HARRIS CORP /DE/
Form 10-Q
May 06, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended April 3, 2015

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to ____________ to ____________

Commission File Number: 1-3863

HARRIS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**34-0276860**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
1025 West NASA Boulevard	
Melbourne, Florida	**32919**
(Address of principal executive offices)	**(Zip Code)**

(321) 727-9100

(Registrant s telephone number, including area code)

No changes

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (l) 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. þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes þ No

The number of shares outstanding of the registrant s common stock as of May 1, 2015 was 104,316,718 shares.

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FORM 10-Q

For the Quarter Ended April 3, 2015

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This Quarterly Report on Form 10-Q contains trademarks, service marks and registered marks of Harris Corporation and its subsidiaries.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

HARRIS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF INCOME

(Unaudited)

	Quarter Ended		Three Quarters Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
	(In millions, except per share amounts)			
Revenue from product sales and services	$ 1,186.6	$ 1,267.5	$ 3,548.3	$ 3,682.6
Cost of product sales and services	(753.4)	(841.0)	(2,323.8)	(2,410.9)
Engineering, selling and administrative expenses	(220.8)	(203.2)	(603.5)	(615.7)
Non-operating income	0.3	0.2	0.5	4.7
Interest income	0.3	0.7	1.7	2.0
Interest expense	(34.0)	(23.2)	(79.5)	(70.6)
Income from continuing operations before income taxes	179.0	201.0	543.7	592.1
Income taxes	(53.4)	(63.9)	(153.5)	(190.5)
Income from continuing operations	125.6	137.1	390.2	401.6
Discontinued operations, net of income taxes		4.1		1.4
Net income	125.6	141.2	390.2	403.0
Noncontrolling interests, net of income taxes	0.1	0.2	0.1	0.4
Net income attributable to Harris Corporation	$ 125.7	$ 141.4	$ 390.3	$ 403.4
Amounts attributable to Harris Corporation common shareholders				
Income from continuing operations	$ 125.7	$ 137.3	$ 390.3	$ 402.0
Discontinued operations, net of income taxes		4.1		1.4
Net income	$ 125.7	$ 141.4	$ 390.3	$ 403.4
Net income per common share attributable to Harris Corporation common shareholders				
Basic net income per common share attributable to Harris Corporation common shareholders				
Continuing operations	$ 1.21	$ 1.28	$ 3.73	$ 3.75
Discontinued operations		0.04		0.02
	$ 1.21	$ 1.32	$ 3.73	$ 3.77

Diluted net income per common share attributable to Harris Corporation common shareholders								
Continuing operations	$	1.20	$	1.27	$	3.69	$	3.72
Discontinued operations				0.04				0.01
	$	1.20	$	1.31	$	3.69	$	3.73
Cash dividends paid per common share	$	0.47	$	0.42	$	1.41	$	1.26
Basic weighted average common shares outstanding		103.7		106.2		104.1		106.3
Diluted weighted average common shares outstanding		104.8		107.4		105.2		107.4

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

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HARRIS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Unaudited)

	Quarter Ended		Three Quarters Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
	(In millions)			
Net income	$ 125.6	$ 141.2	$ 390.2	$ 403.0
Other comprehensive income (loss):				
Foreign currency translation gain (loss)	(36.8)	(3.7)	(110.7)	14.8
Net unrealized loss on hedging derivatives, net of income taxes	(24.2)	(0.1)	(25.4)	(0.5)
Amortization of loss on treasury lock, net of income taxes	0.1	0.1	0.4	0.4
Net unrecognized gain (loss) on post-retirement obligations, net of income taxes	(0.3)	10.5	11.5	11.8
Other comprehensive income (loss), net of income taxes	(61.2)	6.8	(124.2)	26.5
Total comprehensive income	64.4	148.0	266.0	429.5
Comprehensive loss attributable to noncontrolling interests	0.1	0.2	0.1	0.4
Total comprehensive income attributable to Harris Corporation	$ 64.5	$ 148.2	$ 266.1	$ 429.9

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

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HARRIS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

	April 3, 2015	June 27, 2014
	(In millions, except shares)	
Assets		
Current Assets		
Cash and cash equivalents	$ 487.7	$ 561.0
Receivables	652.7	566.1
Inventories	635.7	618.7
Income taxes receivable	15.4	28.1
Current deferred income taxes	116.8	112.2
Other current assets	113.8	105.2
Total current assets	2,022.1	1,991.3
Non-current Assets		
Property, plant and equipment	705.5	728.1
Goodwill	1,665.0	1,711.2
Intangible assets	207.2	257.5
Non-current deferred income taxes	71.2	87.3
Other non-current assets	163.5	155.8
Total non-current assets	2,812.4	2,939.9
	$ 4,834.5	$ 4,931.2
Liabilities and Equity		
Current Liabilities		
Short-term debt	$ 27.3	$ 58.3
Accounts payable	279.6	324.3
Compensation and benefits	178.4	212.8
Other accrued items	301.8	249.8
Advance payments and unearned income	241.0	265.9
Income taxes payable	19.4	
Current deferred income taxes	0.1	2.1
Current portion of long-term debt		1.4
Total current liabilities	1,047.6	1,114.6
Non-current Liabilities		
Long-term debt	1,575.8	1,575.8
Long-term contract liability	74.0	83.8
Other long-term liabilities	296.7	331.6
Total non-current liabilities	1,946.5	1,991.2
Equity		
Shareholders Equity:		
Preferred stock, without par value; 1,000,000 shares authorized; none issued		
Common stock, $1.00 par value; 500,000,000 shares authorized; issued and outstanding 104,213,660 shares at April 3, 2015 and 105,509,073 shares at June 27, 2014	104.2	105.5

Other capital	512.5	509.1
Retained earnings	1,363.1	1,226.3
Accumulated other comprehensive loss	(139.1)	(14.9)
Total shareholders equity	1,840.7	1,826.0
Noncontrolling interests	(0.3)	(0.6)
Total equity	1,840.4	1,825.4
	$ 4,834.5	$ 4,931.2

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

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HARRIS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

	Three Quarters Ended	
	April 3, 2015	March 28, 2014
	(In millions)	
Operating Activities		
Net income	$ 390.2	$ 403.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	163.9	148.6
Share-based compensation	26.0	28.5
Non-current deferred income taxes	20.0	29.8
Gain on sale of discontinued operations		(1.4)
(Increase) decrease in:		
Accounts receivable	(86.6)	(75.8)
Inventories	(17.0)	(5.3)
Increase (decrease) in:		
Accounts payable and accrued expenses	(111.1)	(46.2)
Advance payments and unearned income	(24.9)	(9.7)
Income taxes	25.7	(10.8)
Other	9.0	(6.7)
Net cash provided by operating activities	395.2	454.0
Investing Activities		
Cash paid for intangible assets		(3.3)
Additions of property, plant and equipment	(102.3)	(139.7)
Proceeds from sale of Cyber Integration Center	7.0	27.0
Net cash used in investing activities	(95.3)	(116.0)
Financing Activities		
Proceeds from borrowings	14.3	5.6
Repayments of borrowings	(46.7)	(82.4)
Proceeds from exercises of employee stock options	34.3	133.9
Repurchases of common stock	(164.8)	(222.1)
Cash dividends	(148.7)	(135.5)
Other financing activities	(24.3)	
Net cash used in financing activities	(335.9)	(300.5)
Effect of exchange rate changes on cash and cash equivalents	(37.3)	(8.9)
Net increase (decrease) in cash and cash equivalents	(73.3)	28.6
Cash and cash equivalents, beginning of year	561.0	321.0

Cash and cash equivalents, end of quarter	$ 487.7	$ 349.6

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

April 3, 2015

Note A Significant Accounting Policies and Recent Accounting Standards

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of Harris Corporation and its consolidated subsidiaries. As used in these Notes to Condensed Consolidated Financial Statements (Unaudited) (these Notes), the terms Harris, Company, we, our and u to Harris Corporation and its consolidated subsidiaries. Intracompany transactions and accounts have been eliminated. The accompanying condensed consolidated financial statements have been prepared by Harris, without an audit, in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, such interim financial statements do not include all information and footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with U.S. GAAP for annual financial statements. In the opinion of management, such interim financial statements reflect all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of our financial position, results of operations and cash flows for the periods presented therein. The results for the third quarter and first three quarters of fiscal 2015 are not necessarily indicative of the results that may be expected for the full fiscal year or any subsequent period. The balance sheet at June 27, 2014 has been derived from our audited financial statements, but does not include all of the information and footnotes required by U.S. GAAP for annual financial statements. We provide complete, audited financial statements in our Annual Report on Form 10-K, which includes information and footnotes required by the rules and regulations of the SEC. The information included in this Quarterly Report on Form 10-Q (this Report) should be read in conjunction with the Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and accompanying Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended June 27, 2014 (our Fiscal 2014 Form 10-K).

See *Note B Discontinued Operations* for information regarding discontinued operations. Except for disclosures related to our cash flows, or unless otherwise specified, disclosures in this Report relate solely to our continuing operations.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the accompanying condensed consolidated financial statements and these Notes. These estimates and assumptions are based on experience and other information available prior to issuance of the accompanying condensed consolidated financial statements and these Notes. Materially different results can occur as circumstances change and additional information becomes known.

Adoption of New Accounting Standards

In the first quarter of fiscal 2015, we adopted an accounting standard issued by the Financial Accounting Standards Board (FASB) that clarifies previous U.S. GAAP regarding the release of cumulative translation adjustment (CTA) into earnings in certain situations. When an entity ceases to have a controlling financial interest in a subsidiary or group of assets within a consolidated foreign entity and the sale or transfer of such subsidiary or group of assets results in the complete or substantially complete liquidation of such foreign entity, any related CTA should be reclassified from accumulated other comprehensive income (AOCI) and included in the calculation of the gain or loss on the sale or transfer. Upon a sale or complete or substantially complete liquidation of an investment in a consolidated foreign entity that results in either (1) a loss of a controlling financial interest in the foreign entity or (2) an acquirer obtaining control of an acquiree in which the acquirer held an equity interest immediately before the acquisition date in a business combination achieved in stages, any related CTA should be reclassified from AOCI and included in the calculation of the gain or loss on the sale or liquidation. For a sale of part of an ownership interest in a foreign investment that is accounted for as an equity method investment, a pro rata portion of CTA attributable to that investment should be reclassified from AOCI and included in the calculation of the gain or loss on the sale. The adoption of this standard did not impact our financial position, results of operations or cash flows.

In the first quarter of fiscal 2015, we also adopted an accounting standard issued by the FASB that requires unrecognized tax benefits to be presented as a decrease in a net operating loss, similar tax loss or tax credit carryforward if certain criteria are met. The adoption of this standard did not impact our financial position, results of operations or cash flows.

Accounting Standards Issued But Not Yet Effective

In April 2014, the FASB issued an accounting standards update that raises the threshold for disposals to qualify as discontinued operations and allows companies to have significant continuing involvement and continuing cash flows with discontinued operations. This standard also requires additional disclosures for discontinued operations and new disclosures for individually material disposal transactions that do not meet the definition of a discontinued operation. This standard is to be applied prospectively and is effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2014, which for us is our fiscal 2016. Early adoption is permitted, but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issuance. The adoption of this standard is not expected to have a material impact on our financial position, results of operations or cash flows.

In May 2014, the FASB issued a comprehensive new revenue recognition standard that supersedes nearly all revenue recognition guidance under U.S. GAAP and International Financial Reporting Standards and supersedes some cost guidance for construction-type and production-type contracts. The guidance in this standard is principles-based, and accordingly, entities will be required to use more judgment and make more estimates than under prior guidance, including identifying contract performance obligations, estimating variable consideration to include in the contract price and allocating the transaction price to separate performance obligations. The guidance in this standard is applicable to all contracts with customers, regardless of industry-specific or transaction-specific fact patterns. Additionally, this standard provides guidance for transactions that were not previously addressed comprehensively (e.g., service revenue, contract modifications and licenses of intellectual property) and modifies guidance for multiple-element arrangements. The core principle of this standard is that entities should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. To help financial statement users better understand the nature, amount, timing and potential uncertainty of the revenue that is recognized, this standard requires significantly more interim and annual disclosures. This standard allows for either full retrospective adoption (application to all periods presented) or modified retrospective adoption (application to only the most current period presented in the financial statements, as well as certain additional required footnote disclosures). This standard is currently effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2016, which for us is our fiscal 2018. On April 1, 2015, the FASB proposed delaying the effective date until fiscal years, and interim reporting periods within those years, beginning after December 15, 2017, which for us is our fiscal 2019, and is seeking public comment before making a final decision. We are currently evaluating the impact this standard will have on our financial position, results of operations and cash flows.

In February 2015, the FASB issued an accounting standards update related to the consolidation of variable interest entities. Entities involved with limited partnerships or similar entities will have to re-evaluate those entities for consolidation and revise their documentation. Based on the evaluation, consolidation conclusions may change and additional disclosures may be required. This standard is effective for annual and interim periods beginning after December 15, 2015, which for us is our fiscal 2017. Early adoption is permitted. The adoption of this standard is not expected to have a material impact on our financial position, results of operations or cash flows.

In April 2015, the FASB issued an accounting standards update which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. Entities must adopt the new guidance on a retrospective basis. This standard is effective for annual and interim periods beginning after December 15, 2015, which for us is our fiscal 2017. Early adoption is permitted. The adoption of this standard is not expected to have a material impact on our financial position and will not impact our results of operations or cash flows.

Note B Discontinued Operations

In the third quarter of fiscal 2012, our Board of Directors approved a plan to exit our cyber integrated solutions operation (CIS), which provided remote cloud hosting, and to dispose of the related assets, and we reported CIS as discontinued operations beginning with our financial results presented in our Quarterly Report on Form 10-Q for the third quarter of fiscal 2012. In the first quarter of fiscal 2014, we completed the sale of the remaining assets of CIS for $35 million, including $28 million in cash and a $7 million subordinated promissory note (the CIS Note), which we collected in the first quarter of fiscal 2015.

In the fourth quarter of fiscal 2012, our Board of Directors approved a plan to divest our broadcast communications operation (Broadcast Communications), which provided digital media management solutions in support of broadcast customers, and we reported Broadcast Communications as discontinued operations beginning with our financial results presented in our Annual Report on Form 10-K for fiscal 2012. On February 4, 2013, we completed the sale of Broadcast Communications to an affiliate of The Gores Group, LLC (the Buyer) pursuant to a definitive Asset Sale Agreement entered into December 5, 2012 for $225 million, including $160 million in cash, subject to customary adjustments (including a post-closing working capital adjustment, which is currently in arbitration), a $15 million subordinated promissory note (which was collected in fiscal 2014) and an earnout of up to $50 million

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based on future performance. In the arbitration noted above, the current range of possible outcomes is no additional adjustment to the purchase price, based on our calculation of post-closing working capital, on one hand, to an additional downward adjustment of $72 million to the purchase price, based on the Buyer s claims in its calculation of post-closing working capital, on the other hand. We are not able to determine the likely outcome of the arbitration, but we believe the Buyer s claims in its calculation of post-closing working capital are without merit and its asserted additional downward adjustment to the purchase price is significantly overstated, and we intend to defend against the Buyer s claims and asserted additional downward adjustment to the purchase price vigorously.

Both CIS and Broadcast Communications were formerly part of our Integrated Network Solutions segment.

In the third quarter of fiscal 2014, discontinued operations reflected a $4.8 million tax benefit (primarily related to the realization of additional tax deductions in respect of Broadcast Communications on various fiscal 2013 tax returns compared with our recorded estimates at the end of fiscal 2013), partially offset by a $1.0 million ($0.7 million after-tax) increase in the loss on sale of Broadcast Communications from miscellaneous adjustments for contingencies related to the disposition.

In the first three quarters of fiscal 2014, discontinued operations reflected a $4.8 million tax benefit (primarily related to the realization of additional tax deductions in respect of Broadcast Communications on various fiscal 2013 tax returns compared with our recorded estimates at the end of fiscal 2013) and a $3.1 million ($1.9 million after-tax) gain on the sale of the remaining assets of CIS, partially offset by a $7.6 million ($5.3 million after-tax) increase in the loss on sale of Broadcast Communications from miscellaneous adjustments for contingencies related to the disposition.

Unless otherwise specified, the information set forth in these Notes, other than this *Note B Discontinued Operations*, relates solely to our continuing operations.

Note C Stock Options and Other Share-Based Compensation

During the first three quarters of fiscal 2015, we had two shareholder-approved employee stock incentive plans (SIPs), including the Harris Corporation 2005 Equity Incentive Plan (As Amended and Restated Effective August 27, 2010), under which options or other share-based compensation was outstanding, and we have granted the following types of share-based awards under these SIPs: stock options, performance share awards, performance share unit awards, restricted stock awards and restricted stock unit awards. We believe that such awards more closely align the interests of employees with those of shareholders. Certain share-based awards provide for accelerated vesting if there is a change in control (as defined under our SIPs). The compensation cost related to our share-based awards that was charged against income for the third quarter and first three quarters of fiscal 2015 was $8.6 million and $26.0 million, respectively. The compensation cost related to our share-based awards that was charged against income for the third quarter and first three quarters of fiscal 2014 was $10.1 million and $28.5 million, respectively.

Grants to employees under our SIPs during the third quarter of fiscal 2015 consisted of 6,350 restricted stock awards. Grants to employees under our SIPs during the first three quarters of fiscal 2015 consisted of 981,150 stock options, 212,550 performance share unit awards, 20,080 restricted stock awards and 3,600 restricted stock unit awards. The fair value as of the grant date of each option award was determined using the Black-Scholes-Merton option-pricing model, which used the following assumptions: expected dividend yield of 2.69 percent; expected volatility of 24.33 percent; risk-free interest rates averaging 1.68 percent; and expected term in years of 5.02. The fair value as of the grant date of each performance share unit award was determined based on a fair value from a multifactor Monte Carlo valuation model that simulates our stock price and total shareholder return (TSR) relative to other companies in our TSR peer group, less a discount to reflect the delay in payments of cash dividend-equivalents that are made only upon vesting. The fair value as of the grant date of each restricted stock or restricted stock unit award was based on the closing price of our common stock on the grant date.

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Note D Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are summarized below:

	April 3, 2015(1)	June 27, 2014
	(In millions)	
Foreign currency translation gain (loss)	$ (104.1)	$ 6.6
Net unrealized gain (loss) on hedging derivatives, net of income taxes of $15.6 million at April 3, 2015	(25.2)	0.2
Unamortized loss on treasury lock, net of income taxes	(1.5)	(1.9)
Unrecognized loss on post-retirement obligations, net of income taxes of $1.5 million and $9.5 million at April 3, 2015 and June 27, 2014, respectively	(8.3)	(19.8)
	$ (139.1)	$ (14.9)

(1) Reclassifications out of accumulated other comprehensive loss to earnings were not material for the first three quarters of fiscal 2015 or 2014.

Note E Receivables

Receivables are summarized below:

	April 3, 2015	June 27, 2014
	(In millions)	
Accounts receivable	$ 536.5	$ 457.9
Unbilled costs and accrued earnings on cost-plus contracts	122.0	115.5
	658.5	573.4
Less allowances for collection losses	(5.8)	(7.3)
	$ 652.7	$ 566.1

Note F Inventories

Inventories are summarized below:

	April 3, 2015	June 27, 2014
	(In millions)	
Unbilled costs and accrued earnings on fixed-price contracts	$ 309.8	$ 347.2
Finished products	108.3	104.8
Work in process	54.8	35.7
Raw materials and supplies	162.8	131.0
	$ 635.7	$ 618.7

Unbilled costs and accrued earnings on fixed-price contracts were net of progress payments of $75.4 million at April 3, 2015 and $100.7 million at June 27, 2014.

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Note G Property, Plant and Equipment

Property, plant and equipment are summarized below:

	April 3, 2015	June 27, 2014
	(In millions)	
Land	$ 13.0	$ 12.7
Software capitalized for internal use	143.2	135.5
Buildings	509.5	492.4
Machinery and equipment	1,132.4	1,103.6
	1,798.1	1,744.2
Less accumulated depreciation and amortization	(1,092.6)	(1,016.1)
	$ 705.5	$ 728.1

Depreciation and amortization expense related to property, plant and equipment for the third quarter and first three quarters of fiscal 2015 was $35.8 million and $109.2 million, respectively. Depreciation and amortization expense related to property, plant and equipment for the third quarter and first three quarters of fiscal 2014 was $32.6 million and $102.2 million, respectively.

Note H Accrued Warranties

Changes in our liability for standard product warranties, which is included as a component of the Other accrued items and Other long-term liabilities line items in the accompanying Condensed Consolidated Balance Sheet (Unaudited), during the first three quarters of fiscal 2015 were as follows:

	(In millions)
Balance at June 27, 2014	$ 33.3
Warranty provision for sales made during the first three quarters of fiscal 2015	11.3
Settlements made during the first three quarters of fiscal 2015	(10.7)
Other adjustments to warranty liability, including those for foreign currency translation, during the first three quarters of fiscal 2015	(3.1)
Balance at April 3, 2015	$ 30.8

We also sell extended product warranties and recognize revenue from these arrangements over the warranty period. Costs of warranty services under these arrangements are recognized as incurred. Deferred revenue associated with extended product warranties at April 3, 2015 and June 27, 2014 was $37.6 million and $38.9 million, respectively, and is included as a component of the Advance payments and unearned income and Other long-term liabilities line items in the accompanying Condensed Consolidated Balance Sheet (Unaudited).

Note I Income From Continuing Operations Per Share

The computations of income from continuing operations per share are as follows (in this *Note I*, income from continuing operations refers to income from continuing operations attributable to Harris Corporation common shareholders):

	Quarter Ended		Three Quarters Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
	(In millions, except per share amounts)			
Income from continuing operations	$ 125.7	$ 137.3	$ 390.3	$ 402.0
Adjustments for participating securities outstanding	(0.4)	(0.9)	(1.8)	(2.9)
Income from continuing operations used in per basic and diluted common share calculations (A)	$ 125.3	$ 136.4	$ 388.5	$ 399.1
Basic weighted average common shares outstanding (B)	103.7	106.2	104.1	106.3
Impact of dilutive share-based awards	1.1	1.2	1.1	1.1
Diluted weighted average common shares outstanding (C)	104.8	107.4	105.2	107.4
Income from continuing operations per basic common share (A)/(B)	$ 1.21	$ 1.28	$ 3.73	$ 3.75
Income from continuing operations per diluted common share (A)/(C)	$ 1.20	$ 1.27	$ 3.69	$ 3.72

Potential dilutive common shares primarily consist of employee stock options and performance share and performance share unit awards. Employee stock options to purchase approximately 765,438 and 868,589 shares of our common stock were outstanding at April 3, 2015 and March 28, 2014, respectively, but were not included as dilutive stock options in the computations of income from continuing operations per diluted common share because the effect would have been antidilutive.

Note J Income Taxes

Our effective tax rate (income taxes as a percentage of income from continuing operations before income taxes) was 29.8 percent in the third quarter of fiscal 2015 compared with 31.8 percent in the third quarter of fiscal 2014. In the third quarter of fiscal 2015, our effective tax rate benefited from additional deductions (primarily related to manufacturing) and additional research credits claimed on our fiscal 2014 tax return compared with our recorded estimates at the end of fiscal 2014, as well as from finalizing issues with tax authorities. In the third quarter of fiscal 2014, our effective tax rate benefited from additional deductions (primarily related to manufacturing) and additional research credits claimed on our fiscal 2013 tax return compared with our recorded estimates at the end of fiscal 2013.

Our effective tax rate was 28.2 percent in the first three quarters of fiscal 2015 compared with 32.2 percent in the first three quarters of fiscal 2014. In the first three quarters of fiscal 2015, our effective tax rate benefited from the discrete items noted above regarding the third quarter of fiscal 2015, as well as from, in the second quarter of fiscal 2015, enacted legislation that restored the U.S. Federal income tax credit for qualifying research and development (R&D) expenses for calendar year 2014 and finalizing issues with Canadian and U.S. tax authorities for amounts lower than previously recorded estimates. Also, in the first quarter of fiscal 2015, our effective tax rate benefited from recognition of foreign tax credits resulting from a dividend paid by a foreign subsidiary during fiscal 2013 that exceeded the U.S. tax liability in respect of the dividend. In the first three quarters of fiscal 2014, our effective tax rate benefited from the discrete items noted above regarding the third quarter of fiscal 2014, as well as from the settlement of a state tax audit and a refund resulting from a consolidation of foreign subsidiaries.

Note K Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal market (or most advantageous market, in the absence of a principal market) for the asset or liability in an orderly transaction between market participants at the measurement date. Entities are required to maximize the use of observable inputs and minimize the use of unobservable inputs in measuring fair value, and to utilize a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of inputs used to measure fair value are as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than quoted prices included within Level 1, including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and inputs other than quoted prices that are observable or are derived principally from, or corroborated by, observable market data by correlation or other means.

Level 3 Unobservable inputs that are supported by little or no market activity, are significant to the fair value of the assets or liabilities, and reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability developed using the best information available in the circumstances.

The following table presents the fair value hierarchy of our assets and liabilities measured at fair value on a recurring basis (at least annually) as of April 3, 2015:

	Level 1	Level 2	Level 3	Total
		(In millions)		
Assets				
Deferred compensation plan investments: (1)				
Money market fund	$ 31.9	$	$	$ 31.9
Stock fund	59.6			59.6
Equity security	34.9			34.9
Pension plan investments: (2)				
Stock funds	32.7			32.7
Corporate bonds	9.3			9.3
Government securities	49.5			49.5
Foreign currency forward contracts (3)		0.6		0.6
Liabilities				
Deferred compensation plans (4)	43.1	77.3		120.4
Foreign currency forward contracts (5)		2.2		2.2
Interest-rate swap agreements (6)		41.0		41.0

(1) Represents investments held in a rabbi trust associated with our non-qualified deferred compensation plans, which we include in the Other current assets and Other non-current assets line items in the accompanying Condensed Consolidated Balance Sheet (Unaudited).
(2) Represents investments related to our defined benefit plan in the United Kingdom, which we include in the Other non-current assets line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited).
(3) Includes derivatives designated as hedging instruments, which we include in the Other current assets line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited). The fair value of these contracts was measured using a market approach based on quoted foreign currency forward exchange rates for contracts with similar maturities.
(4) Primarily represents obligations to pay benefits under certain non-qualified deferred compensation plans, which we include in the Compensation and benefits and Other long-term liabilities line items in the accompanying Condensed Consolidated Balance Sheet (Unaudited). Under these plans, participants designate investment options (including money market, stock and fixed-income funds), which serve as the basis for measurement of the notional value of their accounts.
(5) Includes derivatives designated as hedging instruments, which we include in the Other accrued items line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited). The fair value of these contracts was measured using a market approach based on quoted foreign currency forward exchange rates for contracts with similar maturities.
(6) Includes derivatives designated as hedging instruments, as well as economic hedges, which we include in the Other accrued items line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited). The fair value of these interest-rate swap agreements was measured using a market approach based on quoted market interest rates for interest-rate swap agreements with similar attributes.

The following table presents the carrying amounts and estimated fair values of our significant financial instruments that were not measured at fair value (carrying amounts of other financial instruments not listed in the table below approximate fair value due to the short-term nature of those items):

	April 3, 2015		June 27, 2014	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
		(In millions)		
Financial Liabilities				
Long-term debt (including current portion) (1)	$ 1,575.8	$ 1,826.4	$ 1,577.2	$ 1,799.6

(1) The fair value was estimated using a market approach based on quoted market prices for our debt traded in the secondary market. If our long-term debt in our balance sheet were measured at fair value, it would be categorized in Level 2 of the fair value hierarchy.

Note L Derivative Instruments and Hedging Activities

In the normal course of doing business, we are exposed to global market risks, including the effect of changes in foreign currency exchange rates. Additionally, during March 2015, we entered into interest-rate swap agreements to hedge against interest-rate risk related to the anticipated issuance of long-term fixed-rate debt to redeem certain of our long-term debt securities and to fund a portion of the cash consideration payable under the merger agreement with Exelis Inc. (Exelis). See *Note O Pending Acquisition* and *Note P Subsequent Events* for further information. We use derivative instruments to manage our exposure to such risks and formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking hedge transactions. We recognize all derivatives in the accompanying Condensed Consolidated Balance Sheet (Unaudited) at fair value. We do not hold or issue derivatives for trading purposes.

At April 3, 2015, we had open foreign currency forward contracts with an aggregate notional amount of $57.3 million, of which $50.3 million were classified as fair value hedges and $7.0 million were classified as cash flow hedges. This compares with open foreign currency forward contracts with an aggregate notional amount of $155.7 million at June 27, 2014, of which $119.6 million were classified as fair value hedges and $36.1 million were classified as cash flow hedges. At April 3, 2015, contract expiration dates ranged from less than 1 month to 3 months with a weighted average contract life of 1 month.

At April 3, 2015, we also had open interest-rate swap agreements with an aggregate notional amount of $1 billion, of which $800 million were classified as cash flow hedges and $200 million were classified as economic hedges (hedges not designated by us to receive hedge accounting treatment).

Exchange-Rate Risk Balance Sheet Hedges

To manage the exposure in our balance sheet to risks from changes in foreign currency exchange rates, we implement fair value hedges. More specifically, we use foreign currency forward contracts and options to hedge certain balance sheet items, including foreign currency denominated accounts receivable and inventory. Changes in the value of the derivatives and the related hedged items are reflected in earnings in the Cost of product sales and services line item in the accompanying Condensed Consolidated Statement of Income (Unaudited). As of April 3, 2015, we had outstanding foreign currency forward contracts denominated in the British Pound, Australian Dollar, Singapore Dollar, Norwegian Krone and Mexican Peso to hedge certain balance sheet items. The net gains or losses on foreign currency forward contracts designated as fair value hedges were not material in the third quarter and first three quarters of fiscal 2015 or 2014. In addition, no amounts were recognized in earnings in the third quarter and first three quarters of fiscal 2015 or 2014 related to hedged firm commitments that no longer qualify as fair value hedges.

Exchange-Rate Risk Cash Flow Hedges

To manage our exposure to currency risk and market fluctuation risk associated with anticipated cash flows that are probable of occurring in the future, we implement cash flow hedges. More specifically, we use foreign currency forward contracts and options to hedge off-balance sheet future foreign currency commitments, including purchase commitments to suppliers, future committed sales to customers and intersegment transactions. These derivatives are being used to hedge currency exposures from cash flows anticipated across our business segments. We also have hedged U.S. Dollar payments to suppliers to maintain our anticipated profit margins in our international operations. As of April 3, 2015, we had outstanding foreign currency forward contracts denominated in the British Pound, Brazilian Real, Australian Dollar, and Canadian Dollar to hedge certain forecasted transactions.

These derivatives have only nominal intrinsic value at the time of purchase and have a high degree of correlation to the anticipated cash flows they are designated to hedge. Hedge effectiveness is determined by the correlation of the anticipated cash flows from the hedging instruments and the anticipated cash flows from the future foreign currency commitments through the maturity dates of the derivatives used to hedge these cash flows. These financial instruments are marked-to-market using forward prices and fair value quotes with the offset to accumulated other comprehensive income, net of hedge ineffectiveness. Gains and losses from other comprehensive income are reclassified to earnings when the related hedged item is recognized in earnings. The ineffective portion of a derivative s change in fair value is immediately recognized in earnings. The cash flow impact of our derivatives is included in the same category in the accompanying Condensed Consolidated Statement of Cash Flows (Unaudited) as the cash flows of the related hedged items.

The net gains or losses from cash flow hedges recognized in earnings or recorded in other comprehensive income, including gains or losses related to hedge ineffectiveness, were not material in the third quarter and first three quarters of fiscal 2015 or 2014. We do not expect the net gains or losses recognized in the Accumulated other comprehensive loss line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited) as of April 3, 2015 that will be reclassified to earnings from other comprehensive income within the next 12 months to be material.

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Interest-Rate Risk Cash Flow Hedges

As noted above, new fixed-rate long-term debt will be used to redeem certain of our fixed-rate long-term debt securities and to fund a portion of the cash consideration payable under the merger agreement with Exelis. More specifically, in the fourth quarter of fiscal 2015, we issued $800 million of new 10-year and 30-year fixed-rate debt to fund the redemption of the entire outstanding $400 million principal amount of the 5.95% notes, due December 1, 2017 and the entire outstanding $350 million principal amount of the 6.375% notes, due June 15, 2019 at the make-whole redemption prices as set forth in those notes. The issuance of this debt was not dependent on the closing of the Exelis acquisition. Prior to the issuance of this debt, on March 5, 2015 and March 10, 2015, we entered into six interest-rate swap agreements (swaps) with a notional value of $1 billion. We designated four of these swaps, with a notional value of $800 million, as cash flow hedges to mitigate the risk attributable to the benchmark interest rate s effect on the probable cash flows of 10-year and 30-year fixed-rate debt to be issued. If the benchmark interest rates increase during the period of the swaps, the swap positions will become assets and we will receive cash payments from the counterparty when we terminate the swaps upon debt issuance. Conversely, if the benchmark interest rates decrease, the swap positions will become liabilities and we will make cash payments to the counterparties when we terminate the swaps upon debt issuance. These swaps are marked-to-market using fair value quotes, with the offset to the aforementioned assets or liabilities recorded in other comprehensive income, net of hedge ineffectiveness. At the end of the third quarter of fiscal 2015, these swaps were marked-to-market, resulting in a liability of $39.4 million in the Other accrued items line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited) and an unrealized after-tax loss of $24.3 million in the Accumulated other comprehensive loss line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited). These swaps were terminated as planned in the fourth quarter of fiscal 2015, and the accumulated other comprehensive income balances will be amortized to interest expense over the lives of the related fixed-rate debt securities. The ineffective portion of these swaps change in fair value is immediately recognized in earnings in the Interest expense line item in the accompanying Condensed Consolidated Statement of Income (Unaudited), and during the third quarter of fiscal 2015, this amount was immaterial. We will classify the debt issuance proceeds, together with the cash inflow or outflow from the termination of these swaps, as financing cash flows in the fourth quarter of fiscal 2015 in our Consolidated Statement of Cash Flows.

Interest-Rate Risk Economic Hedges

As noted above, on March 5, 2015 and March 10, 2015, we entered into six swaps with a notional value of $1 billion. We entered into two of these swaps, with a notional value of $200 million, to mitigate the risk attributable to the benchmark interest rate s effect on the cash flows of 10-year and 20-year fixed-rate debt anticipated to be issued to fund a portion of the cash consideration payable under the merger agreement with Exelis. These swaps (economic hedges) were not designated to receive hedge accounting treatment and are marked-to-market using fair value quotes, with the offset to the assets or liabilities recorded in earnings. At the end of the third quarter of fiscal 2015, these swaps were marked-to-market, resulting in a liability of $1.6 million in the Other accrued items line item in the accompanying Condensed Consolidated Balance Sheet (Unaudited) and a $1.6 million charge to the Interest expense line item in the accompanying Condensed Consolidated Statement of Income (Unaudited). Upon termination of these swaps in the fourth quarter of fiscal 2015, the difference between the cash ultimately receivable or payable and the amount accrued will be charged to interest expense. We will classify the debt issuance proceeds, together with the cash inflow or outflow from the termination of these swaps, as financing cash flows in the fourth quarter of fiscal 2015 in our Consolidated Statement of Cash Flows.

Credit Risk

We are exposed to the risk of credit losses from non-performance by counterparties to the financial instruments discussed above, but we do not expect any of the counterparties to fail to meet their obligations. To manage credit risks, we select counterparties based on credit ratings, limit our exposure to any single counterparty under defined guidelines and monitor the market position with each counterparty.

See *Note K Fair Value Measurements* for the amount of the assets and liabilities related to these foreign currency forward contracts and swaps in the accompanying Condensed Consolidated Balance Sheet (Unaudited) as of April 3, 2015, and see the accompanying Condensed Consolidated Statement of Comprehensive Income (Unaudited) for additional information on changes in accumulated other comprehensive loss in the third quarter and first three quarters of fiscal 2015.

Note M Changes in Estimates

Estimates and assumptions, and changes therein, are important in connection with, among others, our segments revenue recognition policies related to development and production contracts. Revenue and profits related to development and production contracts are recognized using the percentage-of-completion method, generally based on the ratio of costs incurred to estimated total costs at completion (i.e., the cost-to-cost method). Revenue and profits on cost-reimbursable development and production contracts are recognized as allowable costs are incurred on the contract, and become billable to the customer, in an amount equal to the allowable costs plus the profit on those costs.

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Development and production contracts are combined when specific aggregation criteria are met. Criteria generally include closely interrelated activities performed for a single customer within the same economic environment. Development and production contracts are generally not segmented. If development and production contracts are segmented, we have determined that they meet specific segmenting criteria. Change orders, claims or other items that may change the scope of a development and production contract are included in contract value only when the value can be reliably estimated and realization is probable. Possible incentives or penalties and award fees applicable to performance on development and production contracts are considered in estimating contract value and profit rates and are recorded when there is sufficient information to assess anticipated contract performance. Incentive provisions that increase earnings based solely on a single significant event are generally not recognized until the event occurs.

Under the percentage-of-completion method of accounting, a single estimated total profit margin is used to recognize profit for each development and production contract over its period of performance. Recognition of profit on development and production fixed-price contracts requires estimates of the total cost at completion and the measurement of progress toward completion. The estimated profit or loss on a development and production contract is equal to the difference between the estimated contract value and the estimated total cost at completion. Due to the long-term nature of many of our programs, developing the estimated total cost at completion often requires judgment. Factors that must be considered in estimating the cost of the work to be completed include the nature and complexity of the work to be performed, subcontractor performance, the risk and impact of delayed performance, availability and timing of funding from the customer and the recoverability of any claims outside the original development and production contract included in the estimate to complete. At the outset of each contract, we gauge its complexity and perceived risks and establish an estimated total cost at completion in line with these expectations. After establishing the estimated total cost at completion, we follow a standard estimate at completion (EAC) process in which management reviews the progress and performance on our ongoing development and production contracts at least quarterly and, in many cases, more frequently. If we successfully retire risks associated with the technical, schedule and cost aspects of a contract, we may lower our estimated total cost at completion commensurate with the retirement of these risks. Conversely, if we are not successful in retiring these risks, we may increase our estimated total cost at completion. Additionally, at the outset of a cost-reimbursable contract (for example, contracts containing award or incentive fees), we establish an estimate of total contract value, or revenue, based on our expectation of performance on the contract. As the cost-reimbursable contract progresses, our estimates of total contract value may increase or decrease if, for example, we receive higher or lower than expected award fees. When adjustments in estimated total costs at completion or in estimates of total contract value are determined, the related impact to operating income is recognized using the cumulative catch-up method, which recognizes in the current period the cumulative effect of such adjustments for all prior periods. Anticipated losses on development and production contracts or programs in progress are charged to operating income when identified. Net EAC adjustments resulting from changes in estimates favorably impacted our operating income in the third quarter and first three quarters of fiscal 2015 by $10.7 million ($0.07 per diluted share) and $49.1 million ($0.33 per diluted share), respectively. Net EAC adjustments resulting from changes in estimates favorably impacted our operating income in the third quarter and first three quarters of fiscal 2014 by $18.4 million ($0.12 per diluted share) and $38.9 million ($0.24 per diluted share), respectively.

Note N Business Segments

We structure our operations primarily around the products and services we sell and the markets we serve, and we report the financial results of our operations in the following three reportable operating or business segments RF Communications, Government Communications Systems and Integrated Network Solutions. Our RF Communications segment is a global supplier of secure tactical radio communications and high-grade encryption solutions for military, government and commercial customers and also of secure communications systems and equipment for public safety, utility and transportation customers. Our Government Communications Systems segment conducts advanced research and develops, produces, integrates and supports advanced communications and information systems that solve the mission-critical challenges of our civilian, intelligence and defense government customers worldwide, primarily the U.S. Government. Our Integrated Network Solutions segment provides government, energy, maritime and healthcare customers with integrated communications and information technology (IT) and services, including mission-critical end-to-end IT services, managed satellite and terrestrial communications solutions and standards-based healthcare interoperability solutions. Each business segment is comprised of multiple program areas and product and service lines that aggregate into such business segment.

The accounting policies of our business segments are the same as those described in Note 1: Significant Accounting Policies in our Notes to Consolidated Financial Statements in our Fiscal 2014 Form 10-K. We evaluate each segment s performance based on its operating income or loss, which we define as profit or loss from operations before income taxes excluding interest income and expense, royalties and related intellectual property expenses, equity method investment income or loss and gains or losses from securities and other investments. Intersegment sales are generally transferred at cost to the buying segment, and the sourcing segment recognizes a profit that is eliminated. The Corporate eliminations line items in the tables below represent the elimination of intersegment sales and their related profits. The Unallocated corporate expense line item in the tables below represents the portion of corporate expenses not allocated to our business segments.

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Total assets by business segment are summarized below:

	April 3, 2015	June 27, 2014
	(In millions)	
Total Assets		
RF Communications	$ 1,349.3	$ 1,253.9
Government Communications Systems	1,007.8	975.4
Integrated Network Solutions	1,610.0	1,746.5
Corporate	867.4	955.4
	$ 4,834.5	$ 4,931.2

Segment revenue, segment operating income and a reconciliation of segment operating income to total income from continuing operations before income taxes follow:

	Quarter Ended		Three Quarters Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
	(In millions)			
Revenue				
RF Communications	$ 450.8	$ 457.2	$ 1,270.1	$ 1,334.8
Government Communications Systems	455.1	476.6	1,370.1	1,321.2
Integrated Network Solutions	298.8	348.0	964.1	1,089.5
Corporate eliminations	(18.1)	(14.3)	(56.0)	(62.9)
	$ 1,186.6	$ 1,267.5	$ 3,548.3	$ 3,682.6
Income From Continuing Operations Before Income Taxes				
Segment Operating Income:				
RF Communications	$ 151.0	$ 143.7	$ 392.5	$ 421.0
Government Communications Systems	74.6	77.4	226.1	207.9
Integrated Network Solutions	11.8	21.4	63.4	83.8
Unallocated corporate expense (1)	(23.3)	(17.0)	(54.0)	(47.4)
Corporate eliminations	(1.7)	(2.2)	(7.0)	(9.3)
Non-operating income (2)	0.3	0.2	0.5	4.7
Net interest expense (3)	(33.7)	(22.5)	(77.8)	(68.6)
	$ 179.0	$ 201.0	$ 543.7	$ 592.1

(1) Unallocated corporate expense included $8.5 million of acquisition-related costs associated with the pending acquisition of Exelis.

(2) Non-operating income includes equity method investment income (loss); income (expense) related to intellectual property matters; gains and losses on sales of investments, securities available-for-sale and prepayment of long-term debt; and impairments of investments and securities available-for-sale.

(3) Net interest expense included $8.7 million of debt issuance costs recognized related to financing commitments for a 364-day senior unsecured bridge term loan facility in connection with our pending acquisition of Exelis and a $1.6 million unrealized loss on interest-rate swap agreements (see *Note L Derivative Instruments and Hedging Activities* for further information).

Note O Pending Acquisition

On February 6, 2015, we announced a definitive Merger Agreement (as defined below in this *Note O*) under which we will acquire 100 percent of Exelis in a cash and stock transaction valued at $23.75 per share of Exelis common stock, or an approximately $4.75 billion enterprise value, based on the closing price of our common stock as of February 5, 2015. Under the terms of the transaction, Exelis shareholders will receive

$16.625 in cash, without interest, and 0.1025 of a share of our common stock for each share of Exelis common stock. Upon closing, our shareholders will own approximately 85 percent of the combined company, and Exelis shareholders will own approximately 15 percent of the combined company. The Merger Agreement has been unanimously approved by the Boards of Directors of both companies. The transaction is subject to customary closing conditions, including regulatory and Exelis shareholder approval, and we currently expect the closing to occur in June 2015, although we can give no assurances regarding the timing or occurrence of closing.

In connection with entering into the Merger Agreement with Exelis, for the purpose of financing the cash consideration and other amounts payable under the terms of the Merger Agreement and paying fees and expenses associated with the merger, we entered into financing commitments for a 364-day senior unsecured bridge term loan facility in an aggregate principal amount of $3.4 billion. We subsequently entered into a new senior unsecured term loan facility in an aggregate principal amount of $1.3 billion, which

correspondingly reduced the financing commitments for the bridge term loan facility from $3.4 billion to $2.1 billion. The $1.3 billion term loan facility is comprised of $650 million in a three-year tranche and $650 million in a five-year tranche. We subsequently issued new debt securities, which automatically terminated the remaining $2.1 billion of financing commitments for the bridge facility. See *Note P Subsequent Events* for further information.

Additionally, we amended our existing $1 billion, 5-year senior unsecured revolving credit facility under our revolving credit agreement entered into on September 28, 2012. The amendment makes certain modifications to the revolving credit agreement, including, among others, (i) requiring certain of our subsidiaries that incur, borrow or guarantee debt in a principal amount exceeding $100 million to become guarantors under the revolving credit agreement and (ii) amending the financial maintenance covenant to increase the permitted ratio of consolidated total indebtedness to total capital from 0.600:1.00 to 0.650:1.00 prior to our acquisition of Exelis, then to 0.675:1.00 for the nine-month period from and including the date that we acquire Exelis and to 0.650:1.00 for the term of the revolving credit agreement that follows such nine-month period.

Exelis is a diversified, global aerospace, defense, information and services company headquartered in McLean, Virginia that employs approximately 10,000 people and generated calendar 2014 sales of $3.28 billion. Exelis leverages its deep customer knowledge and technical expertise to deliver affordable, mission-critical solutions for global customers and is a leader in positioning and navigation, sensors, air traffic management solutions, image processing and distribution, communications and information systems. Exelis is focused on strategic growth in the areas of critical networks; intelligence, surveillance, reconnaissance (ISR) and analytics; electronic warfare; and composite aerostructures.

The foregoing description of the Merger Agreement and the transactions contemplated thereby is not complete and is subject to, and qualified in its entirety by reference to, the Agreement and Plan of Merger, dated as of February 5, 2015, by and among Exelis, us, and Harris Communication Solutions (Indiana), Inc., one of our wholly owned subsidiaries (the Merger Agreement), a copy of which was filed as an exhibit to our Current Report on Form 8-K filed on February 9, 2015.

Note P Subsequent Events

On April 27, 2015, in connection with the pending acquisition of Exelis, to fund a portion of the cash consideration and other amounts payable under the terms of the Merger Agreement and to redeem certain of our existing notes, we issued new debt securities in an aggregate principal amount of $2.4 billion, comprised of several tranches with principal amounts, interest rates and maturity dates as follows:

- $500 million of 1.999% Notes due 2018,
- $400 million of 2.700% Notes due 2020,
- $600 million of 3.832% Notes due 2025,
- $400 million of 4.854% Notes due 2035, and
- $500 million of 5.054% Notes due 2045.

As a result of the issuance of this new debt, the remaining $2.1 billion of financing commitments for our bridge term loan facility automatically was terminated. The significant additional indebtedness we incurred in connection with our pending acquisition of Exelis resulted in a downgrade of our debt ratings.

On April 27, 2015, we also issued a redemption notice to redeem our entire outstanding $400 million principal amount of 5.95% Notes due December 1, 2017 at the make-whole redemption price set forth in the 5.95% Notes (estimated to be $451 million) and the entire outstanding $350 million principal amount of 6.375% Notes due June 15, 2019 at the make-whole redemption price set forth in the 6.375% Notes (estimated to be $419 million).

As noted in *Note O Pending Acquisition*, the completion of the acquisition of Exelis is subject to regulatory approval, including the receipt of antitrust clearance in the United States. Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act), and the rules promulgated thereunder, the acquisition may not be completed until notification and report forms have been filed with the Federal Trade Commission and the Department of Justice (DOJ) and the applicable waiting period (or any extensions thereof) has expired or been terminated. On April 23, 2015, we and Exelis received a second request from the DOJ for additional information and documentary material. Although this second request extends the waiting period under the HSR Act, we currently expect the closing of the acquisition to occur in June 2015, subject to customary closing conditions.

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REPORT OF INDEPENDENT REGISTERED CERTIFIED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Harris Corporation

We have reviewed the unaudited condensed consolidated balance sheet of Harris Corporation and subsidiaries as of April 3, 2015, and the related unaudited condensed consolidated statements of income and comprehensive income for the quarter and three quarters ended April 3, 2015 and March 28, 2014, and the unaudited condensed consolidated statements of cash flows for the three quarters ended April 3, 2015 and March 28, 2014. These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the unaudited condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Harris Corporation and subsidiaries as of June 27, 2014, and the related consolidated statements of income, comprehensive income, cash flows, and equity for the year then ended (not presented herein) and we expressed an unqualified opinion on those consolidated financial statements in our report dated August 25, 2014. In our opinion, the accompanying condensed consolidated balance sheet of Harris Corporation and subsidiaries as of June 27, 2014, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Orlando, Florida

May 6, 2015

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

OVERVIEW

The following Management s Discussion and Analysis (this MD&A) is intended to assist in an understanding of our financial condition and results of operations. This MD&A is provided as a supplement to, should be read in conjunction with, and is qualified in its entirety by reference to, our Condensed Consolidated Financial Statements (Unaudited) and accompanying Notes appearing elsewhere in this Report. In addition, reference should be made to our audited Consolidated Financial Statements and accompanying Notes to Consolidated Financial Statements and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Fiscal 2014 Form 10-K. Except for the historical information contained herein, the discussions in this MD&A contain forward-looking statements that involve risks and uncertainties. Our future results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below in this MD&A under Forward-Looking Statements and Factors that May Affect Future Results.

The following is a list of the sections of this MD&A, together with our perspective on their contents, which we hope will assist in reading these pages:

Results of Operations an analysis of our consolidated results of operations and of the results in each of our three business segments, to the extent the segment operating results are helpful to an understanding of our business as a whole, for the periods presented in our Condensed Consolidated Financial Statements (Unaudited). In this section of this MD&A, income from continuing operations refers to income from continuing operations attributable to Harris Corporation common shareholders.

Liquidity and Capital Resources an analysis of cash flows, common stock repurchases, dividends, capital structure and resources, off-balance sheet arrangements and commercial commitments and contractual obligations.

Critical Accounting Policies and Estimates information about accounting policies that require critical judgments and estimates and about accounting standards that have been issued, but are not yet effective for us, and their potential impact on our financial position, results of operations and cash flows.

Forward-Looking Statements and Factors that May Affect Future Results cautionary information about forward-looking statements and a description of certain risks and uncertainties that could cause our actual results to differ materially from our historical results or our current expectations or projections.

Except for disclosures related to our cash flows, or unless otherwise specified, disclosures in this MD&A relate solely to our continuing operations.

As discussed further in *Note O Pending Acquisition* in the Notes, in the third quarter of fiscal 2015, on February 6, 2015, we announced a definitive Merger Agreement under which we will acquire 100 percent of Exelis in a cash and stock transaction valued at $23.75 per share of Exelis common stock, or an approximately $4.75 billion enterprise value, based on the closing price of our common stock as of February 5, 2015. Under the terms of the transaction, Exelis shareholders will receive $16.625 in cash, without interest, and 0.1025 of a share of our common stock for each share of Exelis common stock. Upon closing, our shareholders will own approximately 85 percent of the combined company, and Exelis shareholders will own approximately 15 percent of the combined company. The Merger Agreement has been unanimously approved by the Boards of Directors of both companies. The transaction is subject to customary closing conditions, including regulatory and Exelis shareholder approval, and we currently expect the closing to occur in June 2015, although we can give no assurances regarding the timing or occurrence of closing.

In connection with entering into the Merger Agreement with Exelis, for the purpose of financing the cash consideration and other amounts payable under the terms of the Merger Agreement and paying fees and expenses associated with the merger, we entered into financing commitments for a 364-day senior unsecured bridge term loan facility in an aggregate principal amount of $3.4 billion. We subsequently entered into a new senior unsecured term loan facility in an aggregate principal amount of $1.3 billion, which correspondingly reduced the financing commitments for the bridge term loan facility from $3.4 billion to $2.1 billion. The $1.3 billion term loan facility is comprised of $650 million in

a three-year tranche and $650 million in a five-year tranche. We subsequently issued new debt securities, which automatically terminated the remaining $2.1 billion of financing commitments for the bridge facility. See *Note P Subsequent Events* in the Notes for further information.

On April 27, 2015, in connection with the pending acquisition of Exelis, to fund a portion of the cash consideration and other amounts payable under the terms of the Merger Agreement and to redeem certain of our existing notes, we issued new debt securities in an aggregate principal amount of $2.4 billion. Also, on April 27, 2015, we issued a redemption notice to redeem our entire outstanding $400 million principal amount of 5.95% Notes due December 1, 2017 at the make-whole redemption price set forth in the 5.95% Notes (estimated to be $451 million) and the entire outstanding $350 million principal amount of 6.375% Notes due June 15, 2019 at the make-whole redemption price set forth in the 6.375% Notes (estimated to be $419 million). See *Note P Subsequent Events* in the Notes for further information.

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$ 56,154 $ 15,405 $ 1,469 $ 73,028 Real estate construction 9,084 403 5 9,492

Total $ 65,238 $ 15,808 $ 1,474 $ 82,520

Loans with a predetermined interest rate $ 27,955 $ 21,233 $ 2,740 $ 51,928 Loans with a floating interest rate 17,664 10,690 2,238 30,592

Total $ 45,619 $ 31,923 $ 4,978 $ 82,520

Nonperforming Assets

The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers and also monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company s loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

Nonperforming assets at December 31, 2001, increased $1.2 million or 24.8% to $6.2 million compared with $5.0 million at December 31, 2000. This increase was primarily due to the addition of one loan in the amount of $1.0 million. A specific reserve has been assigned to this loan in an amount equal to the Company s estimated loss exposure. Nonperforming assets were $1.1 million at December 31, 1999. This resulted in ratios of nonperforming assets to total loans plus other real estate of 1.87%, 1.73% and 0.43% for the years ended December 31, 2001, 2000 and 1999, respectively.

The Company generally places a loan on nonaccrual status and ceases to accrue interest when loan payment performance is deemed unsatisfactory. Loans where the interest payments jeopardize the collection of principal are placed on nonaccrual status, unless the loan is both well secured and in the process of collection. Cash payments received while a loan is classified as nonaccrual are recorded as a reduction of principal as long as doubt exists as to collection. If interest on nonaccrual loans had been accrued, such income would have been approximately $251,000 and $113,000 for 2001 and 2000, respectively. The Company is sometimes required to revise a loan s interest rate or repayment terms in a troubled debt restructuring; however, the Company had no restructured loans or additional nonperforming interest-earning assets at either December 31, 2001, December 31, 2000 or December 31, 1999. In addition to an internal loan review, the Company retains IBS for an annual external review to evaluate the loan portfolio.

The Company maintains current appraisals on loans secured by real estate, particularly those categorized as nonperforming loans and potential problem loans. In instances where updated appraisals reflect reduced collateral values, an evaluation of the borrower s overall financial condition is made to determine the need, if any, for possible write-downs or appropriate additions to the allowance for loan losses. The Company records other real estate at fair value at the time of acquisition, less estimated costs to sell.

The following table presents information regarding nonperforming assets at the dates indicated:

	December 31,				
	2001	2000	1999	1998	1997
	(Dollars in thousands)				
Nonaccrual loans	$3,737	$1,214	$ 443	$ 290	$ 298
Accruing loans past due 90 days or more	1,912	3,488	574	866	918
Other real estate	562	274	79	97	714
Total nonperforming assets	$6,211	$4,976	$1,096	$1,253	$1,930
Nonperforming assets to total loans and other real estate	1.87%	1.73%	0.43%	0.67%	1.22%

The Company considers a loan to be impaired based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is based on the present value of expected future cash flows discounted at the loan s effective interest rate or the loan s observable market price or based on the fair value of the collateral if the loan is collateral-dependent.

Allowance for Loan Losses

The allowance for loan losses is a reserve established through charges to earnings in the form of a provision for loan losses. Management has established an allowance for loan losses, which it believes, is adequate for estimated losses in the Company s loan portfolio. Based on an evaluation of the loan portfolio, management presents a quarterly review of the allowance for loan losses to the Company s Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers the diversification by industry of the Company s commercial loan portfolio, the effect of changes in the local real estate market on collateral values, the results of recent regulatory examinations, the effects on the loan portfolio of current economic indicators and their probable impact on borrowers, the amount of charge-offs for the period, the amount of nonperforming loans and related collateral security, the results of Managements internal loan review, the evaluation of its loan portfolio through an annual external loan review conducted by IBS and the annual examination of the Company s financial statements by its independent auditors. Charge-offs occur when loans are deemed to be uncollectible.

The Company follows an internal loan review program to evaluate the credit risk in the loan portfolio. Through the loan review process, the Company maintains an internally classified loan list, which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for loan losses. Loans internally classified as substandard or in the more severe categories of doubtful or loss are those loans that, at a minimum, have clear and defined weaknesses such as a highly-leveraged position, unfavorable financial ratios, uncertain repayment sources or poor financial condition, which may jeopardize recoverability of the debt. At December 31, 2001, the Company had $13.0 million of such loans compared with $9.6 million at December 31, 2000, an increase of $3.4 million, or 35.4%. This increase is primarily due to the classification of one $1.7 million loan relationship and seven smaller loan relationships ranging from $200,000 to $500,000. Specific reserves have been established based on the estimated exposure on these lines. Further, a more conservative problem asset identification process was implemented during 2001 whereas all loans past due greater than 60 days are automatically added to the classified loan list unless the servicing loan officer provides written justification for removal.

In addition to the internally classified loan list and delinquency list of loans, the Company maintains a separate watch list which further aids the Company in monitoring loan portfolios. Watch list loans show warning elements where the present status portrays one or more deficiencies that require attention in the short term or where pertinent ratios of the loan account have weakened to a point where more frequent monitoring is warranted. These loans do not have all of the characteristics of a classified loan (substandard or doubtful) but do show weakened elements as compared with those of a satisfactory credit. The Company reviews these loans to assist in assessing the adequacy of the allowance for loan losses. At December 31, 2001, the Company had $2.3 million of such loans compared with $2.2 million at December 31, 2000, an increase of $100,000, or 4.5%.

In order to determine the adequacy of the allowance for loan losses, the Company establishes both specific and general reserves. The Company establishes specific allocations for the majority of problem loans based on the estimated exposure in each individual loan. The exposure is generally identified by determining the present value of estimated future cash flows or the fair value of collateral if repayment is expected solely from the collateral. The Company establishes general reserves for non-problem loans primarily based on its historical charge-off experience. Consideration is also given to the level and trend of delinquent loans, loan growth, underwriting standards, economic conditions, and other qualitative factors based on management s judgment. During 2001, significant enhancements were made to the allowance methodology to better quantify these internal and external factors, resulting in an increase to general reserves of $439,000 compared to 2000.

Management actively monitors the Company s asset quality and provides specific loss allowances when necessary. Loans are charged-off against the allowance for loan losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

For the twelve months ended December 31, 2001, net loan charge-offs totaled $617,000 or 0.20% of average loans outstanding for the period, compared with $508,000 in net loan charge-offs or 0.19% of average loans for the year ended December 31, 2000. During 2001, the Company recorded a provision for loan losses of $1.4 million compared with $595,000 for 2000. The increase in provision for 2001 is due primarily to loan growth, an increase in problem assets, and the current economic conditions. The Company made a provision for loan losses of $310,000 for 1999. At December 31, 2001, the allowance for loan losses totaled $3.3 million, or 1.01% of total loans. At December 31, 2000, the allowance for loan losses totaled $2.6 million or 0.90% of total loans.

The following table presents, for the periods indicated, an analysis of the allowance for loan losses and other related data:

	Years Ended December 31,				
	2001	**2000**	**1999**	**1998**	**1997**
	(Dollars in thousands)				
Average loans outstanding	$ 302,656	$ 267,996	$ 213,737	$ 169,754	$ 146,061
Gross loans outstanding at end of period	$ 331,255	$ 287,335	$ 255,209	$ 185,886	$ 157,395
Allowance for loan losses at beginning of period	$ 2,578	$ 2,491	$ 1,512	$ 1,129	$ 1,055
Provision for loan losses	1,385	595	310	540	355
Balance acquired with First American acquisition			846		
Charge-offs:					
Commercial and industrial	(462)	(360)	(64)	(113)	(53)
Real estate	(162)	(146)	(2)	(14)	(170)
Consumer	(211)	(172)	(267)	(149)	(162)
Recoveries:					

	Years Ended December 31,				
Commercial and industrial	30	80	65	33	65
Real estate	124	11	42	26	13
Consumer	64	79	49	60	26
Net loan charge-offs	(617)	(508)	(177)	(157)	(281)
Allowance for loan losses at end of period	$ 3,346	$ 2,578	$ 2,491	$ 1,512	$ 1,129
Ratio of allowance to end of period loans	1.01%	0.90%	0.98%	0.81%	0.72%
Ratio of net loan charge-offs to average loans	0.20%	0.19%	0.08%	0.09%	0.19%
Ratio of allowance to end of period nonperforming loans	59.23%	54.83%	244.94%	130.80%	92.85%

The following tables describe the allocation of the allowance for loan losses among various categories of loans and certain other information for the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of loans.

	December 31,			
	2001		2000	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
	(Dollars in thousands)			
Balance of allowance for loan losses applicable to:				
Commercial, industrial and agriculture	$1,792	22.71%	$1,430	26.07%
Real estate:				
Construction and land development		2.87		2.55
1-4 family residential	117	38.07	139	35.71
Commercial mortgage	138	20.58	193	21.31
Farmland		2.96		2.69
Multi-family		2.81		1.72
Consumer	333	10.00	289	9.95
General reserve allocation	966		527	
Total allowance for loan losses	$3,346	100.00%	$2,578	100.00%

	1999		1998		1997	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
	(Dollars in thousands)					
Balance of allowance for loan losses						

applicable to:						
Commercial, industrial and agriculture	$1,543	27.53%	$ 932	31.86%	$ 554	28.45%
Real estate:						
Construction and land development		3.11		1.68		1.95
1-4 family residential	110	32.83	67	26.02	58	26.30
Commercial mortgage	176	20.49	145	25.81	128	26.92
Farmland		3.13		3.90		4.12
Multi-family		2.44		0.45		0.23
Consumer	262	10.47	166	10.28	171	12.03
General reserve allocation	400		202		218	
Total allowance for loan losses	$2,491	100.00%	$1,512	100.00%	$1,129	100.00%

Securities

The Company uses its securities portfolio to ensure liquidity for cash requirements, to manage interest rate risk, to provide a source of income, to ensure collateral is available for municipal pledging requirements and to manage asset quality. At December 31, 2001, investment securities totaled $81.7 million, an increase of $95,000 from $81.6 million at December 31, 2000. The increase was primarily attributable to a decrease in book value or amortized cost of $490,000, offset by an increase in net unrealized gain on securities available for sale of $585,000. The December 31, 2000 net unrealized gain was $700,000 compared to the December 31, 2001 net unrealized gain of $1.3 million. During 2000, securities increased approximately $1.8 million from $79.8 million at December 31, 1999 to $81.6 million at December 31, 2000. The increase was primarily attributable to the change in unrealized gain or loss on securities available for sale. At December 31, 2001, investment securities represented 17.7% of total assets compared to 19.9% of total assets at December 31, 2000. The yield on the investment portfolio for the year ended December 31, 2001, was 6.21% compared to a yield of 6.58% for the year ended December 31, 2000.

During 2001, the total securities portfolio reflects a slight increase while the portfolio mix changed within various categories. U.S. Government securities decreased from $26.2 million at December 31, 2000 to $4.5 million at December 31, 2001 as securities that matured or were called were not reinvested in the same type of security. The Company continues to hold Collateralized Mortgage Obligations (CMO s) in its securities portfolio. A CMO is collateralized directly by mortgages or by mortgage-backed securities issued by government agencies. The Company s investment in CMO s increased from $18.0 million at December 31, 2000 to $34.4 million at December 31, 2001, an increase of $16.4 million or 90.6%. The Company also had an increase of $7.4 million in mortgage-backed securities from $26.6 million at December 31, 2000 to $34.0 million at December 31, 2001.

The following table summarizes the amortized cost of investment securities held by the Company as of the dates shown:

	December 31,		
	2001	**2000**	**1999**
	(Dollars in thousands)		
U.S. Treasury securities	$	$	$ 993
U.S. Government securities	4,208	25,900	25,859
Mortgage-backed securities	33,600	26,482	31,610
CMOs	33,920	17,973	17,451
Equity securities	2,112	1,705	1,420
State and municipal securities	6,590	8,860	3,602

	December 31,		
Total securities	$80,430	$80,920	$80,935

The following table summarizes the contractual maturity of investment securities on an amortized cost basis and their weighted average yields as of December 31, 2001:

	December 31, 2001									
	Within One Year		After One Year but Within Five Years		After Five Years but Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
U.S. Treasury securities	$	%	$	%	$	%	$	%	$	%
U.S. Government securities			3,206	6.50	1,002	7.20			4,208	6.67
Mortgage-backed securities			6,744	6.17	4,422	6.60	22,434	5.59	33,600	5.84
CMOs					2,264	6.18	31,656	5.58	33,920	5.62
Equity securities							2,112	3.78	2,112	3.78
State and municipal securities	130	4.81	625	5.05	3,229	5.27	2,606	5.38	6,590	5.28
Totals	$130	4.81%	$10,575	6.21%	$10,917	6.17%	$58,808	5.51%	$80,430	5.70%

The Company classifies debt and equity securities at the date of purchase into one of two categories: held-to-maturity, or available-for-sale. At each reporting date, the appropriateness of the classification is reassessed. Investments in debt securities are classified as held-to-maturity and measured at amortized cost in the financial statements only if management has the positive intent and ability to hold those securities to maturity. Investments not classified as held-to-maturity are classified as available-for-sale and measured at fair value in the financial statements with unrealized gains and losses reported, net of tax, in a separate component of shareholders equity until realized.

The following table summarizes the carrying value and classification of securities as of the dates shown:

	December 31,		
	2001	2000	1999
	(Dollars in thousands)		
Available-for-sale	$81,715	$81,620	$79,761
Held-to-maturity			
Total securities	$81,715	$81,620	$79,761

The following table summarizes the amortized cost of securities classified as available-for-sale and their approximate fair value as of the dates shown

	December 31, 2001				December 31, 2000			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
	(Dollars in thousands)				(Dollars in thousands)			
U.S. Treasury securities	$	$	$	$	$	$	$	$
U.S. Government securities	4,208	286		4,494	25,900	370	86	26,184
Mortgage-backed securities	33,600	374	22	33,952	26,482	200	80	26,602
CMOs	33,920	494	24	34,390	17,973	83	14	18,042
Equity securities	2,112			2,112	1,705			1,705
State and municipal securities	6,590	177		6,767	8,860	251	24	9,087
Total	$80,430	$1,331	$46	$81,715	$80,920	$904	$204	$81,620

	December 31, 1999			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
	(Dollars in thousands)			
U.S. Treasury securities	$ 993	$	$ 6	$ 987
U.S. Government securities	25,859	6	649	25,216
Mortgage-backed securities	31,610	35	388	31,257
CMOs	17,451	55	141	17,365
Equity securities	1,420			1,420
State and municipal securities	3,602	13	99	3,516
Total	$80,935	$109	$1,283	$79,761

Mortgage-backed securities and CMO s are securities, which have been developed by pooling a number of real estate mortgages and are principally issued by or guaranteed by federal agencies such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. These securities are deemed to have high credit ratings and regular monthly cash flows of principal and interest, which are guaranteed by the issuing agencies. All the Company s mortgage-backed securities at December 31, 2001 were agency-issued collateral obligations.

At December 31, 2001, 80.1% of the mortgage-backed and CMO securities held by the Company had final maturities of more than 10 years. However, unlike U.S. Treasury and U.S. Government agency securities, which have a lump sum payment at maturity, mortgage-backed and CMO securities provide cash flows from regular principal and interest payments and principal prepayments throughout the lives of the securities. Therefore, the average life, or the average amount of time until the Company receives the total amount invested, of the mortgage-backed or CMO security will be shorter than the contractual maturity. The Company estimates the remaining average life of the fixed-rate mortgage-backed and CMO security portfolio to be less than five years. These securities, when purchased at a premium, will generally suffer decreasing net yields as interest rates drop because homeowners tend to refinance their mortgages. Thus, the premium paid must be amortized over a shorter

period. Therefore, securities when purchased at a discount will obtain higher net yields in a decreasing interest rate environment. As interest rates rise, the opposite will generally be true. During a period of increasing interest rates, fixed rate mortgage-backed and CMO securities do not tend to experience heavy prepayments of principal and consequently, the average lives of these securities will not be unduly shortened. Approximately $34.3 million of the Company s mortgage-backed and CMO securities earn interest at floating rates and reprice within one year, and accordingly are less susceptible to declines in value should interest rates increase.

Premises and Equipment

Premises and equipment totaled $13.6 million at December 31, 2001 and $13.5 million at December 31, 2000. The net change reflects an increase of $84,000 million or 0.6% in fixed assets. The increase is primarily due to the major remodeling of the Commerce location, the purchase of a bank facility for the Fort Stockton location, and the purchase of additional furniture and computer hardware for the Company offset by additional accumulated depreciation recorded for the year.

Other Assets

On July 1, 1998, the Company invested $3.1 million in single insurance premium policies. Such policies insured the lives of certain key senior officers. As of December 31, 2001, the net surrender values of these policies totaled $4.2 million. The Company also recorded a receivable of $3.0 million as of December 31, 2001 reflecting the pending settlement of its lawsuit against Guaranty Federal.

Deposits

The Company offers a variety of deposit accounts having a wide range of interest rates and terms. The Company s deposit accounts consist of demand, savings, money market and time accounts. The Company relies primarily on competitive pricing policies and customer service to attract and retain these deposits. The Company does not have or accept any brokered deposits.

Total deposits at December 31, 2001, increased to $383.3 million from $358.3 million at December 31, 2000, an increase of $25.0 million or 7.0%. Noninterest-bearing deposits increased from $55.3 million at December 31, 2000 to $63.7 million at December 31, 2001, an increase of $8.4 million or 15.2%. Certificates of deposit increased from $201.5 million at December 31 2000, to $213.5 million at December 31, 2001, an increase of $12.0 million or 6.0%. Other interest-bearing deposits increased from $101.5 million at December 31, 2000 to $106.0 million at December 31, 2001, an increase of $4.5 million or 4.4%. The increase in deposits is due to a generally increasing customer base across most of the Company s market areas. The Paris and Commerce locations reflected the largest increases in deposits, combining for a $12.6 million or 16.8% increase. Pittsburg, Sulphur Springs, and the main location in Mt. Pleasant combined for an $8.0 million or 3.6% increase, while the remaining locations showed more modest gains. Only one location showed a decline in deposits. Management feels that the majority of the locations will continue to gain market share as the Company becomes better known in their respective markets. In 2000, deposits rose to $358.3 million from $328.6 million, in 1999, an increase of $29.6 million or 9.0%. This increase is primarily attributable to an increase of $20.3 million in certificates of deposit and a $5.0 million increase in public funds. The Company s ratio of average noninterest-bearing demand deposits to average total deposits for years ended December 31, 2001, 2000, and 1999, were 15.0%, 15.8%, and 18.0%, respectively.

The daily average balances and weighted-average rates paid on deposits for each of the years ended December 31, 2001, 2000 and 1999 are presented below:

	Years Ended December 31,

	Years Ended December 31,					
	2001		2000		1999	
	(Dollars in thousands)					
	Amount	Rate	Amount	Rate	Amount	Rate
Regular savings	$ 10,084	1.97%	$ 9,497	2.50%	$ 8,427	2.50%
NOW accounts	33,992	2.09	31,678	2.96	24,214	2.49
Money market checking	60,524	2.96	56,153	5.10	42,228	4.15
Time deposits less than $100,000	125,236	5.62	115,198	5.74	89,889	5.03
Time deposits $100,000 and over	88,603	5.75	78,277	5.98	62,065	5.16
Total interest-bearing deposits	$318,439	4.66%	$290,803	5.27%	$226,823	4.54%
Noninterest-bearing deposits	56,127		54,539		49,702	
Total deposits	$374,566	3.96%	$345,342	4.44%	$276,525	3.72%

The following table sets forth the amount of the Company s certificates of deposit that are $100,000 or greater by time remaining until maturity:

	December 31, 2001
	(Dollars in thousands)
3 months or less	$33,496
Over 3 months through 6 months	13,035
Over 6 months through 1 year	32,064
Over 1 year	9,994
Total	$88,589

Other Borrowings

Federal Home Loan Bank (FHLB) advances may be utilized from time to time as either a short-term funding source or a longer-term funding source. FHLB advances can be particularly attractive as a longer-term funding source to balance interest rate sensitivity and reduce interest rate risk. The Company is eligible for two borrowing programs through the FHLB. The first, called Short Term Fixed, requires delivery of eligible securities for collateral. Maturities under this program range from 1-35 days. The Company does not currently have any borrowings under this program. As of December 31, 2001, the Company does not have any of its investment securities in safekeeping at the FHLB.

The second borrowing program, the Blanket Borrowing Program, is under a borrowing agreement which does not require the delivery of specific collateral. Borrowings are limited by the level of qualified, pledgable real estate loans held and FHLB stock owned. At December 31, 2001, the Company had approximately $33.1 million borrowed of a potential $133.1 million available under this program, leaving approximately $100.0 million in available borrowings.

On March 23, 2000, the Company, in a private placement, issued $7.0 million (7,000 shares with a liquidation amount of $1,000 per security) of 10.875% Fixed Rate Capital Trust Pass-through Securities (TruPS) through a newly formed, wholly-owned subsidiary, Guaranty (TX) Capital Trust I (the Trust). The Trust invested the total proceeds from the sale of the TruPS in 10.875% Junior Subordinated Deferrable Interest Debentures (the Debentures) issued by the Company. The net proceeds from the sale of the Debentures will be used to buy back shares of the Company s stock, provide a $1.5 million additional capital contribution to Guaranty Bank and provide for additional working capital to support growth.

With certain exceptions, the amount of the principal and any accrued and unpaid interest on the Debentures are subordinated in right of payment to the prior payment in full of all senior indebtedness of the Company. The terms of the Debentures are such that they qualify as Tier I capital under the Federal Reserve Board s regulatory capital guidelines applicable to bank holding companies. Interest on the Debentures is payable semi-annually on March 8 and September 8 of each year, commencing September 8, 2000. The interest is deferrable on a cumulative basis for up to five consecutive years following a suspension of dividend payments on all other capital stock. No principal payments are due until maturity on March 8, 2030.

On any March 8 or September 8 on or after March 8, 2010 and prior to maturity, the Debentures are redeemable for cash at the option of the Company, on at least 30 but not more than 60 days notice, in whole or in part, at the redemption prices set forth in the table below, plus accrued interest to the date of redemption.

If Redeemed During 12 Months Beginning March 8,	**Percentage of Principal Amount**	**If Redeemed During 12 Months Beginning March 8,**	**Percentage of Principal Amount**
2010	105.44	2016	102.18%
2011	104.89	2017	101.63%
2012	104.35	2018	101.09%
2013	103.81	2019	100.54%
2014	103.26	2020 and after	100.00%
2015	102.72		

Upon the occurrence of certain special events, the Company will have the right to call the securities at par at any time with the permission of the Federal Reserve.

Fair Values of Financial Instruments

The estimated fair value approximates carrying value for financial instruments except those described below:

Securities: Fair values for securities are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar instruments.

Loans: The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality.

Deposits: The fair value of deposit liabilities with defined maturities and long-term debt is estimated by discounting future cash flows using the interest rates currently offered for deposits or similar borrowings of similar remaining maturities.

Off-Balance-Sheet Instruments: The fair values of these items are not material and are therefore not included on the following schedule.

The estimated year-end fair values of financial instruments are detailed in the following table. The fair value of financial instruments is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

	2001	**2000**

	2001		2000	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in thousands)			
Financial assets:				
Cash and cash equivalents	$ 15,410	$ 15,410	$ 10,212	$ 10,212
Federal funds sold	4,395	4,395	4,995	4,995
Securities available for sale	81,715	81,715	81,620	81,620
Loans, net	327,909	331,073	284,757	290,182
Accrued interest receivable	3,167	3,167	3,742	3,742
Cash surrender value of life insurance	5,178	5,178	4,946	4,946
Financial liabilities:				
Deposits	$383,279	$378,641	$358,265	$358,916
FHLB advances	33,092	32,692	12,403	12,403
Long-term debt	7,000	7,663	7,000	7,000
Accrued interest payable	1,383	1,383	1,752	1,752

While these estimates of fair value are based on management s judgment of appropriate factors, there is no assurance that, were the Company to have disposed of such items at December 31, 2001 and 2000, the estimated fair values would necessarily have been achieved at those dates, since market values may differ depending on various circumstances. The estimated fair values at December 31, 2001 and 2000 should not necessarily be considered to apply at subsequent dates.

In addition, other assets, such as property and equipment, and liabilities of the Company that are not defined as financial instruments are not included in the above disclosures. Also, nonfinancial instruments typically not recognized in financial statements nevertheless may have value but are not included in the above disclosures. These include, among other items, the estimated earning power of core deposit accounts, the trained work force, customer goodwill and similar items.

Capital Resources and Liquidity

Capital management consists of providing equity to support both current and future operations. The Company is subject to capital adequacy requirements imposed by the Federal Reserve and the Bank is subject to capital adequacy requirements imposed by the FDIC and the TDB. Both the Federal Reserve and the FDIC have adopted risk-based capital requirements for assessing bank holding company and bank capital adequacy. These standards define capital and establish minimum capital requirements in relation to assets and off-balance sheet exposure, adjusted for credit risk. The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profiles among bank holding companies and banks, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Assets and off-balance sheet items are assigned to broad risk categories, each with appropriate relative risk weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items.

The risk-based capital standards issued by the Federal Reserve require all bank holding companies to have Tier 1 capital of at least 4.0% and total risk-based capital (Tier 1 and Tier 2) of at least 8.0% of total risk-adjusted assets. Tier 1 capital generally includes common shareholders equity and qualifying perpetual preferred stock together with related surpluses and retained earnings, less deductions for goodwill and various other intangibles. Tier 2 capital may consist of a limited amount of intermediate-term preferred stock, a limited amount of term subordinated debt, certain hybrid capital instruments and other debt securities, perpetual preferred stock not qualifying as Tier 1 capital, and a limited amount of the general valuation allowance for loan losses. The sum of Tier 1 capital and Tier 2 capital is total risk-based capital .

The Federal Reserve has also adopted guidelines which supplement the risk-based capital guidelines with a minimum ratio of Tier 1 capital to average total consolidated assets (leverage ratio) of 3.0% for certain institutions with well diversified risk, including no undue interest rate exposure; excellent asset quality; high liquidity; good earnings; and that are generally considered to be strong banking organizations, rated composite 1 under applicable federal guidelines, and that are not experiencing or anticipating significant growth. Other banking organizations are required to maintain a leverage ratio of at least 4.0% to 5.0%. These rules further provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain capital positions substantially above the minimum supervisory levels and comparable to peer group averages, without significant reliance on intangible assets.

Pursuant to FDICIA, each federal banking agency revised its risk-based capital standards to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities, as well as reflect the actual performance and expected risk of loss on multifamily mortgages. The Bank is subject to capital adequacy guidelines of the FDIC that are substantially similar to the Federal Reserve s guidelines. Also pursuant to FDICIA, the FDIC has promulgated regulations setting the levels at which an insured institution such as the Bank would be considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The Bank is classified well capitalized for purposes of the FDIC s prompt corrective action regulations. **See Supervision and Regulation The Company and " The Bank** .

Shareholders equity increased to $31.8 million at December 31, 2001, from $29.4 million at December 31, 2000, an increase of $2.4 million or 8.2%. This increase was primarily the result of net earnings of $3.3 million and the net change in unrealized gain on available-for-sale securities of $386,000, offset by the payment of common stock dividends of $841,000 and the purchase of treasury stock of $433,000. During 2000, shareholders equity increased by $929,000 or 3.3%, from $28.5 million at December 31, 1999. The increase was primarily the result of net income of $2.5 million and the net change in unrealized gain on available-for-sale securities of $1.2 million, offset by the payment of common stock dividends of $769,000 and the purchase of treasury stock of $2.0 million.

The following table provides a comparison of the Company s and the Bank s leverage and risk-weighted capital ratios as of December 31, 2001 to the minimum and well-capitalized regulatory standards:

	Minimum Required	To Be Well Capitalized Under Prompt Corrective Action Provisions	Actual Ratio at December 31, 2001
The Company			
Leverage ratio	4.00%(1)	N/A	8.44%
Tier 1 risk-based capital ratio	4.00%	N/A	11.52%
Risk-based capital ratio	8.00%	N/A	12.58%
The Bank			
Leverage ratio	3.00%(2)	5.00%	8.25%
Tier 1 risk-based capital ratio	4.00%	6.00%	10.83%
Risk-based capital ratio	8.00%	10.00%	11.85%

(1) The Federal Reserve may require the Company to maintain a leverage ratio of up to 100 basis points above the required minimum.

(2) The FDIC may require the Bank to maintain a leverage ratio of up to 100 basis points above the required minimum.

Liquidity involves the Company s ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate the Company on an ongoing basis. The Company s liquidity needs are met primarily by financing activities, which consisted mainly of growth in core deposits, supplemented by investment securities and earnings through operating activities. Although access to purchased funds from correspondent banks is available and has been utilized on occasion to take advantage of investment opportunities, the Company does not generally rely on these external funding sources. The cash and federal funds sold position, supplemented by amortizing investments along with payments and maturities within the loan portfolio, have historically created an adequate liquidity position.

The Company s capital ratios are greater than the minimums required by regulatory guidelines. The Company intends to maintain an optimal capital and leverage mix. At December 31, 2001, the Company and the Bank had the requisite capital levels to qualify as well capitalized.

The Company s liquidity management objective is to meet maturing debt obligations, fund loan commitments and deposit withdrawals, and manage operations on a cost effective basis. Management believes that sufficient resources are available to

meet the Company s liquidity objective through its debt maturity structure, holdings of liquid assets, and access to the capital markets through a variety of funding vehicles. Proper liquidity management is crucial to ensure that the Company is able to take advantage of new business opportunities as well as meet the demands of its customers.

The Bank s traditional funding sources consist primarily of core deposits, established federal funds lines with major banks, proceeds from matured investments, contracts to repurchase investment securities and principal and interest repayments on loans.

Management is not aware of any events that are reasonably likely to have a material negative effect on the Company s liquidity, capital resources or operations. In addition, management is not aware of any regulatory recommendations regarding liquidity, which if implemented, would have a material negative effect on the Company.

Industry Segments

The principal business of the Company is overseeing the business of the Bank. The Company has no significant assets other than its investment in the Bank, therefore, the banking operation is the Company s only reportable segment.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board issued two statements SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*, which will potentially impact the Company s accounting for its reported goodwill and other intangible assets.

SFAS 141:

- Eliminates the pooling method for accounting for business combinations.
- Requires that intangible assets that meet certain criteria be reported separately from goodwill.
- Requires negative goodwill arising from a business combination to be recorded as an extraordinary gain.

SFAS 142:

- Eliminates the amortization of goodwill and other intangibles that are determined to have an indefinite life.
- Requires, at a minimum, annual impairment tests for goodwill and other intangible assets that are determined to have an indefinite life.

In the year ended December 31, 2001, 2000, and 1999, the Company recorded goodwill amortization expense of $150,000, $175,000 and $150,000. In accordance with the new standards, recorded goodwill with the carrying amount of $2,338,000 at December 31, 2001 will no longer be subject to amortization beginning in fiscal year 2002. Management believes that at January 1, 2002, there is no impairment of recorded goodwill.

Also in July 2001, the Financial Accounting Standards Board issued SFAS 143, *Accounting for Asset Retirement Obligations.* SFAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. SFAS 143, if applicable, will be adopted by the Company upon its required effective date, for its fiscal year ended December 31, 2002.

In August 2001, the Financial Accounting Standards Board issued SFAS 144, *Accounting for the Impairment or Disposition of Long-Lived Assets.* SFAS 144 requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and by broadening the presentation of discounted operations to include

primarily all disposal transactions. It further establishes criteria to determine when a long-lived asset is held for sale and establishes measurement criteria at the asset s or group of assets lower of unamortized cost or fair value at the date the asset is reclassified as held and used. SFAS 144, if applicable, will be adopted by the Company upon its required effective date, for its fiscal year ended December 31, 2002.

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Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk.***

The Company s Asset Liability and Funds Management Policy provides management with the necessary guidelines for effective funds management, and the Company has established a measurement system for monitoring its net interest rate sensitivity position. The Company manages its sensitivity position within established guidelines.

Interest rate risk is managed by the Asset Liability Committee (ALCO), which is composed of senior officers of the Company, in accordance with policies approved by the Company s Board of Directors. The ALCO formulates strategies based on appropriate levels in interest rate risk. In determining the appropriate level of interest rate risk, the ALCO considers the impact on earnings and capital based on the current outlook on interest rates, potential changes in interest rates, regional economies, liquidity, business strategies, and other factors. The ALCO meets regularly to review, among other things, the sensitivity of assets and liabilities to interest rate changes, the book and market values of assets and liabilities, unrealized gains and losses, purchase and sale activity, commitments to originate loans, and the maturities of investments and borrowings. Additionally, the ALCO reviews liquidity, cash flow flexibility, maturities of deposits and consumer and commercial deposit activity. Management uses two methodologies to manage interest rate risk: (i) an analysis of relationships between interest-earning assets and interest-bearing liabilities; and (ii) an interest rate shock simulation model. The Company has traditionally managed its business to reduce its overall exposure to changes in interest rates, however, under current policies of the Company s Board of Directors, management has been given some latitude to increase the Company s interest rate sensitivity position within certain limits if, in management s judgment, it will enhance profitability. As a result, changes in market interest rates may have a greater impact on the Company s financial performance in the future than they have had historically.

To effectively measure and manage interest rate risk, the Company uses an interest rate shock simulation model to determine the impact on net interest income under various interest rate scenarios, balance sheet trends and strategies. From these simulations, interest rate risk is quantified and appropriate strategies are developed and implemented. In addition to the simulation model, the ALCO monitors an interest rate shock report that shocks rates plus and minus 200 basis points to ensure a satisfactory liquidity position for the Company. At December 31, 2001, the Company would experience a change in net earnings of $(968,000) in a minus 200 basis point shock and $123,000 in a plus 200 basis point shock. Additionally, duration and market value sensitivity measures are utilized when they provide added value to the overall interest rate risk management process. The overall interest rate risk position and strategies are reviewed by the Company s Board of Directors on an ongoing basis. The Company manages its exposure to interest rates by structuring its balance sheet in the ordinary course of business. The Company does not currently enter into instruments such as leveraged derivatives, structured notes, interest rate swaps, caps, floors, financial options, financial futures contracts or forward delivery contracts for the purpose of reducing interest rate risk.

An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. The management of interest rate risk is performed by analyzing the maturity and repricing relationships between interest-earning assets and interest-bearing liabilities at specific points in time (GAP) and by analyzing the effects of interest rate changes on net interest income over specific periods of time by projecting the performance of the mix of assets and liabilities in varied interest rate environments. Interest rate sensitivity reflects the potential effect on net interest income of a movement in interest rates. A company is considered to be asset sensitive, or having a positive GAP, when the amount of its interest-earning assets maturing or repricing within a given period exceeds the amount of its interest-bearing liabilities also maturing or repricing within that time period. Conversely, a company is considered to be liability sensitive, or having a negative GAP, when the amount of its interest-bearing liabilities maturing or repricing within a given period exceeds the amount of its interest-earning assets also maturing or repricing within that time period. During a period of rising interest rates, a negative GAP would tend to affect net interest income adversely, while a positive GAP would tend to result in an increase in net interest income. During a period of falling interest rates, a negative GAP would tend to result in an increase in net interest income, while a positive GAP would tend to affect net interest income adversely. However, it is management s intent to achieve a proper balance so that incorrect rate forecasts should not have a significant impact on earnings.

The following table sets forth an interest rate sensitivity analysis for the Company at December 31, 2001:

	Volumes Subject to Repricing Within						
	0-30 days	31-180 days	181-365 days	1-3 years	3-5 years	Greater than 5 years	Total
	(Dollars in thousands)						
Interest-earning assets:							
Securities	$ 150	$ 115	$	$ 5,362	$ 5,793	$70,295	$ 81,715
Loans	60,312	58,756	43,492	82,211	59,229	27,255	331,255
Federal funds sold	4,395						4,395
Total interest-earning assets	64,857	58,871	43,492	87,573	65,022	97,550	417,365
Interest-bearing liabilities:							
NOW, money market and savings deposits	106,033						106,033
Certificates of deposit and other time deposits	22,672	84,314	81,121	20,548	4,718	147	213,520
Borrowed funds	27	134	10,160	641	20,641	8,489	40,092
Total interest-bearing liabilities	128,732	84,448	91,281	21,189	25,359	8,636	359,645
Period GAP	$(63,875)	$(25,577)	$(47,789)	$ 66,384	$ 39,663	$88,914	$ 57,720
Cumulative GAP	$(63,875)	$(89,452)	$(137,241)	$(70,857)	$(31,194)	$57,720	
Period GAP to total assets	(13.87)%	(5.55)%	(10.38)%	14.42%	8.61%	19.31%	
Cumulative GAP to total assets	(13.87)%	(19.42)%	(29.80)%	(15.39)%	(6.77)%	12.53%	
Cumulative interest-earning assets to cumulative interest-bearing liabilities	50.38%	58.04%	54.92%	78.24%	91.11%	116.05%	

The Company s one-year cumulative GAP position at December 31, 2001, was negative $137.2 million or 31.75% of assets. This is a one-day position that is continually changing and is not indicative of the Company s position at any other time. While the GAP position is a useful tool in measuring interest rate risk and contributes toward effective asset and liability management, it is difficult to predict the effect of changing interest rates solely on that measure, without accounting for alterations in the maturity or repricing characteristics of the balance sheet that occur during changes in market interest rates. For example, the GAP position reflects only the prepayment assumptions pertaining to the current rate environment. Assets tend to prepay more rapidly during periods of declining interest rates than during periods of rising interest rates. Because of this and other risk factors not contemplated by the GAP position, an institution could have a matched GAP position in the current rate environment and still have its net interest income exposed to increased rate risk. To better qualify and account for the variables not incorporated into GAP analysis, the Company utilizes an interest rate simulation model as discussed previously. The Company maintains a Rate Committee and the ALCO that reviews the Company s interest rate risk position on a weekly or monthly basis, respectively.

Item 8. ***Financial Statements and Supplementary Data***

The financial statements, the reports thereon, the notes thereto and supplementary data commence at page F-1 of this Annual Report on Form 10-K.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

Information on the change in accountant of the Company reported in a Current Report on Form 8-K/A filed February 25, 2001, is incorporated herein by reference.

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

The information under the captions Election of Directors, Continuing Directors and Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance in the Company s definitive Proxy Statement relating to its 2002 Annual Meeting of Shareholders (the 2002 Proxy Statement), which will be filed within 120 days after December 31, 2001, is incorporated herein by reference in response to this item.

Item 11. ***Executive Compensation***

The information under the caption Executive Compensation and Other Matters in the 2002 Proxy Statement, which will be filed within 120 days after December 31, 2001, is incorporated herein by reference in response to this item.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management***

The information under the caption Beneficial Ownership of Common Stock by Management of the Company and Principal Shareholders in the 2002 Proxy Statement, which will be filed within 120 days after December 31, 2001, is incorporated herein by reference in response to this item.

Item 13. ***Certain Relationships and Related Transactions***

The information under the caption Interests of Management and Others in Certain Transactions in the 2002 Proxy Statement, which will be filed within 120 days after December 31, 2001, is incorporated herein by reference in response to this item.

PART IV

Item 14. ***Exhibits, Financial Statement Schedules, and Reports on Form 8-K***

Consolidated Financial Statements and Schedules

Reference is made to the Financial Statements, the reports thereon, the notes thereto and supplementary data commencing at page F-1 of this Annual Report on Form 10-K. Set forth below is a list of such Financial Statements:

Independent Auditors Report
Consolidated Balance Sheets as of December 31, 2001 and 2000
Consolidated Statements of Earnings for the Years Ended December 31, 2001, 2000 and 1999

Consolidated Statements of Shareholders Equity for the Years Ended
December 31, 2001, 2000 and 1999
Consolidated Statements of Cash Flows for the Years Ended December 31, 2001, 2000 and 1999
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.

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Exhibit Number	Description
2.1	Agreement and Plan of Reorganization dated as of April 23, 1999 between First American Financial Corporation and Guaranty Bancshares, Inc. (incorporated herein by reference to Exhibit 2.1 to the Company s Registration Statement on Form S-4 (Registration No. 333-81881)).
2.2	First Amendment to the Agreement and Plan of Reorganization between First American Financial Corporation and Guaranty Bancshares, Inc. (incorporated herein by reference to Exhibit 2.2 to the Company s Registration Statement on Form S-4 (Registration No. 333-81881)).
2.3	Second Amendment to the Agreement and Plan of Reorganization between First American Financial Corporation and Guaranty Bancshares, Inc. (incorporated herein by reference to Exhibit 2.3 to the Company s Registration Statement on Form S-4 (Registration No. 333-81881)).
3.1	Amended Articles of Incorporation of the Company (incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form S-1 (Registration No. 333-48959) (the Registration Statement)).
3.2	Amended and Restated Bylaws of the Company (incorporated herein by reference to Exhibit 3.2 to the Registration Statement).
4	Specimen form of certificate evidencing the Common Stock (incorporated herein by reference to Exhibit 4 to the Registration Statement).
10	Amended and Restated Declaration of Trust - Guaranty (TX) Trust I - Dated as of March 23, 2000 (incorporated herein by reference to Exhibit 10 to the Company s quarterly report Form 10-Q for the quarter ended March 31, 2000 filed on May 15, 2000).
10.1	Guaranty Bancshares, Inc. 1998 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.1 to the Registration Statement).
10.2*	

	Amended and Restated Guaranty Bancshares, Inc. Employee Stock Ownership Plan with 401(k) Provisions dated December 18, 2001.
21	Subsidiaries of Guaranty Bancshares, Inc. (incorporated herein by reference to Exhibit 21 to the Registration Statement).
23.1*	Consent of Arnold, Walker, Arnold & Co., P.C.
23.2*	Consent of Fisk & Robinson, P. C.
23.3*	Consent of McGladrey & Pullen, LLP
	* Filed herewith

Reports on Form 8-K

The Company filed Form 8-K on October 19, 2001 notifying the Commission of the merger of Registrant s certifying accountant Fisk & Robinson with McGladrey & Pullen, LLP The Company then appointed McGladrey & Pullen, LLP as their new auditors.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, Guaranty Bancshares, Inc., has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Mount Pleasant and the State of Texas on March 8, 2002.

GUARANTY BANCSHARES, INC.

By: /s/ ARTHUR B. SCHARLACH, JR.

Arthur B. Scharlach, Jr.
President

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report or amendment thereto has been signed by the following persons in the indicated capacities on March 8, 2002.

Signature	Positions
/s/ BILL G. JONES	
Bill G. Jones	Chairman of the Board and Chief Executive Officer (principal executive officer)
/s/ CLIFTON A. PAYNE	
Clifton A. Payne	Senior Vice President, Controller and Director (principal financial officer and principal accounting officer)

/s/ B. SCHARLACH, JR.	
Arthur B. Scharlach, Jr.	President and Director
/s/ JOHN A. CONROY	
John A. Conroy	Director
/s/ JONICE CRANE	
Jonice Crane	Director
/s/ C. A. HINTON, SR.	
C. A. Hinton, Sr.	Director
/s/ WELDON MILLER	
Weldon Miller	Director
/s/ D. R. ZACHRY, JR.	
D. R. Zachry, Jr.	Director

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GUARANTY BANCSHARES, INC.

Consolidated Financial Statements
December 31, 2001

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Independent Auditor s Report

The Board of Directors and Shareholders
Guaranty Bancshares, Inc.

We have audited the accompanying consolidated statements of earnings, shareholders equity and cash flows of Guaranty Bancshares, Inc. and Subsidiaries (the Company) for the year ended December 31, 1999 as listed in the index appearing under Item 14 of the Form 10-K Annual Report. 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 audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of Guaranty Bancshares, Inc. and Subsidiaries for the year ended December 31, 1999, in conformity with generally accepted accounting principles. We have not audited the consolidated financial statements for any period subsequent to December 31, 1999.

/s/ ARNOLD, WALKER, ARNOLD & CO., P .C.

ARNOLD, WALKER, ARNOLD & CO., P.C.
Mt. Pleasant, Texas
January 26, 2000

Independent Auditor s Report

The Board of Directors and Stockholders
Guaranty Bancshares, Inc.

We have audited the accompanying consolidated balance sheet of Guaranty Bancshares, Inc. (the Company) as of December 31, 2000 and the related consolidated statement of earnings, shareholders equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The 1999 and 1998 consolidated financial statements of Guaranty Bancshares, Inc. were audited by other auditors whose report dated January 26, 2000, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Guaranty Bancshares, Inc. as of December 31, 2000, and the results of their operations and their consolidated cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ FISK & ROBINSON, P .C.

Dallas, Texas
February 9, 2001

Independent Auditor s Report

The Board of Directors and Stockholders
Guaranty Bancshares, Inc.

We have audited the accompanying consolidated balance sheet of Guaranty Bancshares, Inc. (the Company) as of December 31, 2001 and the related consolidated statement of earnings, shareholders equity and cash flows for the year then ended, as listed in the Index appearing under Item 14 of the Form 10-K Annual Report. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The financial statements for the year ended December 31, 2000 were audited by Fisk & Robinson, P .C. whose partners and employees merged with McG1adrey & Pullen, LLP on October 1, 2001 and whose report dated February 8, 2001, expressed an unqualified report on those statements. The 1999 consolidated financial statements of Guaranty Bancshares, Inc. were audited by other auditors whose report dated January 26, 2000, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Guaranty Bancshares, Inc. as of December 31, 2001, and the results of its operations and its consolidated cash flows for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

/s/ MCGLADREY & PULLEN, LLP

Dallas, Texas
January 18, 2002

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

	2001	2000
Assets		
Cash and due from banks	$ 15,410	$ 10,109
Interest bearing deposits in other banks		103

	2001	2000
Total cash and cash equivalents	15,410	10,212
Federal funds sold	4,395	4,995
Securities available-for-sale	81,715	81,620
Loans, net of allowance for loan losses of $3,346 and $2,578	327,909	284,757
Premises and equipment, net	13,616	13,532
Other real estate	562	274
Accrued interest receivable	3,167	3,742
Other assets	13,735	11,899
	$ 460,509	$ 411,031
Liabilities and Shareholders Equity		
Liabilities		
Deposits		
Noninterest-bearing	$ 63,726	$ 55,274
Interest-bearing deposits	319,553	302,991
Total deposits	383,279	358,265
Federal Home Loan Bank advances	33,092	12,403
Long-term debt	7,000	7,000
Accrued interest and other liabilities	5,311	3,938
Total liabilities	$ 428,682	$ 381,606
Shareholders equity		
Preferred stock, $5.00 par value, 15,000,000 shares authorized, no shares issued		
Common stock, $1.00 par value, 50,000,000 shares authorized, 3,250,016 shares issued	3,250	3,250
Additional paid-in capital	12,659	12,659
Retained earnings	17,723	15,274
Treasury stock, 245,588 and 205,983 shares at cost	(2,653)	(2,220)
Accumulated other comprehensive income	848	462
Total shareholders equity	31,827	29,425
	$ 460,509	$ 411,031

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF EARNINGS
Years Ended December 31, 2001, 2000 and 1999
(Dollars in thousands, except per share amounts)

	2001	2000	1999

	2001	2000	1999
Interest income			
Loans, including fees	$ 24,591	$ 23,218	$ 17,481
Securities			
Taxable	4,280	5,218	3,500
Nontaxable	413	371	126
Federal funds sold and interest-bearing deposits	577	210	461
Total interest income	29,861	29,017	21,568
Interest expense			
Deposits	14,836	15,330	10,292
FHLB advances and federal funds purchased	755	812	214
Long-term debt	772	600	
Total interest expense	16,363	16,742	10,506
Net interest income	13,498	12,275	11,062
Provision for loan losses	1,385	595	310
Net interest income after provision for loan losses	12,113	11,680	10,752
Noninterest income			
Service charges	2,678	2,396	1,901
Net realized (loss) gain on securities transactions	416	(34)	11
Other operating income	3,107	1,361	1,462
Total noninterest income	6,201	3,723	3,374
Noninterest expense			
Employee compensation and benefits	7,592	6,791	5,666
Occupancy expenses	1,901	1,758	1,405
Other operating expenses	4,026	3,591	3,188
Total noninterest expense	13,519	12,140	10,259
Earnings before income taxes	4,795	3,263	3,867
Provision for income taxes			
Current	1,191	423	977
Deferred (benefit)	314	332	(232)
Total provision for income taxes	1,505	755	745
Net Earnings	$ 3,290	$ 2,508	$ 3,122
Basic earnings per common share	$ 1.09	$ 0.80	$ 1.03
Diluted earnings per common share	$ 1.09	$ 0.80	$ 1.03

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY
Years Ended December 31, 2001, 2000, and 1999
(Dollars in thousands, except per share amounts)

	Preferred Stock	Common Stock	Additional Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Shareholders Equity
Balance at January 1, 1999	$	$ 2,898	$ 9,494	$ 11,181	$ 223	$	$ 23,796
Comprehensive Income:							
Net earnings				3,122			3,122
Change in net unrealized gain (loss) on securities available for sale, net of reclassification and tax effects					(997)		(997)
Total comprehensive income							2,125
Purchase of treasury stock						(174)	(174)
Stock issued for acquisition		352	3,165				3,517
Dividends:							
Common - $0.25 per share				(768)			(768)
Balance at December 31, 1999		3,250	12,659	13,535	(774)	(174)	28,496
Comprehensive Income:							
Net earnings				2,508			2,508
Change in net unrealized gain (loss) on securities available for sale, net of reclassification and tax effects					1,236		1,236
Total comprehensive income							3,744
Purchase of treasury stock						(2,046)	(2,046)
Dividends:							
Common - $0.25 per share				(769)			(769)
Balance at December 31, 2000		3,250	12,659	15,274	462	(2,220)	29,425
Comprehensive Income:							
Net earnings				3,290			3,290
Change in net unrealized gain (loss) on securities available for sale, net of reclassification and tax effects					386		386
Total comprehensive income							3,676
Purchase of treasury stock						(433)	(433)
Dividends:							
Common - $0.28 per share				(841)			(841)

	Preferred Stock	Common Stock	Additional Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2001	$	$ 3,250	$ 12,659	$ 17,723	$ 848	$ (2,653)	$ 31,827

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2001, 2000 and 1999
(Dollars in thousands)

	2001	2000	1999
Cash flows from operating activities			
Net earnings	$ 3,290	$ 2,508	$ 3,122
Adjustments to reconcile net earnings to net cash from operating activities:			
Depreciation and amortization	1,134	854	672
Net securities (accretion) amortization	(67)	(42)	196
Net realized (gain) loss on securities transactions	(416)	34	(11)
Provision for loan losses	1,385	595	310
Write-down of other real estate and repossessed assets			13
Gain on sale of premises, equipment and other real estate	(212)	(59)	(90)
Loss on impairment of investment in Aircraft Finance Trust	1,500		
Net change in accrued interest receivable and other assets	(2,480)	(3,768)	843
Net change in accrued interest and other liabilities	1,174	695	(390)
Net cash provided by operating activities	5,308	817	4,665
Cash flows from investing activities			
Securities available for sale:			
Purchases	(49,321)	(16,416)	(34,914)
Proceeds from sales and principal repayments	50,294	16,491	17,197
Securities held to maturity:			
Proceeds from principal repayments			1,343
Purchases of premises and equipment	(1,183)	(2,745)	(4,219)
Proceeds from sale of premises, equipment and other real estate	1,541	152	538
Net increase in loans	(46,470)	(32,901)	(31,639)
Cash paid for acquisitions			(3,380)
Cash and cash equivalents from acquisitions			1,983
Net decrease (increase) in federal funds sold	600	(3,855)	15,985
Net cash used in investing activities	(44,539)	(39,274)	(37,106)
Cash flows from financing activities			
Net change in deposits	25,014	29,628	28,095
Proceeds from borrowings	30,000	2,000	7,000
Repayment of borrowings	(9,311)	(296)	(281)
Proceeds from long-term debt borrowing		7,000	
Purchase of treasury stock	(433)	(2,046)	(174)

	2001	2000	1999
Cash dividends paid	(841)	(769)	(768)
Net cash provided by financing activities	44,429	35,517	33,872
Net change in cash and cash equivalents	5,198	(2,940)	1,431
Cash and cash equivalents at beginning of year	10,212	13,152	11,721
Cash and cash equivalents at end of year	$ 15,410	$ 10,212	$ 13,152

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of the significant accounting policies followed in the preparation of the consolidated financial statements. The policies conform to generally accepted accounting principles in the United States of America and to general practices within the banking industry.

Principles of Consolidation

The consolidated financial statements include the accounts of Guaranty Bancshares, Inc and its wholly-owned subsidiaries Guaranty (TX) Capital Trust I and Guaranty Financial Corp., Inc. which wholly owns Guaranty Bank (Bank) and one non-bank subsidiary, Guaranty Company. Guaranty Bank has two wholly-owned non-bank subsidiaries, Guaranty Leasing Company, and GB Com, Inc. All entities combined are collectively referred to as the Company. All significant intercompany balances and transactions have been eliminated in consolidation.

Nature of Operations

The Company operates ten locations in Northeast Texas and one location in Fort Stockton, Texas. The Company s main sources of income are derived from granting loans primarily in Northeast Texas and investing in securities issued by the U.S. Treasury, U.S. government agencies and state and political subdivisions. A variety of financial products and services are provided to individual and corporate customers. The primary deposit products are checking accounts, money market accounts, and certificates of deposit. The primary lending products are real estate, commercial, and consumer loans. Although the Company has a diversified loan portfolio, a substantial portion of its debtors abilities to honor contracts is dependent on the economy of the area.

Use of Estimates

To prepare financial statements in conformity with generally accepted accounting principles in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual future results could differ. The allowance for loan losses, fair values of financial instruments, the status of contingencies, and the value of the Company s recorded investment in the Aircraft Finance Trust (AFT) are particularly subject to change.

Cash Equivalents and Supplemental Cash Flow Information

Cash and cash equivalents include cash, due from banks and interest-bearing deposits with other banks under 90 days. Net cash flows are reported for loan and deposit transactions, and short-term borrowings with maturities of 90 days or less.

In 2001, 2000 and 1999, cash paid for interest totaled $15,974, $15,929, and $10,365 and cash paid for income taxes totaled $104, $250, and $931. Significant noncash transactions included transfers from loans to other real estate and repossessed assets of $2,157, $903, and $328 in 2001, 2000 and 1999.

Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income. Management determines the appropriate classification of securities at the time of purchase. Other securities including stock in the Independent Bankers Financial Corporation, the Federal Reserve Bank and the Federal Home Loan Bank are carried at cost.

Interest income includes amortization of purchase premiums and discounts. Gains and losses on sales are based on the amortized cost of the security sold. Securities are written down to fair value when a decline in fair value is not temporary.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans

Loans are reported at the principal amount outstanding, net of charge-offs, unearned discounts, purchase discounts and an allowance for loan losses. Unearned discounts on installment loans are recognized using a method that approximates a level yield over the term of the loans. Interest on other loans is reported on the level-yield interest method and includes amortization of net deferred loan fees and costs over the loan term.

Interest income is not reported when full loan repayment is in doubt, typically when the loan is impaired or payments are past due 90 days or more. Payments received on such loans are reported as principal reductions.

Allowance for Loan Losses

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors, including the performance of the bank s loan portfolio, the economy, changes in real estate values and interest rates and the view of the regulatory authorities toward loan classifications.

Management estimates the allowance balance required, in part, by review of the loan portfolio to evaluate potential problem loans. Potential problem loans are classified and separately monitored by management. Loans classified as special mention are those that contain a weakness that, if left unattended, could develop into a problem affecting the ultimate collectibility of the loan. Loans classified as substandard are those loans with clear and defined weaknesses such as highly leveraged positions, unfavorable financial ratios, uncertain repayment sources or poor financial condition, which may jeopardize recoverability of the loan. Loans classified as doubtful are those loans that have characteristics similar to substandard loans, but also have an

increased risk that a loss may occur or at least a portion of the loan may require a charge-off if liquidated at present. Although loans classified as substandard do not duplicate loans classified as doubtful, both substandard and doubtful loans may include some loans that are past due at least 90 days, are on nonaccrual status or have been restructured. Loans classified as loss are those loans that are in the process of being charged off.

Loan impairment is reported when full payment under the loan terms is not expected. Loans are evaluated for impairment when payments are delayed, typically 90 days or more, or when analysis of a borrower s operating results and financial condition indicates the borrower s underlying cash flows are not adequate to meet debt service requirements and it is probable that not all principal and interest amounts will be collected according to the original terms of the loan. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage and consumer loans and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

In addition to allocations made for specific classified loans, general reserve allocations are made after consideration of such factors as past loan loss experience, general prevailing economic conditions, the nature, composition and volume of the loan portfolio, and other qualitative factors based on management s judgment.

While portions of allowance may be allocated for specific credits, the entire allowance is available for any credit that, in management s judgment, should be charged-off.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment in Leveraged Leases

Leveraged lease investments are reported in accordance with Statement of Financial Accounting Standards (SFAS) No. 13, Accounting for Leases. Under SFAS 13, investments in leveraged leases are recorded net of nonrecourse debt. The investments in leveraged leases less deferred taxes arising from differences between pretax accounting income and taxable income represents the lessor s net investment in leveraged leases for purposes of computing periodic net income from the leases. Net investment in leveraged leases is adjusted annually by the difference in net cash flow and the amount of income recognized. If at any time during the lease term the projected net cash receipts over the term of the lease are less than the initial investment, a loss is recognized for the deficiency. Estimated residual values and other important assumptions affecting total net income from the leases are reviewed annually. The net investment balance is adjusted considering all values and assumptions.

During the initial years of the leases, the Company receives benefits for income tax purposes of deductions for depreciation on the equipment and interest on the debt that in the aggregate exceed the rental income from the related equipment. During the later years, rental income will exceed related deductions. Provision has been made for deferred income taxes that arise from these differences. The Company deducts, for tax purposes, rent payments paid to lessors under a master lease. For leases originated during 1995 and earlier years, a prior sale of user lease receivables created a difference between tax and book basis that will not reverse.

Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the related assets. Maintenance, repairs and minor improvements are charged to noninterest expense as incurred.

Other Real Estate

Assets acquired through, or in lieu of, foreclosure are initially recorded at fair value when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

Goodwill

Net assets acquired in purchase transactions are recorded at their fair value at the date of acquisition. Goodwill, the excess of the purchase price over the fair value of net assets acquired, is amortized on a straight-line basis, generally over a 15-year period.

Long-term Assets

Premises and equipment, goodwill and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at discounted amounts.

Income Taxes

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the expected amount to be realized.

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Compensation

Employee compensation expense under stock option plans is reported if options are granted below market price at grant date. Pro forma disclosures of compensation cost of stock-based awards have been determined using the fair value method which considers the time value of the option considering the volatility of the Company s stock and the risk-free interest rate over the expected life of the option using a Black-Scholes valuation model.

Fair Values of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on- and off-balance sheet financial instruments do not include the value of anticipated future business or the value of assets and liabilities not considered financial instruments.

Restrictions on Cash

The Company was required to have $705 and $368 of cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at December 31, 2001 and 2000, respectively. Deposits with the Federal Reserve Bank do not earn interest.

Earnings Per Common Share

Basic earnings per share (EPS) is based on net earnings divided by the weighted-average number of shares outstanding during the period. Diluted EPS includes the dilutive effect of stock options granted using the treasury stock method.

Earnings per common share is computed by dividing net earnings available to common shareholders by the weighted-average number of common shares outstanding for the year. The earnings available to common shareholders and the weighted-average number of common shares outstanding for basic and diluted earnings per share computations were as follows:

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands, except share amounts)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

	2001	2000	1999
Net earnings	$ 3,290	$ 2,508	$ 3,122
Dividends on preferred stock			
Net earnings available to common shareholders used in basic and diluted EPS	$ 3,290	$ 2,508	$ 3,122
Weighted-average shares outstanding Basic	3,016,406	3,125,656	3,045,000
Effect of stock options	10,915	6,864	
Weighted-average shares outstanding Diluted	3,027,321	3,132,520	3,045,000

Comprehensive Income

Comprehensive income is reported for all periods. Comprehensive income includes both net income and other comprehensive income. Other comprehensive income components and related taxes were as follows.

	2001	2000	1999
Unrealized gain (loss) on available-for-sale securities arising during the period	$ 1,001	$ 1,839	$ (1,500)
Reclassification adjustment for amounts realized on securities sales included in net earnings	(416)	34	(11)
Net unrealized gain (loss)	585	1,873	(1,511)
Tax effect	(199)	(637)	514
Total other comprehensive income	$ 386	$ 1,236	$ (997)

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board issued two statements SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*, which will potentially impact the Company s accounting for its reported goodwill and other intangible assets.

SFAS 141:

- Eliminates the pooling method for accounting for business combinations.
- Requires that intangible assets that meet certain criteria be reported separately from goodwill.
- Requires negative goodwill arising from a business combination to be recorded as an extraordinary gain.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

SFAS 142:

- Eliminates the amortization of goodwill and other intangibles that are determined to have an indefinite life.
- Requires, at a minimum, annual impairment tests for goodwill and other intangible assets that are determined to have an indefinite life.

In the year ended December 31, 2001, 2000, and 1999, the Company recorded goodwill amortization expense of $150, $175, and $150. In accordance with the new standards, recorded goodwill with the carrying amount of $2,338,000 at December 31, 2001 will no longer be subject to amortization beginning in fiscal year 2002. Although impairment testing has not been completed, management believes that at January 1, 2002, there is no impairment of recorded goodwill.

Also in July 2001, the Financial Accounting Standards Board issued SFAS 143, *Accounting for Asset Retirement Obligations.* SFAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. SFAS 143, if applicable, will be adopted by the Company upon its required effective date, for its fiscal year ended December 31, 2002.

In August 2001, the Financial Accounting Standards Board issued SFAS 144, *Accounting for the Impairment or Disposition of Long-Lived Assets.* SFAS 144 requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and by broadening the presentation of discounted operations to include primarily all disposal transactions. It further establishes criteria to determine when a long-lived asset is held for sale and establishes measurement criteria at the asset s or group of assets lower of unamortized cost or fair value at the date the asset is reclassified as held and used. SFAS 144, if applicable, will be adopted by the Company upon its required effective date, for its fiscal year ended December 31, 2002.

Reclassifications

Some items in prior financial statements have been reclassified to conform with the current presentation.

NOTE 2 BUSINESS COMBINATIONS

Information relating to business combinations accounted for as a purchase for the three-year period ended December 31, 2001 is summarized below. Under the purchase method of accounting, the results of operations of the acquired institution is included in the Company s results of operations since the date of its acquisition.

(Dollars in millions, except share amounts)	Merger Date	Cash Paid	Common shares issued		Goodwill Created	Assets Acquired
			Shares	Dollars		
First American Financial Corporation Sulphur Springs, Texas	September 1, 1999	$3.4	351,736	$3.4	$3.1	$63.7

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 2 BUSINESS COMBINATIONS (Continued)

The following unaudited information presents pro forma results of operations of the Company for the year ended December 31, 1999 assuming the acquisition had taken place on January 1, 1999.

(Dollars in thousands, except per share data)	1999
Net interest income	$ 11,971
Net income	$ 3,482
Earnings per share, basic	$ 1.06
Earnings per share, diluted	$ 1.06

NOTE 3 SECURITIES

Securities available for sale consist of:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2001:				
U. S. government agency securities	$ 4,208	$ 286	$	$ 4,494
Mortgage-backed securities	67,520	868	46	68,342
Equity securities	2,112			2,112
Obligations of state and political subdivisions	6,590	177		6,767

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	$ 80,430	$ 1,331	$ 46	$ 81,715
December 31, 2000:				
U. S. government agency securities	$ 25,900	$ 370	$ 86	$ 26,184
Mortgage-backed securities	44,455	283	94	44,644
Equity securities	1,705			1,705
Obligations of state and political subdivisions	8,860	251	24	9,087
	$ 80,920	$ 904	$ 204	$ 81,620

Mortgage-backed securities are backed by pools of mortgages that are insured or guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA) and the Government National Mortgage Corporation (GNMA). Equity securities include stock holdings in Independent Bankers Financial Corporation, Federal Home Loan Bank, and Independent Bankers Capital Fund, L.P.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 3 SECURITIES (Continued)

The amortized cost and estimated fair value of securities at year-end 2001, by contractual maturity, are shown below. Equity securities are shown separately since they are not due at a single maturity date. Expected maturities may differ from contractual maturities because borrowers and/or issuers may have the right to call or prepay their obligation with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Due within one year	$ 130	$ 130
Due after one year through five years	10,575	10,869
Due after five years through ten years	10,917	11,255
Due after ten years	56,696	57,349
Equity securities	2,112	2,112
	$ 80,430	$ 81,715

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
(Dollars in thousands)

NOTE 3 SECURITIES (Continued)

Sales of securities available for sale were as follows:

	2001	2000	1999
Proceeds from the sale of securities	$ 50,294	$ 5,314	$ 8,694
Gross gains	441	1	11
Gross losses	25	35	

At year-end 2001, there were no holdings of securities of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of shareholders equity.

Securities with a market value of approximately $50,141 and $49,270 at December 31, 2001, and 2000, were pledged to secure public deposits and for other purposes as required or permitted by law.

NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES

Year-end loans were as follows:

	2001	2000
Commercial	$ 66,642	$ 66,616
Agriculture	8,589	8,318
Real estate		
Construction	9,492	7,316
1-4 family residential	126,114	102,614
Farmland	9,794	7,716
Non-residential and non-farmland	68,165	61,224
Other	9,333	4,946
Consumer	33,204	28,749
Total gross loans	331,333	287,499
Less:		
Unearned discounts	78	164
Allowance for loan losses	3,346	2,578
Total net loans	$ 327,909	$ 284,757

Loans to executive officers, directors, principal shareholders and their affiliates were as follows:

	2001	2000
Beginning balance	$ 12,499	$ 10,713
New loans	14,806	11,390
Repayments	(12,631)	(9,604)
Ending balance	$ 14,674	$ 12,499

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(Dollars in thousands)

NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Changes in the allowance for loan losses were as follows:

	2001	2000	1999
Beginning balance	$ 2,578	$ 2,491	$ 1,512
Provision	1,385	595	310
Balance acquired with First American			846
Charge-offs	(836)	(678)	(333)
Recoveries	219	170	156
Ending balance	$ 3,346	$ 2,578	$ 2,491

Impaired loans were as follows:

	2001	2000
Year-end loans with allowance allocated	$ 3,737	$ 1,214
Year-end loans with no allowance allocated		
Impaired Loans	3,737	1,214
Amount of the allowance allocated	$ 508	$ 332

No interest income was recognized on these impaired loans during 2001 and 2000. There were no commitments to lend additional funds to borrowers whose loans were classified as impaired.

The following table presents information regarding nonperforming assets at the dates indicated:

	December 31, 2001	December 31, 2000
Nonaccrual loans	$ 3,737	$ 1,214
Accruing loans past due 90 days or more	1,912	3,488
Other real estate	562	274
Total nonperforming assets	$ 6,211	$ 4,976
Nonperforming assets to total loans and other real estate	1.87%	1.73%

If interest on nonaccrual loans had been accrued, such income would have been approximately $251 and $113 for 2001 and 2000, respectively.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001, 2000 and 1999
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NOTE 5 PREMISES AND EQUIPMENT

[text]

	2001	2000
Land	$ 2,369	$ 2,369
Building and improvements	12,482	11,973
Furniture, fixtures and equipment	4,255	3,752
Automobiles	175	228
	19,281	18,322
Less accumulated depreciation	5,665	4,790
	$ 13,616	$ 13,532

NOTE 6 INTEREST-BEARING DEPOSITS

Year-end interest-bearing deposits were as follows:

	2001	2000
NOW accounts	$ 33,816	$ 33,314
Savings and money market accounts	72,217	68,195
Certificates of deposit less than $100,000	124,931	118,780
Certificates of deposit of $100,000 or more	88,589	82,702
	$ 319,553	$ 302,991

Year-end scheduled maturities of certificates of deposit were as follows:

	2001	2000
Three months or less	$ 67,926	$ 46,066
Three months through one year	120,355	131,813
One year through three years	20,521	21,455
Over three years	4,718	2,148
	$ 213,520	$ 201,482

Deposits of executive officers, directors and significant shareholders totaled $11,034 and $9,641 at December 31, 2001 and 2000, respectively.

GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 7 FEDERAL HOME LOAN BANK ADVANCES

Federal Home Loan Bank (FHLB) advances were as follows:

		Current Weighted Average Rate	2001	2000
Fixed-rate advances, with monthly interest payments, principal due in:				
	2001	6.85%	$	$ 9,000
	2002	3.95%	10,000	
	2003	4.68%		
	2004	4.68%		
	2005	4.68%		
	2006	4.68%	20,000	
			$ 30,000	$ 9,000
Fixed-rate advances, with monthly principal and interest payments, principal due in:				
	2001	5.23%	$	$ 311
	2002	5.23%	328	328
	2003	5.23%	346	346
	2004	5.23%	365	365
	2005	5.23%	742	742
	2006	5.19%	292	292
	Thereafter	5.19%	1,019	1,019
			3,092	3,403
			$ 33,092	$ 12,403

The maximum month-end balance of FHLB advances outstanding was $33,145 and $19,504 in 2001 and 2000, respectively. Average balances of borrowings outstanding during 2001 and 2000 were $12,392 and $12,147. As a member of the FHLB system, the Bank has the ability to obtain borrowings up to a maximum total of $133,057 subject to the level of qualified, pledgable real estate loans and FHLB stock owned. The advances are collateralized by a blanket pledge of the Bank s mortgage loan portfolio and FHLB stock. The weighted average interest rates on these borrowings were 4.88% and 6.45% for the years ended December 31, 2001 and December 31, 2000, respectively.

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NOTE 8 LONG TERM DEBT

On March 23, 2000, the Company, in a private placement, issued $7,000 (seven thousand shares with a liquidation amount of one thousand dollars per security) of 10.875% Fixed Rate Capital Trust Pass-through Securities (TruPS) through a newly formed, wholly-owned subsidiary, Guaranty (TX) Capital Trust I (the Trust). The Trust invested the total proceeds from the sale of the TruPS in 10.875% Junior Subordinated Deferrable Interest Debentures (the Debentures) issued by the Company. The net proceeds from the sale of the Debentures were used to buy back shares of the Company s stock, provide a $1.5 million additional capital contribution to Guaranty Bank and provide for additional working capital to support growth.

With certain exceptions, the amount of the principal and any accrued and unpaid interest on the Debentures are subordinated in right of payment to the prior payment in full of all senior indebtedness of the Company. The terms of the Debentures are such that they qualify as Tier I capital under the Federal Reserve Board s regulatory capital guidelines applicable to bank holding companies. Interest on the Debentures is payable semi-annually on March 8 and September 8 of each year, commencing September 8, 2000. The interest is deferrable on a cumulative basis for up to five consecutive years following a suspension of dividend payments on all other capital stock. No principal payments are due until maturity on March 8, 2030.

On any March 8 or September 8 on or after March 8, 2010 and prior to maturity, the Debentures are redeemable for cash at the option of the Company, on at least 30 but not more than 60 days notice, in whole or in part, at the redemption prices set forth in the table below, plus accrued interest to the date of redemption.

If Redeemed During 12 Months Beginning March 8,	Percentage of Principal Amount	If Redeemed During 12 Months Beginning March 8,	Percentage of Principal Amount
2010	105.438	2016	102.175
2011	104.894	2017	101.631
2012	104.350	2018	101.088
2013	103.806	2019	100.544
2014	103.263	2020 and after	100.000
2015	102.719		

Upon the occurrence of certain special events, the Company will have the right to call the securities at par at any time with the permission of the Federal Reserve.

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NOTE 9 PREFERRED AND COMMON STOCK

A summary of issued and outstanding shares of stock is as follows:

	Issued and Outstanding Preferred Stock	Common Stock Issued	Common Stock Outstanding	Treasury Stock
Balance at January 1, 1999		2,898,280	2,898,280	

	Issued and Outstanding Preferred Stock	Common Stock Issued	Common Stock Outstanding	Treasury Stock
Purchase of treasury stock				(17,600)
Sale of common stock		351,736	351,736	
Balance at December 31, 1999		3,250,016	3,250,016	(17,600)
Purchase of treasury stock				(188,383)
Balance at December 31, 2000		3,250,016	3,250,016	(205,983)
Purchase of treasury stock				(39,605)
Balance at December 31, 2001		3,250,016	3,250,016	(245,588)

Preferred stock, if outstanding, pays dividends semi-annually. Preferred stock is not cumulative or participating, has no voting rights and is not convertible. Preferred stock has liquidation preferences over common stock of the Company. Dividends on common stock of the Company may not be declared or paid unless dividends for the same period on preferred stock have been paid or declared.

In September 1999, the Company issued 351,736 shares of common stock related to the First American acquisition.

NOTE 10 STOCK OPTIONS

In 2000, the Company granted nonqualified stock options to certain senior officers of the Company and Guaranty Bank under the Company s 1998 Stock Incentive Plan. The grants consist of eight-year options to purchase 89,500 shares at an exercise price of $9.30 per share, which was the market price of the Company s stock on the date the options were granted. The options fully vest and become exercisable in five equal installments commencing on the first anniversary of the date of grant and annually thereafter. At December 31, 2001, none of the options are exercisable and 910,500 options remain available for future grant under the plan.

The weighted-average fair value per share of options granted during 2000 is $2.03. The fair value of options granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: Dividend yield of 2.59%; expected volatility of 7.67%; risk-free interest rate of 6.42%, and an expected life of 8.00 years.

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NOTE 10 STOCK OPTIONS (Continued)

Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, requires pro forma disclosures for companies not adopting its fair value accounting method for stock-based employee compensation. Accordingly, the following pro forma information presents net earnings and earnings per share for 2001 and 2000 had the Standard s fair value method been used to measure compensation cost for stock option plans. No compensation expense related to stock options is actually recognized.

	2001	2000
Net earnings:		
As reported	$ 3,290	$ 2,508

	2001	2000
Pro forma	$ 3,266	$ 2,491
Earnings per share:		
As reported		
Basic	$ 1.09	$ 0.80
Diluted	$ 1.09	$ 0.80
Pro forma		
Basic	$ 1.08	$ 0.80
Diluted	$ 1.08	$ 0.80

The effects of applying Statement of Financial Accounting Standards No. 123 in this pro forma disclosure are not indicative of future amounts. The pro forma effect may increase in the future if more options are granted.

NOTE 11 EMPLOYEE BENEFITS

The Company maintains an Employee Stock Ownership Plan containing Section 401(k) provisions covering substantially all employees. The plan provides for a matching contribution of up to 4% of qualified compensation. Total contributions accrued or paid for 2001, 2000 and 1999 totaled $390, $280 and $294.

The Company maintains a non-qualified, non-contributory Supplemental Retirement Plan. The plan covers an executive officer to provide benefits equal to amounts payable under the Company s retirement plan and certain social security benefits to aggregate a predetermined percentage of the final five-year average salary. The plan is non-funded. Amounts accrued or paid for 2001, 2000 and 1999 totaled $13, $15 and $17.

The Company established a non-qualified, non-contributory, Salary Continuation Plan in 1998. The plan covers an executive officer to provide benefits equal to an amount which represents 75% of projected compensation at retirement as adjusted for amounts payable under the Company s retirement plan and certain social security benefits. This plan is non-funded. As of December 31, 2001 and 2000, $111 and $100 were charged to expense.

During 1998 the Company established a non-qualified, non-contributory, Executive Incentive Retirement Plan. The plan covers a selected group of key personnel to provide benefits equal to amounts computed under an award criteria at various targeted salary levels as adjusted for annual earnings performance of the Company. As of December 31, 2001 and 2000, $35 and $29 were charged to expense.

The Company has a bonus plan that provides guidelines whereby key employees can earn bonus compensation based on the profitability of the Company. The bonus amounts are determined based on the Company s achievement of certain percentages of return on equity targets. This plan is approved and adopted annually by the Board of Directors of the Company at the first board meeting of the year. The bonus pool under this plan for 2001, 2000 and 1999 was $463, $266 and $419, respectively.

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NOTE 12 INCOME TAXES

The sources of year-end gross deferred income tax assets and liabilities were as follows:

	2001	2000
Deferred tax assets:		
Allowance for loan losses	$ 798	$ 616

	2001	2000
Deferred Compensation	197	152
Net Operating Loss Carry Forward		121
Securities basis		134
Other	15	22
	$ 1,010	$ 1,045
Deferred tax liabilities:		
Unrealized gain on available-for-sale securities	(437)	$ (238)
Depreciation	(968)	(993)
Leasing transactions	(885)	(526)
Deferred loan costs, net	(403)	(407)
Other	(48)	(40)
	$ (2,741)	$ (2,204)

A reconciliation of the Company s effective income tax rate and the statutory federal income tax rate for each reported period is as follows:

	2001	2000	1999
Statutory federal income tax rate	35.00%	35.00%	35.00%
Effect of utilization of graduated tax rates	(1.30)	(1.30)	(1.30)
Tax exempt income	(3.68)	(4.58)	(1.94)
Recognition of benefit on lease and AFT transactions	(1.18)	(13.82)	(10.95)
Other, net	2.55	7.84	(1.54)
Effective income tax rate	31.39%	23.14%	19.27%

The net realized gain (loss) on securities and related tax effect for the reported period is as follows:

	2001	2000	1999
Net realized gain (loss) on securities transactions	$ 416	$ (34)	$ 11
Tax effect	(146)	12	(4)

Guaranty Leasing Company is a substantial partner in various complex equipment leasing transactions primarily originated in 1992, 1994 and 1995 involving leveraged leases. During 2001 and 1998, Guaranty Leasing was informed by the Internal Revenue Service (the Service) that certain losses taken by the Partnerships during 1992 and 1994 through 1996 amounting to approximately $1.7 million would be disallowed. The Partnership plans to appeal the Service s determination and to actively contest the Service s position. However, if the Service is ultimately successful in redetermining the amount of the Partnership s taxable loss, the Company s tax liability would be adjusted. Such adjustment may have a material adverse effect on the Company s consolidated financial statements.

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NOTE 12 INCOME TAXES (Continued)

Also, there can be no assurance that the Service will not contest, and ultimately disallow similar types of deductions and losses for other open tax years by the Partnerships in which Guaranty Leasing has ownership. If the Service were to be successful, the potential additional tax liability to the Company may have a material adverse effect on its consolidated financial statements.

NOTE 13 NONINTEREST INCOME AND NONINTEREST EXPENSE

Other noninterest operating income consisted of the following:

	Years Ended December 31,		
	2001	**2000**	**1999**
Fee income	$ 668	$ 663	$ 518
Fiduciary income	136	109	63
Earnings from key-man life insurance	204	234	192
Gain on sale of loans	98		
Gain on sale of assets	36	38	330
Gain on sale of Other Real Estate	176	21	90
Income (loss) from lease transactions		19	172
Income (impairment) from investment in AFT	(1,360)	145	
Gain on settlement of litigation	3,000		
Other noninterest income	149	132	97
	$ 3,107	$ 1,361	$ 1,462

Gain on the settlement of litigation represents the amount received in January 2002 in connection with the November 2001 settlement and concurrent transfer of the Company s rights to certain intangible assets. Estimated costs related to compliance with the provisions of the settlement agreement have been accrued and recorded in the accompanying financial statements.

Management believes its investment in AFT has been permanently impaired by declines in air travel and reduced demand for commercial aircraft. During the third quarter of 2001, AFT recorded an impairment charge of $18,158,000 related to two airplanes. In addition, management has received indications the appraised value of AFT s fleet of airplanes may have declined approximately 9 percent from the year earlier level. Although the investment has had limited marketability, management believes these facts, coupled with the uncertainty surrounding the air transport industry, indicate the value of its investment in AFT has been permanently impaired. Accordingly, an impairment charge was made to income and the carrying amount of the investment was reduced to $1.5 million in the fourth quarter of 2001.

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NOTE 13 NONINTEREST INCOME AND NONINTEREST EXPENSE (Continued)

	Years Ended December 31,		
	2001	2000	1999
Office and computer supplies	$ 429	$ 357	$ 309
Legal and professional fees	785	558	499
Advertising	278	357	231
Postage	180	156	140
FDIC insurance	69	67	33
Other	2,285	2,096	1,976
	$ 4,026	$ 3,591	$ 3,188

NOTE 14 COMMITMENTS AND CONTINGENCIES

In the normal course of business, the Company enters into various transactions, which, in accordance with generally accepted accounting principles, are not included in the consolidated balance sheets. These transactions are referred to as off-balance sheet commitments. The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and letters of credit, which involve elements of credit risk in excess of the amounts recognized in the consolidated balance sheets. The Company minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

The Company enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Customers use credit commitments to ensure that funds will be available for working capital purposes, for capital expenditures and to ensure access to funds at specified terms and conditions. Substantially all of the Company s commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for credit losses.

Letters of credit are written conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company s policies generally require that letters of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

Outstanding commitments and letters of credit at December 31 are approximately as follows:

	Contract or Notional Amount	
	2001	2000
Commitments to extend credit	$ 21,394	$ 23,161
Letters of credit	1,042	1,023

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NOTE 14 COMMITMENTS AND CONTINGENCIES (Continued)

The Company is involved in certain claims and lawsuits occurring in the normal course of business. Management, after consultation with legal counsel, does not believe that the outcome of these actions would have a material impact on the

financial statements of the Company.

Guaranty Leasing Company, a non-bank subsidiary of the Bank, is a partner in various equipment leasing transactions involving leveraged leases. The transactions were structured as wrap leases under which the partnerships are the lessees with respect to the owners of the equipment and are the sublessors under the sublease with the users. During 2000, the Company sold its remaining interest in the wrap leases.

NOTE 15 REGULATORY MATTERS

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting, and other factors. Failure to meet minimum capital requirements can initiate regulatory action. Management believes, as of December 31, 2001 and 2000, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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NOTE 15 REGULATORY MATTERS (Continued)

The following table sets forth the consolidated and bank only actual capital levels in addition to the requirements under prompt corrective action regulations.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
December 31, 2001						
Total capital to risk weighted assets:						
Consolidated	39,836	12.58%	25,341	8.00%		n/a
Bank	38,970	11.85%	26,309	8.00%	32,887	10.00%
Tier 1 capital to risk weighted assets:						
Consolidated	36,490	11.52%	12,671	4.00%		n/a
Bank	35,624	10.83%	13,155	4.00%	19,732	6.00%
Tier 1 capital to average assets:						
Consolidated	36,490	8.44%	17,288	4.00%		n/a
Bank	35,624	8.25%	17,269	4.00%	21,587	5.00%
December 31, 2000						
Total capital to risk weighted assets:						
Consolidated	36,515	12.69%	23,022	8.00%		n/a
Bank	33,575	11.84%	22,682	8.00%	28,353	10.00%
Tier 1 capital to risk weighted assets						
Consolidated	33,937	11.79%	11,511	4.00%		n/a
Bank	30,997	10.93%	11,341	4.00%	17,012	6.00%
Tier 1 capital to average assets:						
Consolidated	33,937	8.60%	15,780	4.00%		n/a
Bank	30,997	7.88%	15,732	4.00%	19,664	5.00%

As of December 31, 2001 and 2000, the Company and the Bank met the level of capital required to be categorized as well capitalized under prompt corrective action regulations. Management is not aware of any conditions subsequent to December 31, 2001 that would change the Company s or the Bank s Capital category.

The Bank is a state-charted banking association and therefore is subject to regulation, supervision and examination by the Texas Department of Banking. The Bank is also a member of the Federal Deposit Insurance Corporation (FDIC). Because the Federal Reserve Bank (FRB) regulates the bank holding company parent of the Bank, the FRB also has supervisory authority that directly affects the Bank. In addition, upon making certain determinations with respect to the condition of any insured bank, such as the Bank, the FDIC may begin proceedings to terminate a bank s federal deposit insurance.

Dividends paid by the Company are mainly provided by dividends from its subsidiaries. However, certain restrictions exist regarding the ability of its bank subsidiary to transfer funds to the Company in the form of cash dividends, loans or advances. These guidelines do not currently restrict the Bank from paying normal dividends to the Company.

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NOTE 16 FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair value approximates carrying value for financial instruments except those described below:

Securities: Fair values for securities are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar instruments.

Loans: The fair value of fixed-rate loans and variable-rate loans which reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality.

Deposits: The fair value of deposit liabilities with defined maturities and long-term debt is estimated by discounting future cash flows using the interest rates currently offered for deposits or similar borrowings of similar remaining maturities.

Off-Balance-Sheet Instruments: The fair values of these items are not material and are therefore not included on the following schedule.

The estimated year-end fair values of financial instruments are detailed in the following table. The fair value of financial instruments is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

	2001		**2000**	
	Carrying Amount	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
Financial assets:				
Cash and cash equivalents	$ 15,410	$ 15,410	$ 10,212	$ 10,212
Federal funds sold	4,395	4,395	4,995	4,995
Securities available for sale	81,715	81,715	81,620	81,620
Loans, net	327,909	331,073	284,757	290,182
Accrued interest receivable	3,167	3,167	3,742	3,742

	2001		2000	
Cash surrender value of life insurance	5,178	5,178	4,946	4,946
Financial liabilities:				
Deposits	$ 383,279	$ 378,641	$ 358,265	$ 358,916
FHLB advances	33,092	32,692	12,403	12,403
Long-term debt	7,000	7,663	7,000	7,000
Accrued interest payable	1,383	1,383	1,752	1,752

While these estimates of fair value are based on management s judgment of appropriate factors, there is no assurance that, were the Company to have disposed of such items at December 31, 2001 and 2000, the estimated fair values would necessarily have been achieved at those dates, since market values may differ depending on various circumstances. The estimated fair values at December 31, 2001 and 2000, should not necessarily be considered to apply at subsequent dates.

In addition, other assets, such as property and equipment, and liabilities of the Company that are not defined as financial instruments are not included in the above disclosures. Also, nonfinancial instruments typically not recognized in financial statements nevertheless may have value but are not included in the above disclosures. These include, among other items, the estimated earning power of core deposit accounts, the trained work force, customer goodwill and similar items.

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NOTE 17 PARENT COMPANY ONLY CONDENSED FINANCIAL STATEMENTS

Condensed financial information of the Company is as follows:

Condensed Balance Sheets
December 31, 2001 and 2000

	2001	2000
Assets		
Cash and cash equivalents	$ 370	$ 2,157
Investment in subsidiaries	37,966	33,489
Cash surrender value of life insurance	838	790
Premises and equipment, net	3	11
Other assets	132	474
	$ 39,309	$ 36,921
Liabilities and Shareholders Equity		
Other liabilities	482	$ 496
Long-term debt	7,000	7,000
Shareholders equity	31,827	29,425
	$ 39,309	$ 36,921

Condensed Statements of Earnings
Years ended December 31, 2001, 2000 and 1999

	2001	2000	1999
Operating income			
Dividends from subsidiaries	$	$	$ 1,700
Interest on interest-bearing deposits		4	
		4	1,700
Costs and expenses			
General and administrative	1,051	994	486
Provision for income taxes			
Current			
Deferred			
Earnings before equity in undistributed earnings of subsidiaries	(1,051)	(990)	1,214
Equity in undistributed earnings of subsidiaries	4,341	3,498	1,908
Net earnings	$ 3,290	$ 2,508	$ 3,122

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NOTE 17 PARENT COMPANY ONLY CONDENSED FINANCIAL STATEMENTS (Continued)

Condensed Statements of Cash Flows
Years ended December 31, 2001, 2000 and 1999

	2001	2000	1999
Cash flows from operating activities			
Net earnings	$ 3,290	$ 2,508	$ 3,122
Adjustments to reconcile net earnings to net cash used in operating activities:			
Equity in undistributed earnings of subsidiaries	(4,091)	(3,498)	(1,908)
Depreciation and amortization	8	9	10
Net change in other assets	294	(387)	32
Net change in other liabilities	(14)	447	4
Net cash (used in) provided by operating activities	(513)	(921)	1,260
Cash flows from investing activities			
Purchase of subsidiary stock		(1,502)	
Purchases of premises and equipment			21
Net cash (used in) provided by investing activities		(1,502)	21

	2001	2000	1999
Cash flows from financing activities			
Purchase of treasury stock	(433)	(2,046)	(174)
Proceeds from issuance of trust preferred securities		7,000	
Cash dividends paid	(841)	(770)	(768)
Net cash (used in) provided by financing activities	(1,274)	4,184	(942)
Net change in cash and cash equivalents	(1,787)	1,761	339
Cash and cash equivalents at beginning of year	2,157	396	57
Cash and cash equivalents at end of year	$ 370	$ 2,157	$ 396

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NOTE 18 QUARTERLY FINANCIAL DATA UNAUDITED

Condensed quarterly results of operations for the years ended December 31, 2001 and 2000 were as follows:

Year ended December 31, 2001

	Dec. 31	Sept. 30	June 30	March 31
Interest income	$ 7,230	$ 7,522	$ 7,493	$ 7,616
Interest expense	3,566	4,024	4,273	4,500
Net interest income	3,664	3,498	3,220	3,116
Provision for loan losses	704	341	185	155
Net interest income after provision for loan losses	2,960	3,157	3,035	2,961
Noninterest income	2,604	1,247	1,092	1,258
Noninterest expense	3,701	3,346	3,207	3,265
Earnings before taxes	1,863	1,058	920	954
Provision for income tax expense	853	239	197	216
Net earnings	$ 1,010	$ 819	$ 723	$ 738
Earnings per common share:				
Basic	$ 0.34	$ 0.27	$ 0.24	$ 0.24
Diluted	$ 0.34	$ 0.27	$ 0.24	$ 0.24

Year ended December 31, 2000

	Dec. 31	Sept. 30	June 30	March 31
Interest income	$ 7,826	$ 7,404	$ 7,112	$ 6,675
Interest expense	4,691	4,498	3,980	3,573
Net interest income	3,135	2,906	3,132	3,102
Provision for loan losses	150	130	185	130
Net interest income after provision for loan losses	2,985	2,776	2,947	2,972
Noninterest income	985	993	868	877
Noninterest expense	3,064	3,033	2,924	3,119
Earnings before taxes	906	736	891	730
Provision for income tax expense	172	195	203	185
Net earnings	$ 734	$ 541	$ 688	$ 545
Earnings per common share:				
Basic	$ 0.23	$ 0.18	$ 0.22	$ 0.17
Diluted	$ 0.23	$ 0.18	$ 0.22	$ 0.17