Due Loans** Included in the nonperforming loan category are loans which have been categorized by management as nonaccrual because collection of interest is doubtful and loans which have been restructured to provide a reduction in the interest rate or a deferral of interest or principal payments. When the payment of principal or interest on a loan is delinquent for 90 days, or earlier in some cases, the loan is placed on nonaccrual status unless the loan is in the process of collection and the underlying collateral fully supports the carrying value of the loan. If the decision is made to continue accruing interest on the loan, periodic reviews are made to confirm the accruing status of the loan. When a loan is placed on nonaccrual status, interest accrued during the current year prior to the judgment of uncollectibility is charged to operations. Interest accrued during prior periods is charged to allowance for credit losses. Generally, any payments received on nonaccrual loans are applied first to outstanding loan amounts and next to the recovery of charged-off loan amounts. Any excess is treated as recovery of lost interest.

Restructured loans are those loans on which concessions in terms have been granted because of a borrower's financial difficulty. Interest is generally accrued on such loans in accordance with the new terms.

**Allowance for Credit Losses** The allowance for credit losses is a valuation allowance available for losses incurred on loans. All losses are charged to the allowance when the loss actually occurs or when a determination is made that such a loss is probable. Recoveries are credited to the allowance at the time of recovery.

Throughout the year, management estimates the probable level of losses to determine whether the allowance for credit losses is adequate to absorb losses in the existing portfolio. Based on these estimates, an amount is charged to the provision for credit losses and credited to the allowance for credit losses in order to adjust the allowance to a level determined to be adequate to absorb losses.

Management's judgment as to the level of losses on existing loans involves the consideration of current and anticipated economic conditions and their potential effects on specific borrowers; an evaluation of the existing relationships among loans, probable credit losses and the present level of the allowance; results of examinations of the loan portfolio by regulatory agencies; and management's internal review of the loan portfolio. In determining the collectibility of certain loans, management also considers the fair value of any underlying collateral. The amounts ultimately realized may differ from the carrying value of these assets because of economic, operating or other conditions beyond the Company's control.

Estimates of credit losses involve an exercise of judgment. While it is possible that in the short term the Company may sustain losses which are substantial in relation to the allowance for credit losses, it is the judgment of management that the allowance for credit losses reflected in the consolidated balance sheets is adequate to absorb probable losses that exist in the current loan portfolio.

Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by SFAS No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosure* applies to all impaired loans, with the exception of groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. A loan is defined as impaired by SFAS No. 114 if, based on current information and events, it is probable that a creditor will be unable to collect all amounts due, both interest and principal, according to the contractual terms of the loan agreement. Specifically, SFAS No. 114 requires that the allowance for credit losses related to impaired loans be determined based on the difference of carrying value of loans and the present value of expected cash flows discounted at the loan's effective interest rate or, as a practical expedient, the loan's observable market price or the fair value of the collateral if

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the loan is collateral dependent. At December 31, 2004, the Company had \$297,000 in nonaccrual loans, \$1.1 million in 90 days or more past due loans, and no restructured loans. At December 31, 2003, the Company had \$2,000 in nonaccrual loans, \$679,000 in 90 days or more past due loans and no restructured loans.

Interest revenue received on impaired loans is either applied against principal or realized as interest revenue, according to management's judgment as to the collectibility of principal.

**Premises and Equipment** Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally using the straight-line method over the estimated useful lives of the assets which range from three to 30 years.



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Goodwill** Goodwill and intangible assets determined to have an indefinite useful life acquired in a purchase business combination completed after June 30, 2001 are no longer amortized pursuant to the adoption of SFAS 142. Goodwill was amortized using the straight-line method through December 31, 2001. Goodwill is annually assessed on September 30<sup>th</sup> for impairment or when events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The Company bases its evaluation on such impairment factors as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present.

**Amortization of Core Deposit Intangibles (CDI)** CDI is amortized using an accelerated amortization method over an eight year period.

**Income Taxes** Bancshares files a consolidated federal income tax return. The Bank computes federal income taxes as if it filed a separate return and remits to, or is reimbursed by, Bancshares based on the portion of taxes currently due or refundable.

Deferred tax assets and liabilities are recognized for the estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

**Stock-Based Compensation** As of December 31, 2004, the Company had two stock-based employee compensation plans. Prior to 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost was reflected in financial statement issued prior to 2003, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. In December 2002, the FASB issued Statement No. 148 (SFAS 148), *Accounting for Stock-Based Compensation: Transition and Disclosure*, an amendment to FASB Statement 123. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 was effective for financial statements for fiscal years ending after December 15, 2002. Effective January 1, 2003, the Company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as provided by SFAS No. 148 for stock-based employee compensation (see Note 14).

For 2002, the Company did not recognize any stock based compensation expense in reported net income. If compensation expense had been recorded based on the fair value at the grant date for awards consistent with SFAS No. 123, the Company's net income and earnings per share would have been as follows for the year ended December 31, 2002:

	Year Ended
	December 31, 2002
	(Dollars in thousands,
	except per share data)
Net income as reported	\$ 21,321

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Deduct: Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(180)
Proforma net income	\$	21,141
Earnings per share:		
Basic-as reported	\$	1.25
Basic-proforma	\$	1.24
Diluted-as reported	\$	1.22
Diluted-proforma	\$	1.21

**Cash and Cash Equivalents** For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks as well as federal funds sold that mature in three days or less.

**Reclassifications** Certain reclassifications have been made to 2003 and 2002 balances to conform to the current year presentation. All reclassifications have been applied consistently for the periods presented.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Earnings Per Share** SFAS No. 128, *Earnings Per Share*, requires presentation of basic and diluted earnings per share. Basic earnings per share has been computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Net income per common share for all periods presented has been calculated in accordance with SFAS No. 128. Outstanding stock options issued by the Company represent the only dilutive effect reflected in diluted weighted average shares.

The following table illustrates the computation of basic and diluted earnings per share:

	December 31,					
	2004		2003		2002	
	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share data)					
Net income	\$ 34,707		\$ 26,548		\$ 21,321	
Basic:						
Weighted average shares outstanding	21,534	\$ 1.61	19,225	\$ 1.38	17,122	\$ 1.25
Diluted:						
Weighted average shares outstanding	21,534		19,225		17,122	
Effect of dilutive securities options	270		311		320	
Total	21,804	\$ 1.59	19,536	\$ 1.36	17,442	\$ 1.22

There were no stock options exercisable at December 31, 2004, 2003 and 2002 that would have had an anti-dilutive effect on the above computation.

**New Accounting Standards***Statements of Financial Accounting Standards*

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*SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.* SFAS 150 establishes standards for how an issuer classifies, measures and discloses in its financial statements certain financial instruments with characteristics of both liabilities and equity. SFAS 150 requires that an issuer classify financial instruments that are within its scope as liabilities, in most circumstances. Such financial instruments include (i) financial instruments that are issued in the form of shares that are mandatorily redeemable; (ii) financial instruments that embody an obligation to repurchase the issuer's equity shares, or are indexed to such an obligation, and that require the issuer to settle the obligation by transferring assets; (iii) financial instruments that embody an obligation that the issuer may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is predominantly based on a fixed amount, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares; and (iv) certain freestanding financial instruments. The Company adopted SFAS 150 on January 1, 2004 and its adoption did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

*SFAS No. 123, Share-Based Payment (Revised 2004).* SFAS 123R establishes standards for the accounting for transactions in which an entity (i) exchanges its equity instruments for goods or services, or (ii) incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of the equity instruments. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the date of the grant. SFAS 123R is effective for the Company beginning on January 1, 2006.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

***Financial Accounting Standards Board Interpretations***

In December 2003, the FASB issued FIN 46R, *Consolidation of Variable Interest Entities*. FIN 46R provides guidance on how to identify a variable interest entity and determine when the assets, liabilities, non-controlling interests and results of operations of a variable interest entity need to be included in a company's consolidated financial statements. A company that holds variable interest in an entity is required to consolidate the entity if the company's interest in the variable interest entity is such that the company will absorb a majority of the variable interest entity's expected losses and/or receive a majority of the entity's expected residual returns, if they occur. As of December 31, 2004, the Company had no investments in variable interest entities requiring consolidation. FIN 46R requires that Prosperity Capital Trust II, Prosperity Statutory Trust III, Prosperity Statutory Trust IV and Paradigm Capital Trust II be deconsolidated from the consolidated financial statements. The Company adopted FIN 46R on January 1, 2004. After adoption, the trust preferred securities issued by each of the foregoing trusts are no longer shown in the consolidated financial statements. Instead, the junior subordinated debentures issued by the Company to each of these trusts are shown as liabilities in the consolidated balance sheets and interest expense associated with such junior subordinated debentures is shown in the consolidated statements of income.

***Emerging Issues Task Force***

In May 2004, the EITF reached a consensus on Issue 03-03 (EITF 03-03) *Applicability of EITF Abstracts, Topic No. D-79, Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises, to Claims-Made Insurance Policies*. This EITF clarifies that a claims-made insurance policy that provides coverage for specific known claims prior to the policy period contains a retroactive provision that should be accounted for accordingly; either separately, if practicable, or, if not practicable, the claims-made insurance policy should be accounted for entirely as a retroactive contract. The Company adopted the provisions of EITF No. 03-03 on January 1, 2004. The adoption of EITF 03-03 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In March 2004, the EITF reached consensus on Issue 03-01 (EITF 03-01), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. This Issue specifically addresses whether an investor has the ability and intent to hold an investment until recovery. In addition, Issue 03-01 contains disclosure requirements that provide useful information about impairments that have not been recognized as other-than-temporary for investments within the scope of this Issue. On September 30, 2004, the Financial Accounting Standards Board deferred the effective date of the Issue's guidance on how to evaluate and recognize an impairment loss that is other-than-temporary. This Issue's guidance is pending the issuance of a final FASB Staff Position (FSP) relating to the draft FSP EITF Issue 03-01-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, which the Board may issue as early as November. This deferral did not change the disclosure guidance which remains effective for fiscal years ending after December 15, 2003. Matters being considered by the FASB which may impact the Company's financial reporting include the accounting as a component in determining net income for declines in market value of debt securities which are due solely to changes in market interest rates and the effect of sales of available-for-sale securities which have market values below cost at the time of sale and whether such sale indicates an absence of intent and ability of the investor to hold to a forecasted recovery of the investment's value to its original cost.

***SEC Staff Accounting Bulletins***

*SEC Staff Accounting Bulletin (SAB) No. 105, Application of Accounting Principles to Loan Commitments.* SAB 105 summarizes the views of the staff of the SEC regarding the application of generally accepted accounting principles to loan commitments accounted for as derivative instruments. SAB 105 provides that the fair value of recorded loan commitments that are accounted for as derivatives under SFAS 133,

*Accounting for Derivative Instruments and Hedging Activities,* should not incorporate the expected future cash flows related to the associated servicing of the future loan. In addition, SAB 105 requires registrants to disclose their accounting policy for loan commitments. The provisions of SAB 105 must be applied to loan commitments accounted for as derivatives that are entered into after March 31, 2004. The adoption of this accounting standard did not have a material impact on the Company's financial statements.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

*American Institute of Certified Public Accounting Statements of Position*

*SOP No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer.* SOP 03-3 addresses accounting for differences between the contractual cash flows of certain loans and debt securities and the cash flows expected to be collected when loans or debt securities are acquired in a transfer and those cash flow differences are attributable, at least in part, to credit quality. As such, SOP 03-3 applies to loans and debt securities acquired individually, in pools or as part of a business combination and does not apply to originated loans. The application of SOP 03-3 limits the interest income, including accretion of purchase price discounts, that may be recognized for certain loans and debt securities. Additionally, SOP 03-3 does not allow the excess of contractual cash flows over cash flows expected to be collected to be recognized as an adjustment of yield, loss accrual or valuation allowance, such as the allowance for possible loan losses. SOP 03-3 requires that increases in expected cash flows subsequent to the initial investment be recognized prospectively through adjustment of the yield on the loan or debt security over its remaining life. Decreases in expected cash flows should be recognized as impairment. In the case of loans acquired in a business combination where the loans show signs of credit deterioration, SOP 03-3 represents a significant change from current purchase accounting practice whereby the acquiree's allowance for loan losses is typically added to the acquirer's allowance for loan losses. SOP 03-3 is effective for loans and debt securities acquired by the Company beginning January 1, 2005. Management is currently evaluating the impact the adoption of SOP 03-3 will have on its financial statements.

**Stock Split** On May 31, 2002, the Company effected a two-for-one stock split in the form of a 100 percent stock dividend to shareholders of record on May 20, 2002. The Company issued approximately 8.1 million shares in connection with the split. All per share and share information has been restated to reflect this stock split.

**2. ACQUISITIONS**

Proforma data is not shown for the following acquisitions due to immateriality.

On August 1, 2004, the Company completed its acquisition of Village Bank and Trust, s.s.b. ( Village ), Austin, Texas. Under the terms of the agreement, the Company paid approximately \$19.1 million in cash for all of the issued and outstanding capital stock of Village. Village was privately held and operated one (1) banking office in the Lakeway area of Austin, Texas. As of June 30, 2004, Village had total assets of \$110.9 million, loans of \$79.7 million, deposits of \$97.3 million and shareholders' equity of \$10.4 million.

In connection with the purchase, the Company recorded a premium of \$12.2 million, of which \$331,000 was identified as core deposit intangibles. The remaining \$11.8 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branch were recorded at their fair values at the acquisition date.

On August 1, 2004, the Company completed its acquisition of Liberty Bancshares, Inc. ( Liberty ), Austin, Texas, pursuant to which Liberty merged into the Company and its wholly owned subsidiary, Liberty Bank, S.S.B., merged into the Bank. Under the terms of the agreement, the Company paid approximately \$9.1 million in cash and issued approximately 1.3 million shares of its Common Stock for all of the issued and outstanding capital stock of Liberty and Liberty Bank and all outstanding stock options of Liberty Bank. Liberty was privately held and operated six (6) banking offices in Austin, Texas. As of June 30, 2004, Liberty had, on a consolidated basis, total assets of \$178.7 million, loans of \$120.3 million, deposits of \$158.9 million and shareholders' equity of \$16.5 million.

In connection with the purchase, the Company recorded a premium of \$27.6 million of which \$3.8 million was identified as core deposit intangibles. The remaining \$23.8 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On December 9, 2003, the Company completed the merger of First State Bank of North Texas, Dallas, Texas ( FSBNT ) into the Bank. Under the terms of the agreement, the Company paid approximately \$12.5 million in cash and issued approximately 393,074 shares of its common stock for all outstanding shares of First State. First State was privately held and operated four (4)



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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

banking offices in Dallas, Texas. One banking center was closed and consolidated with an existing banking center located nearby. As of September 30, 2003, First State had total assets of \$100.7 million, loans of \$20.1 million, deposits of \$91.4 million and shareholders' equity of \$8.8 million.

In connection with the purchase, the Company recorded a premium of \$13.9 million of which \$1.9 million was identified as core deposit intangibles. The remaining \$12.0 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On November 1, 2003, the Company completed the merger of MainBancorp, Inc., Dallas Texas ( MainBancorp ), into the Company. In connection with the transaction, MainBancorp's wholly owned subsidiary, *mainbank, n.a.*, was merged into the Bank. Under the terms of the agreement, the Company issued approximately 1.5 million shares of its Common Stock and paid approximately \$9.2 million in cash for all outstanding shares of MainBancorp stock. In addition, the Company assumed options to acquire 100,851 shares of its Common Stock. MainBancorp was privately held and operated four (4) banking offices in Dallas, Texas. As of September 30, 2003, MainBancorp had, on a consolidated basis, total assets of \$177.1 million, loans of \$90.8 million, deposits of \$153.7 million and shareholders' equity of \$22.6 million.

In connection with the purchase, the Company recorded a premium of \$27.2 million of which \$2.7 million was identified as core deposit intangibles. The remaining \$24.5 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On June 1, 2003, the Company completed the merger of Dallas Bancshares, Dallas, Texas ( Dallas Bancshares ), into the Company. In connection with the transaction, Dallas Bancshares' wholly owned subsidiary, BankDallas, was merged into the Bank. Under the terms of the agreement, the Company paid approximately \$7.1 million in cash. Dallas Bancshares operated one (1) banking office in Dallas, Texas. As of March 31, 2003, Dallas Bancshares had on a consolidated basis, total assets of \$42.0 million, loans of 28.3 million, deposits of \$37.6 million and shareholders' equity of \$4.3 million.

In connection with the purchase, the Company recorded a premium of \$3.0 million of which \$45,000 was identified as core deposit intangibles. The remaining \$2.5 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On May 6, 2003, the Company completed the merger of Abrams Centre Bancshares, Dallas, Texas ( Abrams ), into the Company. In connection with the acquisition, Abrams wholly owned subsidiary, Abrams Centre National Bank, was merged into the Bank. Under the terms of the agreement, the Company paid approximately \$16.9 million in cash. Abrams operated two (2) banking offices in Dallas, Texas. One banking center was closed and consolidated with an existing banking center located nearby. As of March 31, 2003, Abrams, on a consolidated basis, had total assets of \$96.5 million, loans of \$31.7 million, deposits of \$70.8 million and shareholders equity of \$14.0 million.

In connection with the purchase, the Company recorded a premium of \$6.7 million of which \$430,000 was identified as core deposit intangibles. The remaining \$6.3 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On November 1, 2002, the Company completed the acquisition of First National Bank of Bay City, Bay City, Texas ( FNB ), through the merger of FNB with and into the Bank. Under the terms of the agreement, the Company paid approximately \$5.2 million in cash for all of the issued and outstanding common stock of FNB. FNB operated one (1) location in Bay City, Texas, which was closed and consolidated with the Bank's Bay City Banking Center. As of November 1, 2002, FNB had total assets of \$27.1 million, total loans of \$8.2 million and total deposits of \$23.8 million.

In connection with the purchase, the Company recorded a premium of \$2.2 million of which \$168,000 was identified as core deposit intangibles. The remaining \$2.0 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On October 1, 2002, the Company completed the acquisition of Southwest Bank Holding Company, Dallas, Texas ( Southwest ). Southwest's wholly owned subsidiary, Bank of the Southwest, Dallas, Texas, became a subsidiary of the Company. Under the terms of the agreement, the Company paid approximately \$19.7 million in cash. Southwest was privately held and operated two (2) banking offices in Dallas, Texas. As of October 1, 2002, Southwest had total assets of \$121.9 million, total loans of \$58.7 million and total deposits of \$108.9 million.

In connection with the purchase, the Company recorded a premium of \$5.7 million of which \$640,000 was identified as core deposit intangibles. The remaining \$5.0 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On September 1, 2002, the Company completed the acquisition of Paradigm Bancorporation, Inc. ( Paradigm ) in a stock transaction. Under the terms of the agreement, the Company issued approximately 2.58 million shares of its common stock for all outstanding shares of Paradigm (giving effect to the two for one stock split). Paradigm operated a total of eleven (11) banking offices - six (6) in the greater metropolitan Houston area and five (5) in the nearby Southeast Texas cities of Dayton, Galveston, Mont Belvieu, and Winnie, three (3) of which were closed following completion of the transaction. As of September 1, 2002, Paradigm had total assets of \$248.7 million, total loans of \$175.7 million and total deposits of \$218.3 million.

In connection with the purchase, the Company recorded a premium of \$36.6 million of which \$2.8 million was identified as core deposit intangibles. The remaining \$33.8 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On July 12, 2002, the Company completed the acquisition of The First State Bank, Needville, Texas ( First State ) for approximately \$3.7 million in cash. The Bank's existing Needville Banking Center relocated into the former First State Bank location effective July 15, 2002. As of July 12, 2002, First State had total assets of \$16.3 million, loans of \$5.5 million and deposits of \$14.1 million.

In connection with the purchase, the Company recorded a premium of \$1.7 million of which \$293,000 was identified as core deposit intangibles. The remaining \$1.4 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

On May 8, 2002, the Company completed the acquisition of Texas Guaranty Bank, N.A. ( Texas Guaranty ) for approximately \$11.8 million in cash. Texas Guaranty operated three (3) offices in Houston, Texas, all of which became full service banking centers of the Bank. As of May 8, 2002, Texas Guaranty had total assets of \$74.0 million, loans of \$45.7 million and deposits of \$61.8 million.

In connection with the purchase, the Company recorded a premium of \$3.7 million of which \$431,000 was identified as core deposit intangibles. The remaining \$3.3 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**3. GOODWILL AND OTHER INTANGIBLE ASSETS**

Changes in the carrying amount of the Company's goodwill and core deposit intangibles for fiscal 2004 and 2003 were as follows:

	<u>Goodwill</u>	<u>Core Deposit Intangibles</u>
	(Dollars in thousands)	
Balance as of December 31, 2002	\$ 68,290	\$ 4,121
Less:		
Amortization		(818)
Add:		
Acquisition of Abrams Centre Bancshares	6,707	430
Acquisition of Dallas Bancshares	2,953	45
Acquisition of MainBancorp	27,180	2,657
Acquisition of FSBNT	13,884	
Purchase accounting adjustments to prior year acquisitions (deferred tax adjustments):		
Acquisition of Texas Guaranty Bank	12	
Acquisition of First State Bank of Needville	96	
Acquisition of Paradigm Bancorporation	(826)	
Acquisition of First National Bank of Bay City	(311)	308
Acquisition of Southwest Bank Holding Company	27	
	<u>          </u>	<u>          </u>
Balance as of December 31, 2003	\$ 118,012	\$ 6,743
Less:		
Amortization		(1,781)
Add:		
Acquisition of Liberty Bancshares	23,803	3,797
Acquisition of Village Bank & Trust, ssb	11,851	331
Acquisition of MainBancorp	(203)	300
Acquisition of FSBNT	(2,266)	2,102
Purchase accounting adjustments to prior year acquisitions (deferred tax adjustments):		
Acquisition of FSBNT	404	
Acquisition of MainBancorp	748	
Acquisition of Texas Guaranty Bank	(9)	
Acquisition of First State Bank of Needville	(6)	
Acquisition of Paradigm Bancorporation	(127)	
Acquisition of Abrams Centre	153	
Acquisition of Dallas Bancshares	24	
Acquisition of Southwest Bank Holding Company	796	
	<u>          </u>	<u>          </u>
Balance as of December 31, 2004	\$ 153,180	\$ 11,492

The amounts in 2004 related to the acquisitions of MainBancorp and FSBNT, which were acquired in 2003, are purchase accounting entries unknown prior to December 31, 2003. Gross core deposit intangibles outstanding were \$14.3 million at December 31, 2004.



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## PROSPERITY BANCSHARES, INC®. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Core deposit intangibles are amortized on an accelerated basis over their estimated lives which is 8 years. Amortization expense related to intangible assets totaled \$1.8 million in 2004, \$818,000 in 2003 and \$192,000 in 2002. The estimated aggregate future amortization expense for intangible assets remaining as of December 31, 2004 is as follows (dollars in thousands):

2005	\$ 2,106
2006	1,963
2007	1,820
2008	1,678
2009	1,535
Thereafter	2,390
	<hr/>
Total	\$ 11,492
	<hr/>

**4. CASH AND DUE FROM BANKS**

The Bank is required by the Federal Reserve Bank to maintain average reserve balances. Cash and due from banks in the consolidated balance sheets includes amounts so restricted of \$20.9 million and \$29.6 million at December 31, 2004 and 2003, respectively.

**5. SECURITIES**

The amortized cost and fair value of investment securities are as follows:

	December 31, 2004				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Carrying Value
	(Dollars in thousands)				
<b>Available for Sale</b>					
U.S. Treasury securities and obligations of U.S. government agencies	\$ 10,579	\$ 2	\$ 69	\$ 10,512	\$ 10,512
70% non-taxable preferred stock	24,000		6,150	17,850	17,850
States and political subdivisions	14,382	1,366		15,748	15,748
Collateralized mortgage obligations	13,143	76	35	13,184	13,184
Mortgage-backed securities.	112,050	545	502	112,093	112,093
Qualified Zone Academy Bond	8,000			8,000	8,000



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Equity securities		296				296		296
		<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total		\$ 182,450	\$ 1,989	\$ 6,756	\$ 177,683	\$ 177,683		
		<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>		
<b>Held to Maturity</b>								
U.S. Treasury securities and obligations of U.S. government agencies	\$	20,147	\$ 661	\$ 6	\$ 20,802	\$ 20,147		
States and political subdivisions		23,317	510	15	23,812	23,317		
Corporate debt securities		10,491	301		10,792	10,491		
Collateralized mortgage obligations		225,851	97	802	225,146	225,851		
Mortgage-backed securities		845,303	3,559	4,914	843,948	845,303		
		<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>		
Total		\$ 1,125,109	\$ 5,128	\$ 5,737	\$ 1,124,500	\$ 1,125,109		
		<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>		

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	December 31, 2003				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Carrying Value
(Dollars in thousands)					
<b>Available for Sale</b>					
U.S. Treasury securities and obligations of U.S. government agencies	\$ 15,824	\$ 247	\$	\$ 16,071	\$ 16,071
70% non-taxable preferred stock	44,015		327	43,688	43,688
States and political subdivisions	15,141	1,798		16,939	16,939
Collateralized mortgage obligations	17,745	510	68	18,187	18,187
Mortgage-backed securities	159,525	1,179	224	160,480	160,480
Qualified Zone Academy Bond	8,000			8,000	8,000
Equity securities	283			283	283
<b>Total</b>	<b>\$ 260,533</b>	<b>\$ 3,734</b>	<b>\$ 619</b>	<b>\$ 263,648</b>	<b>\$ 263,648</b>
<b>Held to Maturity</b>					
U.S. Treasury securities and obligations of U.S. government agencies	\$ 32,938	\$ 1,591	\$ 14	\$ 34,515	\$ 32,938
States and political subdivisions	30,597	1,121		31,718	30,597
Corporate debt securities	15,619	743		16,362	15,619
Collateralized mortgage obligations	160,742	1,338	191	161,889	160,742
Mortgage-backed securities	873,336	7,806	3,175	877,967	873,336
<b>Total</b>	<b>\$ 1,113,232</b>	<b>\$ 12,599</b>	<b>\$ 3,380</b>	<b>\$ 1,122,451</b>	<b>\$ 1,113,232</b>

In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Management has the ability and intent to hold its securities until they mature, at which time the Company will receive full value for the securities. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of December 31, 2004, management believes the impairments detailed in the table above are temporary and no impairment loss has been realized in the Company's consolidated statements of income.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securities with unrealized losses segregated by length of time such securities have been in a continuous loss position at December 31, 2004 were as follows:

	Less than 12 Months		More than 12 Months		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
(Dollars in thousands)						
<b>Available for Sale</b>						
U.S. Treasury securities and obligations of U.S. government agencies	\$ 9,979	\$ 69	\$		\$ 9,979	\$ 69
70% non-taxable preferred stock	12,250	4,750	5,600	1,400	17,850	6,150
Collateralized mortgage obligations	2,921	13	2,132	22	5,053	35
Mortgage backed securities	44,229	277	17,086	225	61,315	502
<b>Total</b>	<b>\$ 69,379</b>	<b>\$ 5,109</b>	<b>\$ 24,818</b>	<b>\$ 1,647</b>	<b>\$ 94,197</b>	<b>\$ 6,756</b>
<b>Held to Maturity</b>						
U.S. Treasury securities and obligations of U.S. government agencies	\$ 998	\$ 6	\$		\$ 998	\$ 6
States and political subdivisions	3,359	15			3,359	15
Collateralized mortgage obligations	190,352	802			190,352	802
Mortgage backed securities	498,584	3,422	74,922	1,492	573,506	4,914
<b>Total</b>	<b>\$ 693,293</b>	<b>\$ 4,245</b>	<b>\$ 74,922</b>	<b>\$ 1,492</b>	<b>\$ 768,215</b>	<b>\$ 5,737</b>

The amortized cost and fair value of investment securities at December 31, 2004, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations at any time with or without call or prepayment penalties.

	December 31, 2004			
	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(Dollars in thousands)				
Due in one year or less	\$ 18,315	\$ 18,560	\$ 5,407	\$ 5,383
Due after one year through five years	30,129	31,138	5,918	5,883
Due after five years through ten years	5,511	5,708	11,727	12,027

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Due after ten years			34,204	29,113
Subtotal	53,955	55,406	57,256	52,406
Mortgage-backed securities and collateralized mortgage obligations	1,071,154	1,069,094	125,194	125,277
Total	\$ 1,125,109	\$ 1,124,500	\$ 182,450	\$ 177,683

Gross proceeds from the sale of securities classified as available for sale was approximately \$20.1 million for the year ended December 31, 2004 and resulted in a gain of \$78,000 for the same period. There were no sales of securities in 2003.

The Company does not own securities of any one issuer (other than the U.S. government and its agencies) for which aggregate adjusted cost exceeds 10% of the consolidated shareholders' equity at December 31, 2004 and December 31, 2003.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securities with an amortized cost of \$790.2 million and \$600.4 million and a fair value of \$789.6 million and \$605.6 million at December 31, 2004 and 2003, respectively, were pledged to collateralize public deposits and for other purposes required or permitted by law.

**6. LOANS**

The loan portfolio consists of various types of loans made principally to borrowers located in Southeast Texas, Dallas and Austin and is classified by major type as follows:

	December 31,	
	2004	2003
	(Dollars in thousands)	
Commercial and industrial	\$ 144,432	\$ 93,989
Real estate:		
Construction and land development	109,591	36,470
1-4 family residential	260,453	237,055
Home equity	34,453	27,943
Commercial mortgages	369,151	260,882
Farmland	22,240	15,247
Multi-family residential	18,187	20,679
Agriculture	21,906	20,693
Other	2,246	2,274
Consumer	52,887	54,980
<b>Total</b>	<b>1,035,546</b>	<b>770,212</b>
Less unearned discount	33	159
<b>Total</b>	<b>\$ 1,035,513</b>	<b>\$ 770,053</b>

The contractual maturity ranges of the commercial and industrial and construction and land development portfolios and the amount of such loans with predetermined interest rates and floating rates in each maturity range are summarized in the following table:

December 31, 2004			
One Year or Less	After One Through Five Years	After Five Years	Total

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	(Dollars in thousands)			
Commercial and industrial	\$ 72,934	\$ 55,947	\$ 15,551	\$ 144,432
Construction and land development	84,235	19,766	5,590	109,591
<b>Total</b>	<b>\$ 157,169</b>	<b>\$ 75,713</b>	<b>\$ 21,141</b>	<b>\$ 254,023</b>
Loans with a predetermined interest rate	\$ 39,873	\$ 23,736	\$ 4,351	\$ 67,960
Loans with a floating interest rate	117,296	51,977	16,790	186,063
<b>Total</b>	<b>\$ 157,169</b>	<b>\$ 75,713</b>	<b>\$ 21,141</b>	<b>\$ 254,023</b>

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of December 31, 2004 and 2003, loans outstanding to directors, officers and their affiliates totaled \$8.1 million and \$5.6 million, respectively. In the opinion of management, all transactions entered into between the Company and such related parties have been, and are, in the ordinary course of business, made on the same terms and conditions as similar transactions with unaffiliated persons.

An analysis of activity with respect to these related-party loans is as follows:

	<u>Year Ended December 31,</u>	
	<u>2004</u>	<u>2003</u>
	(Dollars in thousands)	
Beginning balance	\$ 5,589	\$ 9,804
New loans and reclassified related loans	4,217	3,333
Repayments	(2,460)	(7,548)
Ending balance	<u>\$ 7,346</u>	<u>\$ 5,589</u>

**7. ALLOWANCE FOR CREDIT LOSSES**

An analysis of activity in the allowance for credit losses is as follows:

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(Dollars in thousands)		
Balance at beginning of year	\$ 10,345	\$ 9,580	\$ 5,985
Balance acquired in the Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Holding Company acquisitions			2,981
Balance acquired in the Abrams Centre Bancshares, Dallas Bancshares, MainBancorp and FSBNT acquisitions		1,900	
Balance acquired in the Liberty Bancshares and Village Bank & Trust, SSB acquisitions	2,365		
Addition provision charged to operations	880	483	1,010
(Charge-offs) and recoveries:			
Loans charged off	(950)	(2,241)	(767)
Loan recoveries	465	623	371

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Net (charge-offs) recoveries	(485)	(1,618)	(396)
Balance at end of year	\$ 13,105	\$ 10,345	\$ 9,580

**8. PREMISES AND EQUIPMENT**

Premises and equipment are summarized as follows:

	<b>Year Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
	(Dollars in thousands)	
Land	\$ 8,636	\$ 7,907
Buildings	30,236	27,823
Furniture, fixtures and equipment	10,739	9,980
Construction in progress	74	106
<b>Total</b>	<b>49,685</b>	<b>45,816</b>
Less accumulated depreciation	(13,892)	(11,517)
<b>Premises and equipment, net</b>	<b>\$ 35,793</b>	<b>\$ 34,299</b>



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**9. DEPOSITS**

Included in interest-bearing deposits are certificates of deposit in amounts of \$100,000 or more. These certificates and their remaining maturities at December 31, 2004 were as follows:

	<b>December 31, 2004</b>
	<b>(Dollars in thousands)</b>
Three months or less	\$ 174,012
Greater than three through six months	68,672
Greater than six through twelve months	73,199
Thereafter	95,407
<b>Total</b>	<b>\$ 411,290</b>

Interest expense for certificates of deposit in excess of \$100,000 was \$8.5 million, \$7.4 million and \$6.9 million, for the years ended December 31, 2004, 2003 and 2002, respectively.

The Company has no brokered deposits and there are no major concentrations of deposits with any one depositor.

**10. OTHER BORROWINGS**

**Other Borrowings** The Company utilizes borrowings to supplement deposits to fund its lending and investment activities. As needed, the Company obtains additional funds from the Federal Home Loan Bank ( FHLB ) and correspondent banks. At December 31, 2004, the Company had \$13.1 million in FHLB borrowings compared with \$11.9 million in FHLB borrowings at December 31, 2003, all of which consisted of long-term FHLB notes payable. The \$1.2 million increase is attributable to the acquisition of one note from Village Bank and Trust, ssb partially offset by normal pay downs on the remaining notes. The maturity dates on the FHLB notes payable range from 2004 to 2028 and the interest rates range from 4.64% to 6.48%. FHLB advances are considered short-term, overnight borrowings. The Company had no FHLB advances outstanding at December 31, 2004 and 2003. The highest outstanding balance of FHLB advances during 2004 was \$50.0 million compared with \$59.3 million during 2003. The Company had no federal funds purchased at December 31, 2004 or 2003.

At December 31, 2004, the Company had \$25.1 million in securities sold under repurchase agreements compared with \$19.0 million at December 31, 2003, an increase of \$6.1 million or 31.8%. The increase is primarily attributable to the Liberty acquisition.

**11. INTEREST RATE RISK**

The Company is principally engaged in providing real estate, consumer and commercial loans, with interest rates that are both fixed and variable. These loans are primarily funded through short-term demand deposits and longer-term certificates of deposit with variable and fixed rates. The fixed real estate loans are more sensitive to interest rate risk because of their fixed rates and longer maturities.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**12. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK**

In the normal course of business, the Company is a party to various financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making these commitments and conditional obligations as it does for on-balance-sheet instruments.

The following is a summary of the various financial instruments entered into by the Company:

	December 31,	
	2004	2003
	(Dollars in thousands)	
Commitments to extend credit	\$ 190,845	\$ 83,609
Standby letters of credit	5,863	4,069

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being fully drawn upon, the total commitment amounts disclosed above do not necessarily represent future cash funding requirements. At December 31, 2004, \$24.6 million of commitments to extend credit have fixed rates ranging from 2.25% to 18.00%.

Standby letters of credit are written conditional commitments issued by the Company to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, the Company would be entitled to seek recovery from the customer. The Company's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

The Company evaluates customer creditworthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer.

**13. INCOME TAXES**

The components of the provision for federal income taxes are as follows:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>		
Current	\$ 16,211	\$ 12,203	\$ 8,963
Deferred	1,533	210	592
<b>Total</b>	<b>\$ 17,744</b>	<b>\$ 12,413</b>	<b>\$ 9,555</b>

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The provision for federal income taxes differs from the amount computed by applying the federal income tax statutory rate on income as follows:

	Year Ended December 31,		
	2004	2003	2002
	(Dollars in thousands)		
Taxes calculated at statutory rate	\$ 18,358	\$ 13,636	\$ 10,807
Increase (decrease) resulting from:			
Tax-exempt interest	(612)	(702)	(690)
Qualified Zone Academy Bond credit	(373)	(373)	(373)
Dividends received deduction	(286)	(436)	(298)
Amortization of CDI and goodwill	623		61
Other, net	35	288	48
<b>Total</b>	<b>\$ 17,744</b>	<b>\$ 12,413</b>	<b>\$ 9,555</b>

Deferred tax assets and liabilities are as follows:

	December 31,	
	2004	2003
	(Dollars in thousands)	
Deferred tax assets:		
Allowance for credit losses	\$ 4,193	\$ 2,056
Nonaccrual loan interest	104	104
Accrued liabilities	349	
Transfers from acquired banks		2,753
Bank premises and equipment	1,080	616
Basis difference in loans	199	
Unrealized loss on available for sale securities	1,669	
Loss carry forwards	1,280	
Credit carry forwards	2,077	
Other	282	31
<b>Total deferred tax assets</b>	<b>11,233</b>	<b>5,560</b>
Deferred tax liabilities:		
Accretion on investments	\$ (1,196)	\$ (702)
Bank premises and equipment		

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Goodwill and core deposit intangibles	(4,879)	(1,265)
Securities premium amortization	(205)	(368)
Investments in partnerships	(1,259)	
Prepaid expenses	(260)	
Unrealized gain on available for sale securities		(1,091)
FHLB dividends	(98)	(25)
Other		
Total deferred tax liabilities	(7,897)	(3,451)
Net deferred tax assets	\$ 3,336	\$ 2,109

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and estimates of future taxable income over the periods for which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these deductible differences at December 31, 2004.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**14. STOCK INCENTIVE PROGRAMS**

The Company had two stock-based employee compensation plans at December 31, 2004. Prior to 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost was reflected in previously reported results prior to 2003, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. In December 2002, the FASB issued Statement No. 148 (SFAS 148), *Accounting for Stock-Based Compensation: Transition and Disclosure*, an amendment to FASB Statement 123. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 is effective for financial statements for fiscal years ending after December 15, 2002. Effective January 1, 2003, the Company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as provided by SFAS No. 148 for stock-based employee compensation.

During 1995, the Company's Board of Directors approved a stock option plan (the 1995 Plan) for executive officers and key associates to purchase common stock of Bancshares. A total of 660,000 options have been granted under the 1995 plan as of December 31, 2004. Compensation expense was not recognized for the stock options granted under the 1995 Plan because the options had an exercise price approximating the fair value of Bancshares' common stock at the date of grant. The maximum number of shares reserved for issuance pursuant to options granted under the 1995 Plan is 680,000 (after two-for-one and four-for-one stock splits). Options to acquire a total of 88,000 shares of common stock of Bancshares were outstanding at December 31, 2004 of which 3,000 shares were exercisable.

During 1998, the Company's Board of Directors and shareholders approved a second stock option plan (the 1998 Plan) which authorizes the issuance of up to 920,000 (after two-for-one stock split) shares of the common stock of Bancshares under both non-qualified and incentive stock options to employees and non-qualified stock options to directors who are not employees. The 1998 Plan also provides for the granting of restricted stock awards, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. Compensation expense was not recognized for the stock options granted under the 1998 Plan because the options had an exercise price approximating the fair value of Bancshares common stock at the date of grant. Options to purchase a total of 784,500 shares of common stock of Bancshares were outstanding at December 31, 2004, of which 36,300 shares were exercisable.

In December 2004, the Company's Board of Directors established the Prosperity Bancshares, Inc. 2004 Stock Incentive Plan (the 2004 Plan), which was approved by the Company's shareholders on February 23, 2005. The 2004 Plan authorizes the issuance of up to 1,250,000 shares of Common Stock upon the exercise of options granted under the 2004 Plan or upon the grant or exercise, as the case may be, of other awards granted under the 2004 Plan. The 2004 Plan provides for the granting of incentive and nonqualified stock options to employees and nonqualified stock options to directors who are not employees. The 2004 Plan also provides for the granting of shares of restricted stock, stock appreciation rights, phantom stock awards and performance awards on substantially similar terms. As of March 1, 2005, no options or other awards had been granted under the 2004 Plan.

On September 1, 2002, the Company acquired Paradigm Bancorporation. The options to purchase shares of Paradigm common stock outstanding at the effective time of the transaction were converted (at a rate of 1 to 1.08658) into options to purchase a total of 34,673 shares of Bancshares Common Stock at exercise prices ranging from \$8.28 to \$11.50 per share. The converted options are governed by the original plan under which they were issued. A total of 14,782 options were outstanding at December 31, 2004.

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On November 1, 2003, the Company acquired MainBancorp, Inc. A portion of the options to purchase shares of MainBancorp common stock outstanding at the effective time of the transaction were converted at the option of the holder into options to purchase a total of 100,851 shares of Bancshares Common Stock at exercise prices ranging from \$8.03 to \$16.26 per share. The converted options are governed by the original plan under which they were issued. A total of 31,127 options were outstanding at December 31, 2004.

On August 1, 2004, the Company acquired Liberty Bancshares, Inc. A portion of the options to purchase shares of Liberty Bank common stock outstanding at the effective time of the transaction, at the option of the holder, were converted into options to purchase a total of 107,948 shares of Bancshares Common Stock at exercise prices ranging from \$3.66 to \$7.79 per share. The converted options are governed by the original plan under which they were issued. No options were outstanding at December 31, 2004.

All options acquired in connection with the Paradigm, MainBancorp and Liberty acquisitions were fully vested upon consummation of the respective transactions. The market value of the options has been included in the purchase price of the respective acquisitions.



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31,					
	2004		2003		2002	
	Number	Weighted-	Number	Weighted-	Number	Weighted-
	of	Average	of	Average	of	Average
	Options	Exercise	Options	Exercise	Options	Exercise
		Price		Price		Price
Options outstanding, beginning of period	599,692	\$ 11.69	684,153	\$ 8.65	530,180	\$ 4.47
Options granted	576,948 <sup>(1)</sup>	22.69	164,851 <sup>(2)</sup>	14.58	287,804 <sup>(3)</sup>	16.92
Options forfeited	(52,000)	19.65	(78,674)	15.91	(29,237)	15.55
Options exercised	(206,231)	4.60	(170,638)	5.83	(104,504)	2.48
Options outstanding, end of period	918,409	\$ 19.64	599,692	\$ 11.69	684,153	\$ 8.65

- (1) Includes options to acquire 107,948 shares of Bancshares Common Stock assumed in connection with the Liberty acquisition.  
(2) Includes options to acquire 100,851 shares of Bancshares Common Stock assumed in connection with the MainBancorp acquisition.  
(3) Includes options to acquire 34,673 shares of Bancshares Common Stock assumed in connection with the Paradigm acquisition.

At December 31, 2004, there were 85,209 options exercisable under all plans at a weighted average exercise price of \$14.00. During 2004, 260,231 options were exercised. At December 31, 2003, there were 79,192 options exercisable under all plans at a weighted average exercise price of \$9.68 and 170,638 options were exercised. At December 31, 2002, there were 54,153 options exercisable under all plans and 104,504 options were exercised.

During 2004, the Company granted 469,000 options under the 1998 Plan. The options were granted at exercise prices ranging from \$23.60 per share to \$27.02 per share. Compensation expense in the amount of \$141,000 was recorded.

During 2003, the Company granted 64,000 options under the 1998 Plan. The options were granted at exercise prices ranging from \$19.30 per share to \$23.10 per share. Compensation expense in the amount of \$24,000 was recorded.

During 2002, the Company granted 254,000 options under the 1998 Plan. The options were granted at exercise prices ranging from \$16.55 per share to \$19.01 per share. Compensation expense was not recorded for the stock options because the exercise price approximated the fair value of common stock at the date of grant and the Company had not adopted SFAS No. 123.

The weighted-average fair value of the stock options granted on the respective grant dates ranged from \$5.09 to \$6.94 in 2004 and ranged from \$3.89 to \$5.13 in 2003 respectively. The weighted-average remaining contractual life of options outstanding as of December 31, 2004 ranged

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from 9.05 years to 9.80 years for the options granted in 2004 and ranged from 8.35 years to 8.84 years for the options granted in 2003, respectively. The weighted-average fair value of the stock options on the grant dates ranged from \$3.89 to \$5.13 in 2003 and ranged from \$3.86 to \$4.10 in 2002 respectively. The weighted-average remaining contractual life of options outstanding as of December 31, 2004 ranged from 8.35 years to 8.84 years for the options granted in 2003 and ranged from 7.33 years to 7.91 years for the options granted in 2002, respectively.

The fair value of options was estimated using an option-pricing model with the following weighted average assumptions:

	Year Ended December 31,		
	2004	2003	2002
Expected life	5.82	4.50	4.50
Risk free interest rate	3.56%	2.58%	5.57%
Volatility	22.00%	23.00%	23.00%
Dividend yield	1.13%	1.25%	1.31%

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents information relating to the Company's stock options outstanding at December 31, 2004:

Range of Exercise Prices	Options Outstanding 2004		
	Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Life (years)
\$ 0.00 - \$ 5.00	80,000	\$ 2.76	2.07
\$ 5.01 - \$10.00	13,433	7.52	5.46
\$10.01 - \$15.00	143,349	10.10	8.36
\$15.00 - \$20.00	202,627	17.68	7.76
\$20.01 - \$25.00	75,000	23.56	9.34
\$25.01 - \$30.00	404,000	22.02	9.80
	<b>918,409</b>	<b>\$ 19.64</b>	<b>8.35</b>

**15. PROFIT SHARING PLAN**

The Company has adopted a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code whereby the participants may contribute a percentage of their compensation as permitted under the Code. Matching contributions are made at the discretion of the Company. Presently, The Company matches 50 % of an employee's contributions, up to 15% of compensation, not to exceed the maximum allowable pursuant to the Internal Revenue Code and excluding catch-up contributions. Such matching contributions were approximately \$681,000, \$593,000 and \$439,000, for the years ended December 31, 2004, 2003 and 2002, respectively.

**16. COMMITMENTS AND CONTINGENCIES**

Leases The following table presents a summary of non-cancelable future operating lease commitments as of December 31, 2004 (dollars in thousands):

2005	\$ 2,028
2006	1,890
2007	1,753
2008	1,419
2009	1,102
Thereafter	2,548

Total	\$ 10,740
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It is expected that in the normal course of business, expiring leases will be renewed or replaced by leases on other property or equipment.

Rent expense under all noncancelable operating lease obligations aggregated approximately \$1.8 million for the year ended December 31, 2004, \$1.3 million for the year ended December 31, 2003 and \$1.6 million for the year ended December 31, 2002.

**Litigation** The Company has been named as a defendant in various legal actions arising in the normal course of business. In the opinion of management, after reviewing such claims with outside counsel, resolution of such matters will not have a materially adverse impact on the consolidated financial statements.

**17. REGULATORY MATTERS**

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Any institution that fails to meet its minimum capital requirements is subject to actions by regulators that could have a direct material effect on the Company's and the Bank's financial statements. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines based on the Bank's assets, liabilities and certain off- balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and the Bank's classification under the regulatory framework for prompt corrective action are also subject to qualitative judgements by the regulators about the components, risk weightings and other factors.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

To meet the capital adequacy requirements, the Company and the Bank must maintain minimum capital amounts and ratios as defined in the regulations. As of December 31, 2004 the Company and the Bank met all capital adequacy requirements to which they are subject.

At December 31, 2004, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There have been no conditions or events since that notification which management believes have changed the Bank's category.

The following is a summary of the Company's and the Bank's capital ratios at December 31, 2004 and 2003 (dollars in thousands):

	Actual		For Capital Adequacy Purposes		To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>CONSOLIDATED:</b>						
<b>As of December 31, 2004:</b>						
Total Capital (to Risk Weighted Assets)	\$ 173,179	14.67%	\$ 94,411	8.0%	N/A	N/A
Tier I Capital (to Risk Weighted Assets)	160,074	13.56	47,205	4.0	N/A	N/A
Tier I Capital (to Average Tangible Assets)	160,074	6.30	76,218	3.0	N/A	N/A
<b>As of December 31, 2003:</b>						
Total Capital (to Risk Weighted Assets)	\$ 161,154	16.90%	\$ 76,282	8.0%	N/A	N/A
Tier I Capital (to Risk Weighted Assets)	150,809	15.82	38,141	4.0	N/A	N/A
Tier I Capital (to Average Tangible Assets)	150,809	7.10	63,753	3.0	N/A	N/A

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**As of December 31, 2004:**

Total Capital (to Risk Weighted Assets)	\$ 167,157	14.20%	\$ 94,156	8.0%	\$ 117,695	10.0%
Tier I Capital (to Risk Weighted Assets)	154,052	13.09	47,078	4.0%	70,617	6.0
Tier I Capital (to Average Tangible Assets)	154,052	6.07	76,120	3.0%	126,867	5.0

**As of December 31, 2003:**

Total Capital (to Risk Weighted Assets)	\$ 146,823	15.40%	\$ 76,262	8.0%	\$ 95,328	10.0%
Tier I Capital (to Risk Weighted Assets)	136,478	14.32	38,131	4.0	57,197	6.0
Tier I Capital (to Average Tangible Assets)	136,478	6.43	63,724	3.0	106,207	5.0

Dividends paid by Bancshares and the Bank are subject to restrictions by certain regulatory agencies. Dividends paid by Bancshares during the years ended December 31, 2004 and 2003 were \$6.7 million and \$4.9 million, respectively. There were \$40.0 million of dividends paid by the Bank to Bancshares during the year ended 2004 and \$37.9 million paid by the Bank to Bancshares during the year ended 2003.

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PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**18. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

Disclosures of the estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies could have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

**Cash and Cash Equivalents** For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

**Interest-Bearing Deposits in Financial Institutions** The carrying amount is a reasonable estimate of fair value.

**Securities** For securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

**Loan Receivables** For certain homogeneous categories of loans (such as some residential mortgages and other consumer loans), fair value is estimated by discounting the future cash flows using the risk-free Treasury rate for the applicable maturity, adjusted for servicing and credit risk. The carrying value of variable rate loans approximates fair value because the loans reprice frequently to current market rates.

**Junior Subordinated Debentures** The fair value of the junior subordinated debentures was calculated using the quoted market price.

**Deposits** The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

**Other Borrowings** Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt using a discounted cash flows methodology.

**Off-Balance Sheet Financial Instruments** The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the counterparties.

**Securities Sold Under Repurchase Agreements** The fair value of securities sold under repurchase agreements is the amount payable on demand at the reporting date.



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The estimated fair values of the Company's interest-earning financial instruments are as follows (dollars in thousands):

	December 31,			
	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Cash and due from banks	\$ 58,760	\$ 58,760	\$ 71,983	\$ 71,983
Interest bearing deposits in financial institutions	200	200	200	200
Federal funds sold	79,150	79,150	11,730	11,730
Held to maturity securities	1,125,109	1,124,500	1,113,232	1,122,451
Available for sale securities	177,683	177,683	263,648	263,648
Loans	1,035,513	1,046,218	770,053	782,961
Less allowance for credit losses	(13,105)	(13,105)	(10,345)	(10,345)
<b>Total</b>	<b>\$ 2,463,310</b>	<b>\$ 2,473,406</b>	<b>\$ 2,220,501</b>	<b>\$ 2,242,628</b>
<b>Financial liabilities:</b>				
Deposits	\$ 2,317,076	\$ 2,322,213	\$ 2,083,748	\$ 2,089,859
Junior subordinated debentures	47,424	42,795	59,804	60,704
Other borrowings				
Securities sold under repurchase agreements	25,058	25,058	19,006	19,006
Federal Home Loan Bank notes payable	13,116	14,021	11,929	13,015
<b>Total</b>	<b>\$ 2,402,674</b>	<b>\$ 2,404,087</b>	<b>\$ 2,174,487</b>	<b>\$ 2,182,584</b>

The differences in fair value and carrying value of commitments to extend credit and standby letters of credit were not material at December 31, 2004 and 2003.

The fair value estimates presented herein are based on pertinent information available to management as of the dates indicated. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**19. JUNIOR SUBORDINATED DEBENTURES**

At December 31, 2004, the Company had four issues of junior subordinated debentures outstanding totaling \$47.4 million as shown in the following table:

<b>Description</b>	<b>Issuance Date</b>	<b>Trust Preferred Securities Outstanding</b>	<b>Interest Rate</b>	<b>Junior Subordinated Debt Owed to Trusts</b>	<b>Maturity Date</b>
Prosperity Statutory Trust II	July 31, 2001	\$ 15,000,000	3-month LIBOR + 3.58%, not to exceed 12.50%	\$ 15,464,000	July 31, 2031
Paradigm Capital Trust II (1)	Aug. 31, 2002	6,000,000	3-month LIBOR + 4.50%	6,186,000	Feb. 20, 2031
Prosperity Statutory Trust III	Aug. 15, 2003	12,500,000	6.50%(2)	12,887,000	Sept. 17, 2033
Prosperity Statutory Trust IV	Dec. 30, 2003	12,500,000	6.50%(3)	12,887,000	Dec. 30, 2033

- (1) Assumed in connection with the Paradigm acquisition on September 1, 2002.
- (2) The debentures bear a fixed interest rate until September 17, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 3.00%.
- (3) The debentures bear a fixed interest rate until December 30, 2008, when the rate begins to float on a quarterly basis based on the three-month LIBOR plus 2.85%.

On December 31, 2004, the Company redeemed in full the \$12.4 million in junior subordinated debentures issued to Prosperity Capital Trust I. Prosperity Capital Trust I in turn redeemed in full the trust preferred securities and common securities it issued.

Each of the trusts is a capital or statutory business trust organized for the sole purpose of issuing trust securities and investing the proceeds in the Company's junior subordinated debentures. The preferred trust securities of each trust represent preferred beneficial interests in the assets of the respective trusts and are subject to mandatory redemption upon payment of the junior subordinated debentures held by the trust. The common securities of each trust are wholly-owned by the Company. Each trust's ability to pay amounts due on the trust preferred securities is solely dependent upon the Company making payment on the related junior subordinated debentures. The debentures, which are the only assets of each trust, are subordinate and junior in right of payment to all of the Company's present and future senior indebtedness. The Company has fully and unconditionally guaranteed each trust's obligations under the trust securities issued by each respective trust to the extent not paid or made by each trust, provided such trust has funds available for such obligations.

Under the provisions of each issue of the debentures, the Company has the right to defer payment of interest on the debentures at any time, or from time to time, for periods not exceeding five years. If interest payments on either issue of the debentures are deferred, the distributions on the applicable trust preferred securities and common securities will also be deferred.

In late 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46R (FIN 46R), *Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 (Revised December 2003)*. FIN 46R requires that trust preferred securities be deconsolidated from the Company's consolidated financial statements. The Company adopted FIN 46R on January 1, 2004 and as a result, no longer reflects the trust preferred securities in its consolidated financial statements. Instead, the junior subordinated debentures are shown as liabilities in the Company's consolidated balance sheets and interest expense associated with the junior subordinated debentures is shown as interest expense in the Company's consolidated statements of income.

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**20. PARENT COMPANY ONLY FINANCIAL STATEMENTS****PROSPERITY BANCSHARES, INC.****(Parent Company Only)****BALANCE SHEETS**

	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Dollars in thousands)</b>	
<b>ASSETS</b>		
Cash	\$ 4,614	\$ 14,398
Investment in subsidiary	311,656	259,284
Investment in Prosperity Capital Trust I		380
Investment in Prosperity Statutory Trust II	464	464
Investment in Prosperity Statutory Trust III	387	387
Investment in Prosperity Statutory Trust IV	387	387
Investment in Paradigm Capital Trust II	186	186
Goodwill, net	3,983	3,983
Other assets	1,753	245
<b>TOTAL</b>	<b>\$ 323,430</b>	<b>\$ 279,714</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Accrued interest payable and other liabilities	\$ 359	\$ 322
Junior subordinated debentures	47,424	59,804
<b>Total liabilities</b>	<b>47,783</b>	<b>60,126</b>
<b>SHAREHOLDERS' EQUITY:</b>		
Common stock	22,418	20,967
Capital surplus	134,288	102,594
Retained earnings	122,647	94,610
Unrealized (loss) gain on available for sale securities, net of tax benefit and tax	(3,099)	2,024
Less treasury stock, at cost, 37,088 shares	(607)	(607)
<b>Total shareholders' equity</b>	<b>275,647</b>	<b>219,588</b>
<b>TOTAL</b>	<b>\$ 323,430</b>	<b>\$ 279,714</b>



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**PROSPERITY BANCSHARES, INC.****(Parent Company Only)****STATEMENTS OF INCOME**

	<b>For the Years Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>		
<b>OPERATING INCOME:</b>			
Dividends from subsidiaries	\$ 40,000	\$ 37,900	\$ 18,350
Other income	112	79	66
<b>Total income</b>	<b>40,112</b>	<b>37,979</b>	<b>18,416</b>
<b>OPERATING EXPENSE:</b>			
Junior subordinated debentures interest expense	4,046	2,630	2,170
Other expenses	369	278	174
<b>Total operating expense</b>	<b>4,415</b>	<b>2,908</b>	<b>2,344</b>
<b>INCOME BEFORE INCOME TAX BENEFIT AND EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES</b>	<b>35,697</b>	<b>35,071</b>	<b>16,072</b>
FEDERAL INCOME TAX BENEFIT	1,498	990	797
<b>INCOME BEFORE EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES (DISTRIBUTIONS IN EXCESS OF EARNINGS) EQUITY IN UNDISTRIBUTED EARNINGS OF SUBSIDIARIES</b>	<b>37,195</b>	<b>36,061</b>	<b>16,869</b>
	(2,488)	(9,513)	4,452
<b>NET INCOME</b>	<b>\$ 34,707</b>	<b>\$ 26,548</b>	<b>\$ 21,321</b>

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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**PROSPERITY BANCSHARES, INC.****(Parent Company Only)****STATEMENTS OF CASH FLOWS**

	<b>For the Years Ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
	(As Restated) (Dollars in thousands)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 34,707	\$ 26,548	\$ 21,321
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiaries	2,488	9,513	(4,452)
Amortization of goodwill			
Stock option compensation expense	141	25	
(Increase) decrease in other assets	(1,508)	369	268
Increase (decrease) in accrued interest payable and other liabilities	37	(189)	(43)
<b>Total adjustments</b>	<b>1,158</b>	<b>9,718</b>	<b>(4,227)</b>
<b>Net cash provided by operating activities</b>	<b>35,865</b>	<b>36,266</b>	<b>17,094</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Cash paid for acquisitions	(28,016)	(44,805)	(24,789)
Capital contribution to subsidiary	(10)		
<b>Net cash used in investing activities</b>	<b>(28,026)</b>	<b>(44,805)</b>	<b>(24,789)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Issuance of common stock in connection with the exercise of stock options	1,047	995	260
Redemption of junior subordinated debentures (net)	(12,000)		
Payments of cash dividends	(6,670)	(4,855)	(3,866)
Cash paid to dissenting shareholders			(3)
Proceeds from issuance of junior subordinated debentures (net)		24,770	
<b>Net cash (used in) provided by financing activities</b>	<b>(17,623)</b>	<b>20,910</b>	<b>(3,609)</b>
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(9,784)</b>	<b>12,371</b>	<b>(11,304)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>14,398</b>	<b>2,027</b>	<b>13,331</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 4,614</b>	<b>\$ 14,398</b>	<b>\$ 2,027</b>

**21. RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS**

Subsequent to the issuance of its December 31, 2004 consolidated financial statements, the Company determined that amounts presented in the Company's consolidated statements of cash flows for years ended December 31, 2004, 2003 and 2002 reflected an error in the presentation of Company common stock issued in connection with acquisitions. Specifically, the amounts presented in the Company's consolidated statements of cash flows for the years ended December 31, 2004, 2003 and 2002 reflect a correction in the presentation of Company common stock issued in connection with acquisitions to present this activity as a non-cash activity rather than it being presented as cash flows in the financing and investing activities sections of the consolidated statement of cash flows. The Company also corrected certain other immaterial miscellaneous items. There was no change in the net increase in cash and cash equivalents for each of the periods. Further, these changes had no effect on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.



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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The effect on the Company's consolidated statements of cash flows for the years ended December 31, 2004, 2003 and 2002 is reflected in the table below:

Consolidated statement of cash flows:

	2004		2003		2002	
	As Previously Reported	As Restated	As Previously Reported	As Restated	As Previously Reported	As Restated
(Dollars in thousands)						
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>						
Stock option compensation expense	\$	\$ 141	\$	\$ 25	\$	\$
(Increase) decrease in accrued interest receivable and other assets	(5,550)	(4,056)	3,663	4,871	7	(1,525)
Increase (decrease) in accrued interest payable and other liabilities	6,729	7,649	(3,857)	(3,995)	(2,520)	(2,567)
Net cash provided by operating activities	\$ 46,368	\$ 48,923	\$ 39,519	\$ 40,614	\$ 26,118	\$ 24,539
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Net proceeds from sale of bank premises, equipment and other real estate	\$ 2,522	\$ 3,297	\$ 3,243	\$ 3,243	\$ 1,229	\$ 1,229
Net (increase) decrease in loans	(68,254)	(68,254)	37,769	38,001	37,291	36,838
Premium paid for the purchase of Liberty Bancshares and Village Bank & Trust ssb in 2004, Abrams Centre Bancshares, Dallas Bancshares, FSBNT and MainBancorp in 2003 and Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Bank Holding Company in 2002	(39,782)		(53,856)		(49,769)	
Net liabilities acquired in the purchase of Liberty Bancshares and Village Bank & Trust ssb in 2004, Abrams Centre Bancshares, Dallas Bancshares, FSBNT and MainBancorp in 2003 and Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Bank Holding Company in 2002	45,450		124,840		59,158	
Purchase of Liberty Bancshares and Village Bank & Trust ssb in 2004, Abrams Centre Bancshares, Dallas Bancshares, FSBNT and MainBancorp in 2003 and Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of Bay City and Southwest Bank Holding Company in 2002		(28,282)		(45,665)		(40,785)
Cash and cash equivalents acquired in the purchase of Liberty Bancshares and Village Bank & Trust ssb in 2004, Abrams Centre Bancshares, Dallas Bancshares, FSBNT and MainBancorp in 2003 and Texas Guaranty Bank, The First State Bank, Paradigm Bancorporation, First National Bank of		62,719		158,902		52,206

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Bay City and Southwest Bank Holding Company in 2002

Net cash provided by (used in) investing activities	\$ 13,351	\$ 42,895	\$ (225,967)	\$ (183,482)	\$ (33,835)	\$ (32,256)
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## PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	2004		2003		2002	
	As Previously	As	As Previously	As	As Previously	As
	Reported	Restated	Reported	Restated	Reported	Restated
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Stock issued in connection with the Liberty Bancshares acquisition in 2004 and the FSBNT and MainBancorp acquisitions in 2003	\$ 31,958	\$	\$ 43,580	\$	\$	\$
Stock option compensation expense	141					
Net cash (used in) provided by financing activities	(5,522)	(37,621)	189,362	145,782	46,796	46,796
Net increase in cash and cash equivalents	\$ 54,197	\$ 54,197	\$ 2,914	\$ 2,914	\$ 39,079	\$ 39,079
<b>NONCASH ACTIVITIES:</b>						
Stock issued in connection with the Liberty Bancshares acquisition in 2004, MainBancorp and FSBNT acquisitions in 2003 and Paradigm Bancorporation acquisition in 2002	\$	\$ 31,958	\$	\$ 43,580	\$	\$ 49,184