CITRIX SYSTEMS INC
Form 10-K
February 15, 2019
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2018
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .

Commission File Number 0-27084

CITRIX SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware	75-2275152
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

851 West Cypress Creek Road
Fort Lauderdale, Florida 33309
(Address of principal executive offices, including zip code)
Registrant’s Telephone Number, Including Area Code:
(954) 267-3000

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

Common Stock, $.001 Par Value	The Nasdaq Stock Market LLC
(Title of each class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No o

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

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

x Large accelerated filer	o Accelerated filer
o Non-accelerated filer	o Smaller reporting company
	o Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to section 13(a) of the Exchange Act. o

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

The aggregate market value of Common Stock held by non-affiliates of the registrant computed by reference to the price of the registrant's Common Stock as of the last business day of the registrant's most recently completed second fiscal quarter (based on the last reported sale price on The Nasdaq Global Select Market as of such date) was $13,765,749,900. As of February 8, 2019 there were 131,725,833 shares of the registrant's Common Stock, $.001 par value per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant intends to file a definitive proxy statement pursuant to Regulation 14A within 120 days of the end of the fiscal year ended December 31, 2018. Portions of such definitive proxy statement are incorporated by reference into Part III of this Annual Report on Form 10-K.

CITRIX SYSTEMS, INC.
TABLE OF CONTENTS

Part I:			
	Item 1	Business	3
	Item 1A.	Risk Factors	12
	Item 1B.	Unresolved Staff Comments	27
	Item 2	Properties	27
	Item 3	Legal Proceedings	27
	Item 4	Mine Safety Disclosures	27
Part II:			
	Item 5	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	28
	Item 6	Selected Financial Data	29
	Item 7	Management's Discussion and Analysis of Financial Condition and Results of Operations	30
	Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	48
	Item 8	Financial Statements and Supplementary Data	48
	Item 9	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	49
	Item 9A.	Controls and Procedures	49
	Item 9B.	Other Information	51
Part III:			
	Item 10	Directors, Executive Officers and Corporate Governance	51
	Item 11	Executive Compensation	51
	Item 12	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	51
	Item 13	Certain Relationships and Related Transactions and Director Independence	51
	Item 14	Principal Accounting Fees and Services	51
Part IV:			
	Item 15	Exhibits, Financial Statement Schedules	52
	Item 16	Form 10-K Summary	57

PART I

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Actual results could differ materially from those set forth in the forward-looking statements. Certain factors that might cause such actual results to differ materially from those set forth in these forward-looking statements are included in Part I, Item 1A "Risk Factors" beginning on page 12.

ITEM 1. BUSINESS

Business Overview

Citrix Systems, Inc., or Citrix, the Company, we or us, is a Delaware corporation incorporated on April 17, 1989. Citrix aims to power a better way to work by delivering the experience, security, and choice people and organizations need to unlock innovation, engage customers, and be productive - anytime, anywhere. It is our vision to deliver a general purpose digital workspace that empowers all users with unified, secure, and reliable access to all apps and content needed to be productive - anytime, anywhere. We help customers reimagine the future of work by delivering unified digital workspace, networking, and analytics solutions that improve employee experience and productivity, while also simplifying IT's ability to adopt and manage complex cloud environments.

Digital transformation is occurring in every industry at a rapid pace. Businesses today are adopting cloud services and software as a service, or SaaS, apps on a broad basis. Many businesses are juggling multiple cloud providers and dozens of new SaaS apps. Yet, we believe many organizations will still be managing legacy infrastructure and on-premises workloads for many years to come. This combination of increased complexity with mobility and new workstyles results in a fragmented user experience, an increase in security risks, and IT teams challenged to properly manage the technology needs of organizations.

As a result of this convergence of cloud, legacy systems, and newer technologies, including artificial intelligence and machine learning, organizations are now seeking to adopt multi-cloud, hybrid-cloud strategies for their IT infrastructure, so that they can provide flexibility to navigate all systems and security to address ever-expanding attack surfaces, all without sacrificing experience for their end users.

As we continue on our journey of cloud transformation as an organization, we are focused on three strategic priorities. First, we are accelerating our move to a subscription-based business model and to offer all of our solutions as cloud services to give organizations flexibility in how they work. Second, we are continuing to unify our portfolio to simplify user and IT experience. Finally, to help meet the expected demands of the future, we are expanding our opportunities with adjacent technologies to help extend value to our customers and meet their needs in the future. In 2018, Citrix made acquisitions in two such areas, acquiring Cedexis for Intelligent Traffic Management to boost the capabilities of our networking solutions, and Sapho to expand Intelligent Workflow capabilities into the Citrix Workspace solutions.

In 2018, we retired all of our point product brand names to simplify our positioning and product naming to make our solutions easier to understand, sell and buy. Citrix simplified its solutions naming to three categories: Digital Workspace, Networking, and Analytics. We moved all products to a functional descriptor naming mechanism, such as Citrix Virtual Apps and Desktops, Citrix ADC, Citrix SD-WAN, Citrix Endpoint Management, etc. We market and license our solutions through multiple channels worldwide, including selling through resellers and direct over the Web. Our partner community comprises thousands of value-added resellers, or VARs known as Citrix Solution Advisors, value-added distributors, or VADs, systems integrators, or SIs, independent software vendors, or ISVs, original equipment manufacturers, or OEMs, and Citrix Service Providers, or CSPs.

Separation of GoTo Business

On January 31, 2017, we completed the separation and subsequent merger of the GoTo family of service offerings of our wholly-owned subsidiary, GetGo, Inc., or GetGo, to LogMeIn, Inc., or LogMeIn, pursuant to a pro rata distribution to our stockholders of 100% of the shares of common stock of GetGo, pursuant to a Reverse Morris Trust, or RMT, transaction. The GoTo family of service offerings consisted of GoToMeeting, GoToWebinar, GoToTraining, GoToMyPC, GoToAssist, Grasshopper and OpenVoice, or collectively the GoTo Business, and had historically been part of our GoTo Business segment. As a result, the consolidated financial statements included in this Annual Report on Form 10-K and related financial information reflect the GoTo Business operations, assets and liabilities, and cash flows as discontinued operations for all periods presented. See Note 3 to our consolidated financial statements

included in this Annual Report on Form 10-K for further information.

Solutions and Services

We are enabling the future of work by delivering digital workspace, networking, and analytics solutions that help customers drive innovation and be productive anytime, anywhere. Our unified, contextual and secure digital workspace enables customers to deliver and manage the apps, desktops, data and devices users need. The Citrix networking portfolio, when implemented with digital workspace, ensures consistency of user experience, enables agile delivery of new and merging application types, and facilitates reliability and performance from any resource location. Our customers can realize the full benefits of hybrid and multi-cloud environments while simplifying management and overcoming security challenges. Our solutions and services target customers of all sizes, from small businesses to large global enterprises.

Our secure digital workspace technologies are available as cloud services and can be managed as hybrid and multi-cloud environments. Our cloud-based services, or Citrix Cloud Services, enable our customers to provide a flexible way to manage their applications and data. This cloud-based approach is designed to provide reduced infrastructure, centralized control and SaaS-style updates resulting in lower administration cost and complexity. These cloud services are available as an integrated service or as individual services scaled to meet our customers' business needs.

We offer subscription-based and on-premise subscription software and perpetual licenses for our solutions, along with annual subscriptions for software updates and technical support. Perpetual licenses allow our customers to use the version of software initially purchased into perpetuity, while subscription licenses are limited to a specified period of time. Customer Success Services, which include software maintenance subscriptions, give customers the right to upgrade to new software versions if and when any updates are delivered during the subscription term. Perpetual license software comes primarily in electronic-based forms. We also offer on-premise subscription licenses to service providers through the Citrix Service Provider program, which are invoiced on a monthly basis based on reported license usage. Our services delivered via the cloud are accessed over the Internet for usage during the subscription period. Our hardware appliances come pre-loaded with software for which customers can purchase perpetual licenses and annual support and maintenance.

Digital Workspace (formerly Workspace Services)

Application Virtualization and VDI

Our Application Virtualization and Virtual Desktop Infrastructure, or VDI, solutions give employees the freedom to work from anywhere while cutting IT costs, securely delivering Windows, Linux, Web and SaaS apps, plus full virtual desktops to any device.

- Citrix Virtual Apps and Desktops (formerly XenDesktop) is a fully-integrated, cloud-enabled app and desktop virtualization solution that gives customers the flexibility to remotely deliver desktops and applications - from any cloud, on-premises datacenters or both. Citrix Virtual Apps and Desktops include HDX technologies to give users a high-definition experience - even when using multimedia, real-time voice and video collaboration, USB devices and 3D graphics content - while consuming less bandwidth than competing solutions. Citrix Virtual Apps and Desktops is available in multiple editions designed for different requirements, from simple VDI-only deployments to sophisticated, enterprise-class desktop and application delivery services that can meet the needs of everything from basic call center environments to high-powered graphics workstations. With Citrix Virtual Apps and Desktops Advanced and Premium editions - as well as the cloud service - customers also receive Citrix Virtual Apps to manage and mobilize Windows applications.
- Citrix Virtual Apps (formerly XenApp) is a widely deployed solution that enables Windows and Linux applications to be remotely delivered to Macs, PCs, thin clients and Android/iOS mobile devices from any cloud, on-premises datacenter or both. Citrix Virtual Apps enable people to work better by running applications in the security of the data center or cloud, and using Citrix HDX technologies to deliver a superior user experience to any device, anywhere. Keeping business applications under the centralized control of IT administrators enhances security and reduces the costs of managing applications on every PC. Exclusively available as a cloud service, on-premises or hybrid solution, it allows customers to choose the deployment option that best aligns with their enterprise cloud strategy. In partnership with Microsoft, Citrix Virtual Apps is designed to embrace and extend Microsoft Remote Desktop technology by providing advanced provisioning, performance, monitoring and management functionality. Our joint solution with Microsoft lowers the cost of delivering and maintaining Windows applications for all users in the

enterprise.

Citrix Endpoint Management (formerly Enterprise Mobility Management)

Increasingly, for many employees, mobile devices are their workspaces. Our Citrix Endpoint Management (formerly XenMobile) solutions are designed to increase productivity and security with mobile device management, or MDM, mobile application management, or MAM, mobile content management, or MCM, secure network gateway, secure email, and enterprise-grade mobile apps in one comprehensive solution.

- Citrix Endpoint Management provides unified endpoint management for a secure digital workspace allowing IT to meet mobile device security and compliance requirements for "bring your own device" programs and corporate devices while enabling user productivity. As part of a workspace, Citrix Endpoint Management centralizes the management of mobile devices, traditional desktops, laptops and Internet of Things, or IoT, through a single platform. Citrix Endpoint Management directly integrates with Microsoft EMS/Intune to extend mobility and device management capabilities.

Content Collaboration

Our Content Collaboration offering meets the collaboration and mobility needs of users, with scalable data security requirements for small business to the enterprise.

- Citrix Content Collaboration (formerly ShareFile) is a secure, cloud-based file sharing and storage solution built for mobile business, giving users enterprise-class data services across all corporate and personal mobile devices, while maintaining total IT control. Citrix Content Collaboration protects data throughout the storage and transfer process, using up to 256-bit encryption and SSL or Transport Layer Security, or TLS, encryption protocols for transfer and 256-bit encryption for files at rest on ShareFile servers. Password protection and granular access to folders and files stored with Citrix Content Collaboration ensure that data remains in control of the company. With Citrix Content Collaboration Enterprise, organizations can manage their data on-premises in customer managed StorageZones, select Citrix managed secure cloud options or create a mix of both to meet the needs for data sovereignty, compliance, performance and costs. For businesses that use multiple storage repositories, Citrix Content Collaboration provides unified access to a wide range of cloud-based and on-premises storage repositories, making it simple and easy for employees to find and access their files and documents. Additionally, Citrix Content Collaboration supports e-signature, feedback and approval workflows that help businesses adopt the mobile, digital office.

Citrix Workspace

We offer customers the opportunity to acquire a number of Citrix products through a single comprehensive integrated offering, Citrix Workspace, which includes our Citrix Virtual Apps and Desktops, Citrix Endpoint Management, Citrix Content Collaboration, Citrix Analytics and networking products. Citrix Workspace securely delivers the apps, desktops, branch networking and WAN, enterprise mobility management and data people need for business productivity. We offer one of the industry's most complete and integrated digital workspaces that is streamlined for IT control and easily accessible for users.

- Citrix Workspace delivers a unified user experience for any app or desktop on any device, including tablets, smartphones, PCs, Macs or thin clients. IT can securely deliver content over low-bandwidth high-latency WANs, highly variable 3G/4G mobile networks or a reliable corporate LAN to improve end-user experience while offering enterprise-grade security to data and applications. Citrix Workspace provides a unified, flexible solution that can streamline device, application and desktop deployment and lifecycle management to increase employee engagement, productivity, and reduce IT costs. Citrix Workspace offers choice of device, cloud and network and can be deployed on-premises, via the cloud or as a hosted service.

Networking

Our Networking products are available via hardware or software-based solutions and allow organizations to deliver apps and data with the security, reliability, and speed trusted by thousands of customers worldwide.

- Citrix ADC (formerly NetScaler ADC) is a software-defined application delivery controller designed to meet the demands of organizations undergoing digital transformation. Citrix ADC enables the adoption of hybrid and multi-cloud application delivery with improved application performance, reliability and security at an optimized price point. Citrix ADC allows customers to obtain detailed application analytics with the value of machine learning. It also optimizes application delivery for cloud native application architectures based on the Kubernetes orchestration platform, and provides service graph analytics for efficient troubleshooting within the microservices environment. Additionally, we extend the platform with best-of-breed web application firewall, or WAF, capabilities

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that protect web applications and sites from both known and unknown attacks, which include application-layer and zero-day threats.

- Citrix SD-WAN (formerly NetScaler SD-WAN) increases the security, performance and reliability of applications delivered from the legacy data center, cloud, or SaaS, while delivering additional value for virtualized applications and desktops. The platform combines routing, security, WAN optimization, and path control to simplify implementation and maintenance of the branch network, allowing customers to adopt a hybrid WAN architecture that effectively increases WAN capacity and manageability.

Support

Citrix offers technical support to minimize business downtime for our customers. Several options are available.

- Customer Success Services are offered in support of our perpetual software and our cloud-based services. Customers are given a choice of tiered offerings combining product version upgrades, guidance, enablement, support and proactive monitoring to help customers and partners fully realize their business goals and maximize their Citrix investments. Additionally, customers may upgrade to receive personalized support from a dedicated team led by an assigned account manager. Fees associated with this offering are recognized ratably over the term of the contract.

- Hardware Maintenance is offered in support of our Networking products. Customers are given a choice of tiered offerings including technical support, software upgrades, and replacement of malfunctioning appliances. Dedicated account management is available as an add-on to the program. Fees associated with this offering are recognized ratably over the term of the contract.

Professional Services

We offer a portfolio of professional services to help business partners and customers manage the quality of implementation, operation and support of our solutions. These services are available for additional fees, paid on an annual or transactional basis.

- Citrix Consulting guides the successful implementation of Citrix technologies and solutions with proven methodologies, tools and leading practices. Citrix Consulting focuses on strategic engagements with enterprise customers who have complex, mission-critical, or large-scale Citrix deployments. These engagements are typically fee-based engagements for the most challenging projects in terms of scope and complexity, requiring consultants with project methodology qualifications and Citrix expertise. Citrix Consulting is also responsible for developing best practices which are disseminated to businesses, partners and end users through training and written documentation. Leveraging these best practices enables our integration resellers to provide more complex systems, reach new buyers within existing customer organizations, and provide more sophisticated system proposals to prospective customers.

- Product Training & Certification enables customers and partners to be successful with Citrix and achieve business objectives faster. Authorized Citrix training is available as needed. Traditional or virtual instructor-led training offerings feature Citrix Certified Instructors delivering Citrix-developed courseware in a classroom or remote setting at one of our Citrix Authorized Learning Centers, or CALCs, worldwide. Self-Paced Online offerings provide technically robust course content without an instructor and include hands-on practice via virtual labs. Certifications validate key skills and are available for administrators, engineers, architects and sales professionals.

Customers

We believe that the primary IT buyers involved in decision-making related to our solutions are the following:

- Strategic IT Executives including chief information officers, chief technology officers, chief information security officers and vice presidents of infrastructure, who have responsibility for ensuring that IT services are enablers to business initiatives and are delivered with the best performance, availability, security and cost.
- Desktop Operations Managers who are responsible for managing Windows Desktop environments including corporate help desks.
- IT Infrastructure Managers who are responsible for managing and delivering Windows-based applications.
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Directors of Messaging and Mobility, who are, respectively, responsible for messaging technologies and defining mobile strategies and solutions for securing and managing mobile devices including their content and applications.

- Network Architects who are responsible for delivering Web-based applications who have primary responsibility for the WAN infrastructure for all applications.

6

- Server Operations Managers who are responsible for specifying datacenter systems and managing daily operations.
- Small business owners who are responsible for choosing the systems needed to support their business goals, such as SaaS.
- Chief technology officer and engineering department (managers and architects, among others) for telecommunications service providers.
- Line of business and functional executives that determine the need for our cloud and subscription-based offerings at certain enterprises.
- Chief information officer and engineering departments within service providers, using our solutions to deliver desktops and applications as hosted cloud services.

The IT buyers for our solutions include a wide variety of industries including those in financial services, technology, healthcare, education, government and telecom.

Technology Relationships

We have a number of technology relationships in place to accelerate the development of existing and future solutions and our go-to-market initiatives. These relationships include cross-licensing, OEM, resell, joint reference architectures, and other arrangements that result in better solutions for our customers.

Microsoft

For almost 30 years, Citrix and Microsoft have maintained a strategic partnership spanning product development, go-to-market initiatives and partner development, enabling our mutual customers' secure, high-performance delivery of applications, desktops and data to their employees anywhere, anytime on any device. Together, Citrix and Microsoft offer solutions and services that aid and accelerate the transition from on-premises IT infrastructure and practices to emerging hybrid-cloud and multi-cloud delivery models for the full breadth of legacy and modern applications. These solutions and services include the unique ability to deliver Windows 10 desktops hosted within the Microsoft Azure cloud platform, services to deploy apps directly on Azure, Office 365 and Microsoft Teams integrations, and smart tools to simplify the deployment of a new class of integrated workspaces that include legacy Windows apps and a growing array of popular SaaS applications.

In 2018, we announced a new collaboration agreement to provide customers a simplified experience by enabling them to purchase and deploy Citrix-powered digital workspaces and networking solutions directly within Microsoft Azure. We also announced a number of new services and capabilities to assist organizations in the planning and execution of their cloud migrations and accelerate adoption. We also created the Citrix and Microsoft Cloud Alliance program to provide our joint partners with the resources, training and enablement needed to ensure our customers' success.

Google

We continue to build on our five-year partnership with Google through which we bring digital workspace solutions to enterprise customers who are increasingly looking to public and hybrid clouds to address competitive demands and solve business challenges. Our technology integrations provide cloud delivery of Citrix applications and desktops, power management and Citrix ADC with Google Cloud. In 2018, we announced a new Citrix ADC integration that allows developers to take advantage of Google Cloud Platform cloud computing capabilities alongside Citrix load balancing and traffic management features to manage their workloads in a simple, secure and reliable way. We also continue to optimize Citrix Endpoint Management to support Android and Chrome devices, as well as Citrix Workspace App to enable organizations to provision, manage and deliver apps on Chrome devices.

Additional Relationships

We have developed our partner ecosystem to enable infrastructure choice for our Citrix Cloud customers. For public cloud choice, we have relationships with Microsoft Azure, Google Cloud, AWS and Oracle. Moreover, in the past year we announced the Citrix Workspace Appliance program to enable a hybrid cloud choice for on-premises solutions. We are also forging partnerships with SaaS providers to deliver cloud access control and intelligent workspaces. In August of 2018, we announced the availability of the Citrix IT Service Management Connector, an offering jointly developed with ServiceNow that reduces the time involved in application and desktop provisioning, and improves the employee experience.

Delivering Secure and Cost-Effective Hybrid Cloud Solutions with Hewlett Packard Enterprise, Cisco, Lenovo and FlexxibleIT

In delivering choice, we recognize that many enterprise customers have significant investments in on-premises infrastructure that continues to serve their financial investments or have regulatory requirements that require data control and governance. Together with our infrastructure partners like Hewlett Packard Enterprise, or HPE, Cisco, Lenovo and FlexxibleIT,

we provide a simple and fast way to deploy hybrid cloud app and desktop virtualization that is scalable and secure. With Citrix Cloud Services, companies can quickly and cost-effectively create a centrally managed, enterprise-class virtualized app and desktop environment in a rack-mounted appliance and manage VDI as-a-service in the cloud with simple subscription-based pricing. Compute, network and storage are pre-integrated with a Citrix Cloud connection in an easy to use hyper converged infrastructure, or HCI, appliance, and the offering is tested and certified as Citrix Ready, which showcases verified products that are trusted to enhance Citrix solutions for mobility, virtualization, networking and cloud platforms.

We continue to invest in our Global System Integrator partnerships with organizations that have multiple offerings in the market with Citrix Digital Workspace and Citrix Networking solutions, including IBM, DXC, and Fujitsu. In addition, our partners continue to expand their focus on the broad range of our solutions. We also continue to provide an easy way for our customers to locate compatible solutions and our channel partners to evaluate and deploy joint offerings through our Citrix Ready program. Active partners, including Amazon Web Services, Cisco, Google, Microsoft and hundreds of other technology companies, use the Citrix Ready Program to learn about and integrate with Citrix technology across our products for workspace, networking, and analytics with the number of verified products available in the Citrix Ready Marketplace growing over the past year.

Research and Development

Our innovation engine continues to advance, and our growth in Citrix Cloud Services has also accelerated our innovation and shortened the time to value for end-users. As of December 31, 2018, we held a worldwide portfolio of 2,725 patents and had an additional 1,126 patent applications pending.

We focus our research and development efforts on developing new cross-portfolio solutions across our Digital Workspaces, Networking and Analytics solutions and services, while continuing to invest in functional improvements to our core market technologies to expand Citrix differentiation and opportunity within each category. We solicit extensive feedback concerning product development from customers, both directly from and indirectly, through our channel distributors and partners. We believe that our global software development teams and our core technologies represent a significant competitive advantage for us. Included in the software development teams are individuals focused on research activities that include prototyping ways to integrate emerging technologies and standards into our product offerings. We incurred research and development expenses of $440.0 million in 2018, $415.8 million in 2017 and $395.4 million in 2016.

Sales, Marketing and Services

We market and license our solutions through multiple channels worldwide, including selling through resellers, direct and over the Web. Our partner community comprises thousands of value-added resellers known as Citrix Solution Advisors, VADs, SIs, ISVs, OEMs, and CSPs. Distribution channels are managed by our worldwide sales and services organization. Partners receive training and certification opportunities to support our portfolio of solutions and services.

We reward our partners that identify new business, and provide sales expertise, services delivery, customer education, technical implementation and support of our portfolio of solutions through our incentive program. We continue to focus on increasing the productivity of our existing partners, while also adding new transacting partners, building capacity through targeted recruitment, introducing programs to increase partner mindshare, limit channel conflict and increase partner loyalty to us.

As we lead with the cloud, we have been cultivating a global base of technology partners within our CSP program. Our CSP program provides subscription-based services in which the CSP partners host software services to their end users. Our CSP partners, consisting of managed service providers, ISVs, Citrix Solution Advisors, hosting providers and telcos, among others, license our desktop, application, networking and enterprise mobility management solutions on a monthly consumption basis. With our software, these partners then create differentiated offers of their own, consisting of cloud-hosted applications and cloud-hosted desktops, which they manage for various customers, ranging from SMBs to enterprise IT. Besides supplying technology, we are actively engaged in assisting these partners in developing their hosted businesses either within their respective data centers or leveraging public cloud infrastructure by supplying business and marketing assistance.

Engagement with SIs and ISVs continues to be a substantial part of our strategic roadmap within large enterprise and government markets. Our integrator partnerships include organizations such as Atos, Accenture, Avanade, Capgemini,

Dimension Data, DXC, Fujitsu, IBM Global Services, TCS and Wipro, who all deliver consultancy or global offerings powered by the Citrix Workspace. The ISV program maintains a strong representation across targeted industry verticals including healthcare, financial services and telecommunications. Members in the ISV program include Allscripts, Cerner Corporation, Epic Systems Corporation and McKesson Corporation, among several others. For all of our channels, we regularly take actions to improve the effectiveness of our partner programs and further strengthen our channel relationships through management of

non-performing partners, recruitment of partners with expertise in selling into new markets and forming additional strategic global and national partnerships.

Our corporate marketing organization provides an integrated global approach to sales and industry event support, digital and social marketing, sales enablement tools and collateral, advertising, direct mail, industry analyst relations and public relations coverage to market our solutions. Our efforts in marketing are focused on generating leads for our sales organization and our indirect channels to acquire net new accounts and expand our presence with existing customers. Our partner development organization actively supports our partners to improve their commitment and capabilities with Citrix solutions. Our customer sales organization consists of field-based sales engineers and corporate sales professionals who work directly with our largest customers, and coordinate integration services provided by our partners. Additional sales personnel, working in central locations and in the field, provide support including recruitment of prospective partners and technical training with respect to our solutions.

In fiscal year 2018, one distributor, the Arrow Group, accounted for 14%, of our total net revenues. In fiscal year 2017 and 2016, two distributors, Ingram Micro and Arrow, accounted for 13% and 12%, respectively, of our total net revenues. Our distributor arrangements with Ingram Micro and Arrow consist of several non-exclusive, independently negotiated agreements with its subsidiaries, each of which covers different countries or regions. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies and Estimates" and Note 2 to our consolidated financial statements included in this Annual Report on Form 10-K for the year ended December 31, 2018 for information regarding our revenue recognition policy.

International revenues (sales outside the United States) accounted for approximately 47.0% of our net revenues for the year ended December 31, 2018, 46.3% of our net revenues for the year ended December 31, 2017 and 46.3% of our net revenues for the year ended December 31, 2016. For detailed information on our international revenues, please refer to Note 12 to our consolidated financial statements included in this Annual Report on Form 10-K for the year ended December 31, 2018.

Segment Revenue

We operate under one reportable segment. For additional information, see Note 12 to our consolidated financial statements included in this Annual Report on Form 10-K for the year ended December 31, 2018.

Operations

For our cloud-based solutions, we use a combination of co-located hosting facilities and increasingly Microsoft Azure and Amazon Web Services as well as other infrastructure-as-a-service providers. For our Networking products, which include Citrix ADC, we use independent contractors to provide a redundant source of manufacture and assembly capabilities. Independent contractors provide us with the flexibility needed to meet our product quality and delivery requirements. We have manufacturing relationships that we enter into in the ordinary course of business, primarily with Flextronics under which we have subcontracted the majority of our hardware manufacturing activity, generally on a purchase order basis. These third-party contract manufacturers also provide final test, warehousing and shipping services. This subcontracting activity extends from prototypes to full production and includes activities such as material procurement, final assembly, test, control, shipment to our customers and repairs. Together with our contract manufacturers, we design, specify and monitor the tests that are required to meet internal and external quality standards. Our contract manufacturers manufacture our products based on forecasted demand for our solutions. Each of the contract manufacturers procures components necessary to assemble the products in our forecast and test the products according to our specifications. We are dual-sourced on our components, however, in some instances, those sources may be located in the same geographic area. Accordingly, if a natural disaster occurred in one of those areas, we may need to seek additional sources. Products are then shipped to our distributors, VARs or end-users. If the products go unsold for specified periods of time, we may incur carrying charges or obsolete material charges for products ordered to meet our forecast or customer orders. In 2018, we did not experience any material difficulties or significant delays in the manufacture and assembly of our products.

We are responsible for all purchasing, inventory, scheduling, order processing and accounting functions related to our operations. For our software products, production, warehousing and shipping are performed by our independent contractors HPE, Ireland and Digital River. Master software, development of user manuals, packaging designs, initial product quality control and testing are primarily performed at our facilities. In some cases, independent contractors also duplicate master software, print documentation and package and assemble products to our specifications.

While it is generally our practice to promptly ship our products upon receipt of properly finalized orders, at any given time, we have confirmed product license orders that have not shipped and are unfulfilled. We refer to those unfulfilled product license orders at the end of a given period as “product and license backlog.” As of December 31, 2018 and 2017, the amount of

product and license backlog was not material. We do not believe that backlog, as of any particular date, is a reliable indicator of future performance.

We believe that our fourth quarter revenues and expenses are affected by a number of seasonal factors, including the lapse of many corporations' fiscal year budgets and an increase in amounts paid pursuant to our sales compensation plans due to compensation plan accelerators that are often triggered in the fourth quarter. We believe that these seasonal factors are common within our industry. Such factors historically have resulted in first quarter revenues in any year being lower than the immediately preceding fourth quarter. We expect this trend to continue through the first quarter of 2019. In addition, our European operations generally generate lower revenues in the summer months because of the generally reduced economic activity in Europe during the summer. This seasonal factor also typically results in higher fourth quarter revenues on a sequential basis.

Competition

We sell our solutions in intensely competitive markets. Some of our competitors and potential competitors have significantly greater financial, technical, sales and marketing and other resources than we do. As the markets for our solutions and services continue to develop, additional companies, including those with significant market presence in the computer appliances, software, cloud services and networking industries, could enter the markets in which we compete and further intensify competition. In addition, we believe price competition could become a more significant competitive factor in the future. As a result, we may not be able to maintain our historic prices and margins, which could adversely affect our business, results of operations and financial condition. See “Technology Relationships” and Part I-Item 1A entitled “Risk Factors” included in this Annual Report on Form 10-K for the year ended December 31, 2018.

Digital Workspace

Our Application Virtualization and VDI solutions are based on a proprietary technology platform, the success of which will depend on organizations and customers perceiving technological, operational and security benefits and cost savings associated with adopting desktop and application virtualization solutions. We differentiate our platform from basic virtualization solutions with robust security, higher flexibility and better end user experience to enable IT to deliver Windows and Linux apps and desktops for better business outcomes. Citrix also provides a hardened browser integrated into a web/SaaS access control solution. This enables customers to tightly control how web and SaaS applications are consumed by their users and prevents information leakage. Integration between Secure Web Gateway and Secure Browser Service provides customers with a protective layer between the internet and their secure internal network. Citrix Analytics is a user behavior analytics solution focused on the digital workspace. We also differentiate ourselves from other vendors because we are the only one to offer unified management for all components of the digital workspace that uniquely addresses the needs of on-premises, cloud or hybrid deployments. We also face numerous competitors that provide automation of these processes and approaches, including VMware's Horizon product and the emergence of virtual applications and desktop delivery from public and private cloud services, including Amazon Web Service’s product Amazon WorkSpaces. Also, there continues to be an increase in the number of alternatives to Windows-based applications and Windows operating system powered desktops, particularly in SaaS-delivered applications and mobile devices, such as smartphones and tablets. We believe Citrix Virtual Apps and Desktops give us a competitive advantage by providing customers multiple ways to virtualize and deliver desktops and/or apps with a single integrated virtualization system and delivering a higher performance user experience, more robust security and the flexibility for people to use any device and IT to use any infrastructure, public or private clouds, hyper-converged, traditional servers and storage, or combinations of each.

Our unified endpoint management solution line, Citrix Endpoint Management, competes with companies including AirWatch by VMware, MobileIron, BlackBerry and many other competitors. We believe we differentiate ourselves from these competitors by providing a complete solution, with MDM, MAM and superior core mobile productivity applications, including secure mobile email, calendar, browser, and editing along with integration with Microsoft's EMS mobility management platform and Microsoft Intune. With Citrix Endpoint Management, we also provide robust security and mobile productivity applications that have the deepest and most user friendly integration with Microsoft Office 365. Our apps feature unique workflow integrations designed to make people work better, a significant advantage over competitors that do not focus on the end user experience and either have basic applications or rely on third parties to deliver similar integrations.

We also see competition from competitors that are combining mobile and desktop technologies. We believe our solution, Citrix Workspace, is one of the best solutions available today that can securely deliver a secure digital workspace - with any Windows, Linux, Web, SaaS and native mobile applications, data and virtual desktops - to any device, anywhere. For example, VMware offers the VMware Workspace Suite and more recently introduced VMware Workspace ONE. We expect other vendors to follow suit. We offer market-leading technologies for every component of the Citrix Workspace. Furthermore, we

believe that our end-user experience is a competitive edge when compared to the alternative solutions due to the integration, intuitiveness and self-service features of our offerings.

In the content collaboration space, our Citrix Content Collaboration solution's direct competition includes Dropbox, Box, Syncplicity, Egnyte, Inc., BlackBerry's Watchdox, Accellion, and Google, as well as legacy solutions such as traditional file transfer protocol, or FTP. Many of these competitors have strong brand recognition through consumer and free versions of their products. However, we believe Citrix Content Collaboration offers a superior solution for businesses as it is built specifically for the needs of the business. Our solutions are further differentiated through our ability to store data on-premise or in the Cloud, integration into Citrix Workspace, collaboration with external parties at no additional cost, and the ability to create workflows, eSignatures, and custom forms. Integration into Citrix Analytics for a holistic workspace-centric user behavior analysis, and the ability to connect Citrix Content Collaboration to existing storage repositories are additional key differentiators.

Networking

Our Citrix ADC hardware products compete in traditional data-center-deployed application environments against other established competitors, including F5 Networks, Inc., Dell, Inc., KEMP Technologies, Inc., Fortinet Inc., Radware, A10 Networks, Broadcom, Array Networks, Inc., and AVI Networks, Inc. In addition, with new cloud-integrated and software centric use cases, large cloud providers, such as Amazon Web Services and Microsoft Azure, provide customers with competitive ADC solutions built into their public cloud platforms. The ADC segment also includes a number of emerging start-up and open source software-based companies, such as HA PROXY Technologies, LLC. and NGINX, Inc., which generally focus on developers rather than enterprise customers. We continue to enhance Citrix ADC’s feature capability and invest in go-to-market resources to market Citrix ADC to our existing customer base and new potential customers.

Our Citrix SD-WAN product competes against both traditional WAN optimization and infrastructure vendors, such as Riverbed, VMware, Cisco, Silver Peak Systems and Oracle. Additionally, WAN service providers are integrating and reselling SD-WAN products as a part of their service offering from vendors including VMware, Cisco, Riverbed and Versa Networks, Inc. We have partnered with Microsoft to provide SD-WAN capability into Azure as a part of the Azure Virtual WAN.

Technology and Intellectual Property

Innovation is a core Citrix competency. We have developed many innovations that are important enablers of our continued leadership. Our success is dependent upon our solutions, which are based on intellectual property and core proprietary and open source technologies. These technologies include innovations that optimize the end-to-end user experience in virtual desktop and virtual application environments, enhance networking capabilities and deliver a holistic mobile computing experience.

We have been awarded numerous domestic and foreign patents and have numerous pending patent applications in the United States and foreign countries. Our technology is also protected under copyright laws. Additionally, we rely on trade secret protection and confidentiality and proprietary information agreements to protect our proprietary technology. We have established proprietary trademark rights in markets across the globe, and own hundreds of U.S. and foreign trademark registrations and pending registration applications for marks comprised of or incorporating the Citrix name. See our "Research and Development" discussion above and Part I-Item 1A entitled “Risk Factors” included in this Annual Report on Form 10-K for the year ended December 31, 2018.

Available Information

Our Internet address is http://www.citrix.com. We make available, free of charge, on or through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. The information on our website is not part of this Annual Report on Form 10-K for the year ended December 31, 2018.

Employees

As of December 31, 2018, we had approximately 8,200 employees. We believe our relations with employees are good. In certain countries outside the United States, our relations with employees are governed by labor regulations that provide for specific terms of employment between our company and our employees.

11

ITEM 1A. RISK FACTORS

Our operating results and financial condition have varied in the past and could in the future vary significantly depending on a number of factors. From time to time, information provided by us or statements made by our employees contain "forward-looking" information that involves risks and uncertainties. In particular, statements contained in this Annual Report on Form 10-K for the year ended December 31, 2018, and in the documents incorporated by reference into this Annual Report on Form 10-K for the year ended December 31, 2018, that are not historical facts, including, but not limited to, statements concerning our strategy and operational and growth initiatives, our transition to a subscription-based business model, product development and offerings of solutions and services, market branding and positioning, distribution and sales channels, our partners and other strategic or technology relationships, financial information and results of operations for future periods, competition, seasonal factors, stock-based compensation, licensing and subscription renewal programs, international operations and expansion, investment transactions and valuations of investments and derivative instruments, restructuring charges, reinvestment or repatriation of foreign earnings, fluctuations in foreign exchange rates, tax estimates and other tax matters, liquidity, stock repurchases and dividends, our debt, changes in accounting rules or guidance, changes in domestic and foreign economic conditions, acquisitions, litigation matters and intellectual property matters, constitute forward-looking statements and are made under the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are neither promises nor guarantees. Our actual results of operations and financial condition could vary materially from those stated in any forward-looking statements. The following factors, among others, could cause actual results to differ materially from those contained in forward-looking statements made in this Annual Report on Form 10-K for the year ended December 31, 2018, in the documents incorporated by reference into this Annual Report on Form 10-K or presented elsewhere by our management from time to time. Such factors, among others, could have a material adverse effect upon our business, results of operations and financial condition. We caution readers not to place undue reliance on any forward-looking statements, which only speak as of the date made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

RISKS RELATED TO OUR BUSINESS AND INDUSTRY

Our transition from a perpetual licenses to a subscription-based business model and from on-premises software to cloud-delivered services is subject to numerous risks and uncertainties.

The focus of our business model is shifting away from sales of perpetual licenses to sales of subscriptions. Additionally, we expect our customers will increasingly rely on our cloud-delivered services instead of on-premises deployments. This transition may give rise to a number of risks, including the following:

- we may not be able to effectively or efficiently transition our customers from consuming our solutions and services as on premises solutions to cloud-based solutions;
- we may not be able to implement effective go-to-market strategies and train or properly incentivize our sales team and channel partners in order to effectively market our subscription offerings;
- we may be unsuccessful in maintaining our target pricing, adoption and renewal rates;
- we may select solution prices that are not optimal and could negatively affect our sales or earnings;
- we may incur costs at a higher than forecasted rate as we expand our cloud-delivered services thereby decreasing our gross margins;
- we may experience unpredictability in revenue as a result of usage fluctuations within our cloud service provider business;
- we may not be able to meet customer demand or solution requirements for cloud-delivered services;
- we may encounter customer concerns regarding changes to pricing, service availability, and security; and
- our cloud-delivered services are primarily operated through third party data centers, which we do not control and which may be vulnerable to damage, interruption and cyber-related risks.

As we transition our customers from perpetual licenses to subscriptions, we expect an impact on the timing of revenue recognition and a potential reduction of cash flows. Because subscription revenue is typically recognized over time, we may experience a near-term reduction in revenue and revenue growth as more customers move away from perpetual licenses to subscriptions.

Our subscription-based business model and expansion of our cloud-delivered services may also require a considerable investment in resources, including technical, financial, legal, sales, information technology and operation systems. Market acceptance of such offerings is affected by a variety of factors, including but not limited to: security, reliability, scalability, customization, performance, current license terms, customer preference, customer concerns with entrusting a third party to store and manage their data, public concerns regarding privacy and the enactment of restrictive laws or regulations.

In addition, the metrics we use to gauge the status of our business may evolve over the course of the transition as significant trends emerge. If we are unable to successfully establish our subscription-based business model or expand our cloud-delivered services, and navigate our transition in light of the foregoing risks and uncertainties, our business, results of operations and financial condition could be negatively impacted.

Our business could be adversely impacted by conditions affecting the information technology market.

The markets for our solutions and services are characterized by:

- rapid technological change;
- evolving industry standards;
- fluctuations in customer demand;
- changing customer business models and increasingly sophisticated customer needs; and
- frequent new solution and service introductions and enhancements.

The demand for our solutions and services depends substantially upon the general demand for business-related computer appliances and software, which fluctuates based on numerous factors, including capital spending levels, the spending levels and growth of our current and prospective customers, and general economic conditions. As we continue to grow our subscription service offerings, we must continue to innovate and develop new solutions and features to meet changing customer needs. Our failure to respond quickly to technological developments or customers' increasing technological requirements could lower the demand for any solutions and services and/or make our solutions uncompetitive and obsolete. Moreover, the purchase of our solutions and services is often discretionary and may involve a significant commitment of capital and other resources. We need to continue to develop our skills, tools and capabilities to capitalize on existing and emerging technologies, which will require us to devote significant resources.

U.S. economic forecasts for the information technology, or IT, sector are uncertain and continue to highlight an industry in transition from legacy platforms to mobile, cloud, data analytics and social solutions. If our current and prospective customers cut costs, they may significantly reduce their information technology expenditures. Additionally, if our current and prospective customers shift their IT spending more rapidly towards newer technologies and solutions as mobile, cloud, data analytics and social platforms evolve, the demand for our solutions and services most aligned with legacy platforms (such as our desktop virtualization solutions) could decrease. Fluctuations in the demand for our solutions and services could have a material adverse effect on our business, results of operations and financial condition.

We face intense competition, which could result in customer loss, fewer customer orders and reduced revenues and margins.

We sell our solutions and services in intensely competitive markets. Some of our competitors and potential competitors have significantly greater financial, technical, sales and marketing and other resources than we do. We compete based on our ability to offer to our customers the most current and desired solution and services features. We expect that competition will continue to be intense, and there is a risk that our competitors' products may be less costly, more heavily discounted or free, provide better performance or include additional features when compared to our solutions. Additionally, there is a risk that our solutions may become outdated or that our market share may erode. Further, the announcement of the release, and the actual release, of new solutions incorporating similar features to our solutions could cause our existing and potential customers to postpone or cancel plans to license certain of our existing and future solution and service offerings. Existing or new solutions and services that provide alternatives to our solutions and services could materially impact our ability to compete in these markets. As the markets for our solutions and services, especially those solutions in early stages of development, continue to develop, additional companies, including companies with significant market presence in the computer hardware, software, cloud, networking, mobile, data sharing and related industries, could enter, or increase their footprint in, the markets in which we compete and further intensify competition. In addition, we believe price competition could become a more significant competitive factor in the future. As a result, we may not be able to maintain our historic prices and margins, which could adversely affect our business, results of operations and financial condition.

We expect to continue to face additional competition as new participants enter our markets and as our current competitors seek to increase market share. Further, we may see new and increased competition in different geographic regions. The generally low barriers to entry in certain of our businesses increase the potential for challenges from new

industry competitors, whether small and medium sized businesses or larger, more established companies. Smaller companies new to our market may have more flexibility to develop on more agile platforms and have greater ability to adapt their strategies and cost structures, which may give them a competitive advantage with our current or prospective customers. We may also experience increased competition from new types of solutions as the options for Digital Workspace and Networking offerings increase. Further, as our industry evolves and if our company grows, companies with which we have strategic alliances may become competitors in other product areas, or our current competitors may enter into new strategic relationships with new or existing competitors, all of which may further increase the competitive pressures we face.

A significant portion of our revenues historically has come from our Application Virtualization and VDI solutions and our Networking products, and decreases in sales for these solutions could adversely affect our results of operations and financial condition.

A significant portion of our revenues has historically come from our Application Virtualization and VDI solutions and Networking products. We continue to anticipate that sales of these solutions and products and related enhancements and upgrades will constitute a majority of our revenue for the near future. Declines and variability in sales of certain of these solutions and products could occur as a result of:

- new competitive product releases and updates to existing products delivered as on premises solutions, especially cloud-based products;
- industry trend to focus on the secure delivery of applications on mobile devices;
- introduction of new or alternative technologies, products or service offerings by third parties;
- termination or reduction of our product offerings and enhancements;
- potential market saturation;
- failure to enter new markets;
- price and product competition resulting from rapid and frequent technological changes and customer needs;
- general economic conditions;
- complexities and cost in implementation;
- failure to deliver satisfactory technical support;
- dissatisfied customers; or
- lack of commercial success of our technology relationships.

We have experienced increased competition in the Application Virtualization and VDI business from directly competing solutions, alternative products and products on new platforms. For example, Amazon Web Services provides Amazon WorkSpaces and VMware provides Horizon, both of which compete with these offerings among numerous other competitors. Also, there continues to be an increase in the number of alternatives to Windows operating system powered desktops, in particular mobile devices such as smartphones and tablets. Users may increasingly turn to these devices to perform functions that would have been traditionally performed on desktops and laptops, which in turn may reduce the market for our Application Virtualization and VDI solutions. Further, increased use of certain SaaS applications may result in customers relying less on Windows applications. If sales of our Application Virtualization and VDI solutions decline as a result of these or other factors, our revenue would decrease and our results of operations and financial condition would be adversely affected.

Similarly, we have experienced increased competition for our Networking products, including our core Citrix ADC solution. For example, there are an increasing number of alternatives to traditional ADC hardware solutions, enabling our customers to build internal solutions, rely on open source technology or leverage software and cloud-based offerings. In addition, our Networking business generates a substantial portion of its revenues from a limited number of customers with uneven and declining purchasing patterns. As a result, the potential for declining sales within our Networking business may not be offset by gains in other areas of our Networking and other businesses, which could result in our operations and financial condition being adversely affected.

Our growth prospects depend on increasing the number of users within our customer base, as well as attracting new customers.

We believe that our penetration into our existing customer base is limited and that we have an opportunity to expand the pool of the available users of our solutions. This represents a longer-term opportunity to both expand within our installed base and to attract new customers. There are no guarantees, however, that we will be able to capitalize on this opportunity if we do not innovate and expand the set of potential users, or otherwise attract customer interest and adoption. If we are unable to expand the number of users within our customer base or unable to attract new customers, our revenue would decrease and our results of operations and financial condition would be adversely affected.

In order to be successful, we must attract, engage, retain and integrate key employees and have adequate succession plans in place, and failure to do so could have an adverse effect on our ability to manage our business.

Our success depends, in large part, on our ability to attract, engage, retain, and integrate qualified executives and other key employees throughout all areas of our business. Identifying, developing internally or hiring externally, training

and retaining highly-skilled managerial, technical, sales and services, finance and marketing personnel are critical to our future, and competition for experienced employees can be intense. In order to attract and retain executives and other key employees in a competitive marketplace, we must provide a competitive compensation package, including cash- and equity-based compensation. If we do not obtain the stockholder approval needed to continue granting equity compensation in a competitive manner, our ability to attract, retain, and motivate executives and key employees could be weakened. Failure to successfully

hire executives and key employees or the loss of any executives and key employees could have a significant impact on our operations. Competition for qualified personnel in our industry is intense because of the limited number of people available with the necessary technical skills and understanding of solutions in our industry. The loss of services of any key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring may harm our business and results of operations.

Effective succession planning is also important to our long-term success. We have experienced significant changes in our senior management team over the past several years, including the appointments of David J. Henshall as our President and Chief Executive Officer in 2017 and Andrew Del Matto as our Executive Vice President and Chief Financial Officer in 2018. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution. Further, changes in our management team may be disruptive to our business, and any failure to successfully integrate key new hires or promoted employees could adversely affect our business and results of operations.

Industry volatility and consolidation may result in increased competition.

The industry has been volatile and there has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue, especially in light of the increased availability of domestic cash resulting from the Tax Cuts and Jobs Act. In addition, we expect companies will attempt to strengthen or hold their market positions in an evolving and volatile industry. For example, some of our competitors have made acquisitions or entered into partnerships or other strategic relationships to offer a more comprehensive solution than they had previously offered. Further, some companies are making plans or may be under pressure by stockholders to divest businesses and such divestitures may result in stronger competition. Additionally, as IT companies attempt to strengthen or maintain their market positions in the evolving digital workspace services, networking and data sharing markets, these companies continue to seek to deliver comprehensive IT solutions to end users and combine enterprise-level hardware and software solutions that may compete with our Digital Workspace and Networking solutions. These consolidators or potential consolidators may have significantly greater financial, technical and other resources and brand loyalty than we do, and may be better positioned to acquire and offer complementary solutions and services. The companies resulting from these possible combinations may create more compelling solution and service offerings and be able to offer greater pricing flexibility or sales and marketing support for such offerings than we can. These heightened competitive pressures could result in a loss of customers or a reduction in our revenues or revenue growth rates, all of which could adversely affect our business, results of operations and financial condition.

Actual or perceived security vulnerabilities in our solutions and services or cyberattacks on our networks could have a material adverse impact on our business, results of operations and financial condition.

Use of our solutions and services may involve the transmission and/or storage of data, including in certain instances customers' business, financial and personal data. Thus, maintaining the security of our solutions, computer networks and data storage resources is important as security breaches could result in solution or service vulnerabilities and loss of and/or unauthorized access to confidential information. We aim to engineer secure solutions and services, enhance security and reliability features in our solutions and services, deploy security updates to address security vulnerabilities and seek to respond to known security incidents in sufficient time to minimize any potential adverse impact. We have in the past, and may in the future, discover vulnerabilities in our solutions or underlying technology, which could expose our operations and our customers to risk until such vulnerabilities are addressed. In addition, to the extent we are diverting our resources to address and mitigate these vulnerabilities, it may hinder our ability to deliver and support our solutions and customers in a timely manner.

As a more general matter, unauthorized parties may attempt to misappropriate or compromise our confidential information or that of third parties, create system disruptions, product or service vulnerabilities or cause shutdowns. These perpetrators of cyberattacks also may be able to develop and deploy viruses, worms, malware and other malicious software programs that directly or indirectly attack our products, services or infrastructure (including third party cloud service providers -- such as Microsoft Azure and Amazon Web Services and Google Cloud Platform - upon which we rely). Because techniques used by these perpetrators to sabotage or obtain unauthorized access to our systems change frequently and generally are not recognized until long after being launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. Despite our efforts to build secure services, we can make no assurance that we will be able to detect, prevent, timely and adequately address, or

mitigate the negative effects of cyberattacks or other security breaches. For example, in late 2018, our file sync and sharing service was the target of a “credential stuffing” attack, in which we believe that malicious third-party actors used credentials obtained from breaches unrelated to any Citrix service to attempt to gain access to individual Citrix Content Collaboration customer accounts. To date, we believe the event had limited impact on a small percentage of Citrix Content Collaboration customers; however, these types of attacks have the potential to materially and adversely impact our customers and, as a result, our results of operations and financial condition.

A breach of our security measures as a result of third-party action, malware, employee error, malfeasance or otherwise could result in (among other consequences):

- loss or destruction of customer data;
- interruption in the delivery of our cloud services;
- negative publicity and harm to our reputation or brand, which could lead some customers to seek to cancel subscriptions, stop using certain of our solutions or services, reduce or delay future purchases of our solutions or services, or use competing solutions or services;
- individual and/or class action lawsuits, which could result in financial judgments against us or the payment of settlement amounts, which would cause us to incur legal fees and costs;
- regulatory enforcement action under the General Data Protection Regulation or other legal authority, which could result in significant fines and/or penalties or other sanctions and which would cause us to incur legal fees and costs; and/or
- in the event that we or one of our customers were the victim of a cyberattack or other security breach, additional costs associated with responding to such breach, such as investigative and remediation costs, and the costs of providing data owners or others with notice of the breach, legal fees, costs of any additional fraud detection activities required by such customers' credit card issuers, and costs incurred by credit card issuers associated with the compromise and additional monitoring of systems for further fraudulent activity.

Any of these actions could materially adversely impact our business, results of operations and financial condition.

Regulation of privacy and data security may adversely affect sales of our solutions and result in increased compliance costs.

We believe increased regulation is likely with respect to the solicitation, collection, processing or use of personal, financial and consumer information as regulatory authorities around the world are considering a number of legislative and regulatory proposals concerning data protection, privacy and data security. This includes the California Consumer Privacy Act, which is set to come into effect in 2020, and the Global Data Protection Regulation, or GDPR. The GDPR is a new European Union-wide legal framework to govern data collection, use and sharing and related consumer privacy rights, which became effective in May 2018. The GDPR includes significant penalties for non-compliance. In addition, the interpretation and application of consumer and data protection laws and industry standards in the United States, Europe and elsewhere are often uncertain and in flux. The application of existing laws to cloud-based solutions is particularly uncertain and cloud-based solutions may be subject to further regulation, the impact of which cannot be fully understood at this time. Moreover, it is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data and privacy practices. For example, although the GDPR will apply across the European Union without a need for local implementing legislation, local data protection authorities will still have the ability to interpret the GDPR through so-called opening clauses, which permit region-specific data protection legislation and have the potential to create inconsistencies on a country-by-country basis. In addition to the possibility of fines, application of these laws in a manner inconsistent with our data and privacy practices could result in an order requiring that we change our data and privacy practices, which could have an adverse effect on our business and results of operations. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business. Also, any new regulation, or interpretation of existing regulation, imposing greater fees or taxes or restricting information exchange over the Web, could result in a decline in the use and adversely affect sales of our solutions and our results of operations. Finally, as a technology vendor, our customers will expect that we can demonstrate compliance with current data privacy and security regulation, and our inability to do so may adversely impact sales of our solutions and services to certain customers, particularly customers in highly-regulated industries.

Our solutions could contain errors that could delay the release of new products or that may not be detected until after our products are shipped.

Despite significant testing by us and by current and potential customers, our products, especially new products or releases or acquired products, could contain errors. In some cases, these errors may not be discovered until after commercial shipments have been made. Errors in our products could delay the development or release of new products and could adversely affect market acceptance of our products. Additionally, our products depend on

third-party products, which could contain defects and could reduce the performance of our products or render them useless. Because our products are often used in mission-critical applications, errors in our products or the products of third parties upon which our products rely could give rise to warranty or other claims by our customers, which may have a material adverse effect on our business, financial condition and results of operations.

Certain of our offerings have sales cycles which are long and/or unpredictable which could cause significant variability and unpredictability in our revenue and operating results for any particular period.

Generally, a substantial portion of our large and medium-sized customers implement our Digital Workspace solutions on a departmental or enterprise-wide basis. We have a long sales cycle for these departmental or enterprise-wide sales because:

- our sales force generally needs to explain and demonstrate the benefits of a large-scale deployment of our solution to potential and existing customers prior to sale;
- our service personnel typically spend a significant amount of time assisting potential customers in their testing and evaluation of our solutions and services;
- our customers are typically large and medium size organizations that carefully research their technology needs and the many potential projects prior to making capital expenditures for software infrastructure; and
- before making a purchase, our potential customers usually must get approvals from various levels of decision makers within their organizations, and this process can be lengthy.

Our long sales cycle for these solutions makes it difficult to predict when these sales will occur, and we may not be able to sustain these sales on a predictable basis. In addition, the long sales cycle for these solutions makes it difficult to predict the quarter in which sales will occur. Delays in sales could cause significant variability in our revenue and operating results for any particular period, and large projects with significant IT components may fail to meet our customers' business requirements or be canceled before delivery, which likewise could adversely affect our revenue and operating results for any particular period.

Overall, the timing of our revenue is difficult to predict. Our quarterly sales have historically reflected an uneven pattern in which a disproportionate percentage of a quarter's total sales occur in the last month, weeks and days of each quarter. In addition, our business is subject to seasonal fluctuations and such fluctuations are generally most significant in our fourth fiscal quarter, which we believe is due to the impact on revenue from the availability (or lack thereof) in our customers' fiscal year budgets and an increase in expenses resulting from amounts paid pursuant to our sales compensation plans as performance milestones are often triggered in the fourth quarter. We believe that these seasonal factors are common within our industry. In addition, our European operations generally generate lower revenues in the summer months because of the generally reduced economic activity in Europe during the summer.

Our success depends on our ability to attract and retain and further access large enterprise customers.

We must retain and continue to expand our ability to reach and access large enterprise customers by adding effective value-added distributors, or VADs, system integrators, or SIs, and other partners, as well as expanding our direct sales teams and consulting services. Our inability to attract and retain large enterprise customers could have a material adverse effect on our business, results of operations and financial condition. Large enterprise customers usually request special pricing and purchase of multiple years of subscription and maintenance up-front and generally have longer sales cycles. By allowing these customers to purchase multiple years of subscription or maintenance up-front and by granting special pricing, such as bundled pricing or discounts, to these large customers, we may have to defer recognition of some or all of the revenue from such sales. This deferral, compounded with the longer sales cycles, could reduce our revenues and operating profits for a given reporting period and make revenues difficult to predict.

Changes to our licensing or subscription renewal programs, or bundling of our solutions, could negatively impact the timing of our recognition of revenue.

We continually re-evaluate our licensing programs and subscription renewal programs, including specific license models, delivery methods, and terms and conditions, to market our current and future solutions and services. We could implement new licensing programs and subscription renewal programs, including promotional trade-up programs or offering specified enhancements to our current and future solution and service lines. Such changes could result in deferring revenue recognition until the specified enhancement is delivered or at the end of the contract term as opposed to upon the initial shipment or licensing of our software solution. We could implement different licensing models in certain circumstances, for which we would recognize licensing fees over a longer period, including offering additional solutions in a SaaS model. Changes to our licensing programs and subscription renewal programs, including the timing of the release of enhancements, upgrades, maintenance releases, the term of the contract, discounts, promotions, auto-renewals and other factors, could impact the timing of the recognition of revenue for our

solutions, related enhancements and services and could adversely affect our operating results and financial condition. Further, companies that we acquire may operate with different cost and margin structures, which could further cause fluctuations in our operating results and adversely affect our operating margins. Moreover, if our quarterly financial results or

17

our predictions of future financial results fail to meet the expectations of securities analysts and investors, our stock price could be negatively affected.

Sales and renewals of our support solutions constitute a large portion of our deferred revenue.

We anticipate that sales and renewals of our support solutions will continue to constitute a substantial portion of our deferred revenue. Our ability to continue to generate both recognized and deferred revenue from our support solutions will depend on our customers continuing to perceive value in automatic delivery of our software upgrades and enhancements. Additionally, a decrease in demand for our support solutions could occur as a result of a decrease in demand for our Digital Workspace and Networking solutions. If our customers do not continue to purchase our support solutions, our deferred revenue would decrease significantly and our results of operations and financial condition would be adversely affected.

Adverse changes in general global economic conditions could adversely affect our operating results.

As a globally operated company, we are subject to the risks arising from adverse changes in global economic and market conditions. Economic uncertainty and volatility in our significant geographic locations, including the potential impact resulting from "Brexit", a US-China trade war or other international trade disputes, may adversely affect sales of our solutions and services and may result in longer sales cycles, slower adoption of technologies and increased price competition. For example, if the U.S. or the European Union countries were to experience an economic downturn, these adverse economic conditions could contribute to a decline in our customers' spending on our solutions and services. Additionally, in response to economic uncertainty, we expect that many governmental organizations that are current or prospective customers for our solutions and services would cutback spending significantly, which would reduce the amount of government spending on IT and demand for our solutions and services from government organizations. Adverse economic conditions also may negatively impact our ability to obtain payment for outstanding debts owed to us by our customers or other parties with whom we do business.

Our international presence subjects us to additional risks that could harm our business.

We conduct significant sales and customer support, development and engineering operations in countries outside of the United States. During the year ended December 31, 2018, we derived 47.0% of our revenues from sales outside the United States. Potential growth and profitability could require us to further expand our international operations. To successfully maintain and expand international sales, we may need to establish additional foreign operations, hire additional personnel and recruit additional international resellers. Our international operations are subject to a variety of risks, which could adversely affect the results of our international operations. These risks include:

- compliance with foreign regulatory and market requirements;
- variability of foreign economic, political, labor conditions and global policy uncertainty;
- changing restrictions imposed by regulatory requirements, tariffs or other trade barriers or by U.S. export laws;
- regional data privacy laws that apply to the transmission of our customers' data across international borders;
- health or similar issues such as pandemic or epidemic;
- difficulties in staffing and managing international operations;
- longer accounts receivable payment cycles;
- potentially adverse tax consequences;
- difficulties in enforcing and protecting intellectual property rights;
- compliance with the Foreign Corrupt Practices Act, including potential violations by acts of agents or other intermediaries;
- burdens of complying with a wide variety of foreign laws; and
- as we generate cash flow in non-U.S. jurisdictions, if required, we may experience difficulty transferring such funds to the U.S. in a tax efficient manner.

We are also monitoring developments related to the decision by the British government to leave the European Union (EU) following a referendum in June 2016 in which voters in the United Kingdom approved an exit from the EU (often referred to as "Brexit"), which could have implications for our business. In March 2017, the United Kingdom began the official process to leave the EU by April 2019. There remains considerable uncertainty around the withdrawal. Failure to obtain parliamentary approval of any negotiated withdrawal agreement would mean that the United Kingdom would leave the European Union on March 29, 2019, potentially with no agreement. Brexit could

lead to economic and legal uncertainty, including significant volatility in global stock markets and currency exchange rates, and increasingly divergent laws, regulations and licensing requirements applicable to us as the United Kingdom determines which EU laws to replace or replicate. Any of these effects of Brexit, among others, could adversely affect our operations and financial results.

Our success depends, in part, on our ability to anticipate and address these risks. We cannot guarantee that these or other factors will not adversely affect our business or results of operations.

We rely on indirect distribution channels and major distributors that we do not control.
We rely significantly on independent distributors and resellers to market and distribute our solutions and services. Our distributors generally sell through resellers. Our distributor and reseller base is relatively concentrated. We maintain and periodically revise our sales incentive programs for our independent distributors and resellers, and such program revisions may adversely impact our results of operations. Changes to our sales incentive programs can result from a number of factors, including our transition to a subscription-based business model. Our competitors may in some cases be effective in providing incentives to current or potential distributors and resellers to favor their products or to prevent or reduce sales of our solutions. The loss of or reduction in sales to our distributors or resellers could materially reduce our revenues. Further, we could maintain individually significant accounts receivable balances with certain distributors. The financial condition of our distributors could deteriorate and distributors could significantly delay or default on their payment obligations. Any significant delays, defaults or terminations could have a material adverse effect on our business, results of operations and financial condition.
We are in the process of diversifying our base of channel relationships by adding and training more channel partners with abilities to reach larger enterprise customers and additional mid-market customers and to sell our newer solutions and services. We are also in the process of building relationships with new types of channel partners, such as systems integrators and service providers. In addition to this diversification of our partner base, we will need to maintain a healthy mix of channel members who service smaller customers. We may need to add and remove distribution partners to maintain customer satisfaction, support a steady adoption rate of our solutions, and align with our transition to a subscription-based business model, which could increase our operating expenses, credit risk, and adversely impact our go-to-market effectiveness. We also bear the risk that our existing or newer channel partners will fail to comply with US or international anti-corruption or anti-competition laws, in which case we might be fined or otherwise penalized as a result of the agency relationship with such partners. Through our Citrix Partner Network and other programs, we are currently investing, and intend to continue to invest, significant resources to develop these channels, which could adversely impact our results of operations if such channels do not result in increased revenues.
Our Networking business could suffer if there are any interruptions or delays in the supply of hardware or hardware components from our third-party sources.
We rely on a concentrated number of third-party suppliers, who provide hardware or hardware components for our Networking products, and contract manufacturers. If we are required to change suppliers, there could be a delay in the supply of our hardware or hardware components and our ability to meet the demands of our customers could be adversely affected, which could cause the loss of Networking sales and existing or potential customers and delayed revenue recognition and adversely affect our results of operations. While we have not, to date, experienced any material difficulties or delays in the manufacture and assembly of our Networking products, our suppliers may encounter problems during manufacturing due to a variety of reasons, including failure to follow specific protocols and procedures, failure to comply with applicable regulations, or the need to implement costly or time-consuming protocols to comply with applicable regulations (including regulations related to conflict minerals), equipment malfunction, natural disasters and environmental factors, any of which could delay or impede their ability to meet our demand.
We are exposed to fluctuations in foreign currency exchange rates, which could adversely affect our future operating results.
Our results of operations are subject to fluctuations in exchange rates, which could adversely affect our future revenue and overall operating results. In order to minimize volatility in earnings associated with fluctuations in the value of foreign currency relative to the U.S. dollar, we use financial instruments to hedge our exposure to foreign currencies as we deem appropriate for a portion of our expenses, which are denominated in the local currency of our foreign subsidiaries. We generally initiate our hedging of currency exchange risks one year in advance of anticipated foreign currency expenses for those currencies to which we have the greatest exposure. When the dollar is weak, foreign currency denominated expenses will be higher, and these higher expenses will be partially offset by the gains realized from our hedging contracts. If the dollar is strong, foreign currency denominated expenses will be lower. These lower expenses will in turn be partially offset by the losses incurred from our hedging contracts. There is a risk that there will be fluctuations in foreign currency exchange rates beyond the one year timeframe for which we hedge our risk and there is no guarantee that we will accurately forecast the expenses we are hedging. Further, a substantial portion

of our overseas assets and liabilities are denominated in local currencies. To protect against fluctuations in earnings caused by changes in currency exchange rates when remeasuring our balance sheet, we utilize foreign exchange forward contracts to hedge our exposure to this potential volatility. There is no assurance that our hedging strategies will be effective. In addition, as a result of entering into these contracts with counterparties who are unrelated to us, the risk of a counterparty default exists in fulfilling the hedge contract. Should there be a counterparty default, we could be unable to recover anticipated net gains from the transactions.

RISKS RELATED TO ACQUISITIONS, STRATEGIC RELATIONSHIPS AND DIVESTITURES

Acquisitions and divestitures present many risks, and we may not realize the financial and strategic goals we anticipate.

We have in the past addressed, and may continue to address, the development of new solutions and services and enhancements to existing solutions and services through acquisitions of other companies, product lines and/or technologies. However, acquisitions, including those of high-technology companies, are inherently risky. We cannot provide any assurance that any of our acquisitions or future acquisitions will be successful in helping us reach our financial and strategic goals. The risks we commonly encounter in undertaking, managing and integrating acquisitions are:

- an uncertain revenue and earnings stream from the acquired company, which could dilute our earnings;
- difficulties and delays integrating the personnel, operations, technologies, solutions and systems of the acquired companies;
- undetected errors or unauthorized use of a third-party's code in solutions of the acquired companies;
- our ongoing business may be disrupted and our management's attention may be diverted by acquisition, transition or integration activities;
- challenges with implementing adequate and appropriate controls, procedures and policies in the acquired business;
- difficulties managing or integrating an acquired company's technologies or lines of business;
- potential difficulties in completing projects associated with purchased in-process research and development;
- entry into markets in which we have no or limited direct prior experience and where competitors have stronger market positions and which are highly competitive;
- the potential loss of key employees of the acquired company;
- potential difficulties integrating the acquired solutions and services into our sales channel;
- assuming pre-existing contractual relationships of an acquired company that we would not have otherwise entered into, the termination or modification of which may be costly or disruptive to our business;
- being subject to unfavorable revenue recognition or other accounting treatment as a result of an acquired company's practices;
- potential difficulties securing financing necessary to consummate substantial acquisitions;
- issuing shares of our stock, which may be dilutive to our stockholders; and
- intellectual property claims or disputes.

Our failure to successfully integrate acquired companies due to these or other factors could have a material adverse effect on our business, results of operations and financial condition.

Any future divestitures we make may also involve risks and uncertainties. Any such divestitures could result in disruption to other parts of our business, potential loss of employees or customers, exposure to unanticipated liabilities or result in ongoing obligations and liabilities to us following any such divestiture. For example, in connection with a divestiture, we may enter into transition services agreements or other strategic relationships, including long-term services arrangements, or agree to provide certain indemnities to the purchaser in any such transaction, which may result in additional expense. Further, if we do not realize the expected benefits or synergies of such transactions, our operating results and financial conditions could be adversely affected.

If we determine that any of our goodwill or intangible assets, including technology purchased in acquisitions, are impaired, we would be required to take a charge to earnings, which could have a material adverse effect on our results of operations.

We have a significant amount of goodwill and other intangible assets, such as product related intangible assets, from our acquisitions. We do not amortize goodwill and intangible assets that are deemed to have indefinite lives. However, we do amortize certain product related technologies, trademarks, patents and other intangibles and we periodically evaluate them for impairment. We review goodwill for impairment annually, or sooner if events or changes in circumstances indicate that the carrying amount could exceed fair value, at the reporting unit level, which for us also represents our operating segments. Significant judgments are required to estimate the fair value of our goodwill and intangible assets, including estimating future cash flows, determining appropriate discount rates, estimating the applicable tax rates, foreign exchange rates and interest rates, projecting the future industry trends and market conditions, and making other assumptions. Although we believe the assumptions, judgments and estimates we have

made have been reasonable and appropriate, different assumptions, judgments and estimates, materially affect our results of operations. Changes in these estimates and assumptions, including changes in our reporting structure, could materially affect our determinations of fair value. In addition, due to uncertain market conditions and potential changes in our strategy and product portfolio, it is possible that the forecasts we use to support our goodwill and other intangible assets could change in the future, which could result in non-cash charges that would adversely affect our results of operations and financial condition. Also, we may make divestitures of businesses in the future. If we determine that any of the intangible assets associated with our acquisitions is impaired or goodwill is impaired, then we would be required to reduce the value of those assets or to write them off completely by taking a charge to current earnings. If we are required to write down or

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write off all or a portion of those assets, or if financial analysts or investors believe we may need to take such action in the future, our stock price and operating results could be materially and adversely affected.

Our inability to maintain or develop our strategic and technology relationships could adversely affect our business.

We have several strategic and technology relationships with large and complex organizations, such as Microsoft and Google, and other companies with which we work to offer complementary solutions and services. We depend on the companies with which we have strategic relationships to successfully test our solutions, to incorporate our technology into their products and to market and sell those solutions. There can be no assurance we will realize the expected benefits from these strategic relationships or that they will continue in the future. If successful, these relationships may be mutually beneficial and result in industry growth. However, such relationships carry an element of risk because, in most cases, we must compete in some business areas with a company with which we have a strategic relationship and, at the same time, cooperate with that company in other business areas. Also, if these companies fail to perform or if these relationships fail to materialize as expected, we could suffer delays in product development, reduced sales or other operational difficulties and our business, results of operations and financial condition could be materially adversely affected.

RISKS RELATED TO INTELLECTUAL PROPERTY AND BRAND RECOGNITION

Our efforts to protect our intellectual property may not be successful, which could materially and adversely affect our business.

We rely primarily on a combination of copyright, trademark, patent and trade secret laws, confidentiality procedures and contractual provisions to protect our source code, innovations and other intellectual property, all of which offer only limited protection. The loss of any material trade secret, trademark, tradename, patent or copyright could have a material adverse effect on our business. Despite our precautions, it could be possible for unauthorized third parties to infringe our intellectual property rights or misappropriate, copy, disclose or reverse engineer our proprietary information, including certain portions of our solutions or to otherwise obtain and use our proprietary source code. We have sought to protect our intellectual property through offensive litigation, which may be costly and unsuccessful and/or subject us to successful counterclaims or challenges to our intellectual property rights. In addition, our ability to monitor and control such misappropriation or infringement is uncertain, particularly in countries outside of the United States. If we cannot protect our intellectual property from infringement and our proprietary source code against unauthorized copying, disclosure or use, we could lose market share, including as a result of unauthorized third parties' development of solutions and technologies similar to or better than ours.

The scope of our patent protection may be affected by changes in legal precedent and patent office interpretation of these precedents. Further, any patents owned by us could be invalidated, circumvented or challenged. Any of our pending or future patent applications, whether or not being currently challenged, may not be issued with the scope of protection we seek, if at all; and if issued, may not provide any meaningful protection or competitive advantage.

Our ability to protect our proprietary rights could be affected by differences in international law and the enforceability of licenses. The laws of some foreign countries do not protect our intellectual property to the same extent as do the laws of the United States and Canada. For example, we derive a significant portion of our sales from licensing our solutions under "click-to-accept" license agreements that are not signed by licensees and through electronic enterprise customer licensing arrangements that are delivered electronically, all of which could be unenforceable under the laws of many foreign jurisdictions in which we license our solutions. Moreover, with respect to the various confidentiality, license or other agreements we utilize with third parties related to their use of our solutions and technologies, there is no guarantee that such parties will abide by the terms of such agreements.

Our solutions and services, including solutions obtained through acquisitions, could infringe third-party intellectual property rights, which could result in material litigation costs.

We are routinely subject to patent infringement claims and may in the future be subject to an increased number of claims, including claims alleging the unauthorized use of a third-party's code in our solutions. This may occur for a variety of reasons, including:

- the expansion of our product lines through product development and acquisitions;
- the volume of patent infringement litigation commenced by non-practicing entities;
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an increase in the number of competitors in our industry segments and the resulting increase in the number of related solutions and services and the overlap in the functionality of those solutions and services;

- an increase in the number of our competitors and third parties that use their own intellectual property rights to limit our freedom to operate and exploit our solutions, or to otherwise block us from taking full advantage of our markets;
- our reliance on the technology of others and, therefore, the requirement to obtain intellectual property licenses from third parties in order for us to commercialize our solutions or services, which licenses we may not be able to obtain or continue to obtain from these third parties on reasonable terms; and
- the unauthorized or improperly licensed use of third-party code in our solutions.

Further, responding to any infringement claim, regardless of its validity or merit, could result in costly litigation. Further, intellectual property litigation could compel us to do one or more of the following:

- pay damages (including the potential for treble damages), license fees or royalties (including royalties for past periods) to the party claiming infringement;
- cease selling solutions or services that use the challenged intellectual property;
- obtain a license from the owner of the asserted intellectual property to sell or use the relevant technology, which license may not be available on reasonable terms, or at all; or
- redesign the challenged technology, which could be time consuming and costly, or not be accomplished.

If we were compelled to take any of these actions, our business, results of operations or financial condition may be adversely impacted.

Our use of "open source" software could negatively impact our ability to sell our solutions and subject us to possible litigation.

The solutions or technologies acquired, licensed or developed by us may incorporate so-called "open source" software, and we may incorporate open source software into other solutions in the future. Such open source software is generally licensed by its authors or other third parties under open source licenses, including, for example, the GNU General Public License, the GNU Lesser General Public License, "Apache-style" licenses, "Berkeley Software Distribution," "BSD-style" licenses, and other open source licenses. Even though we attempt to monitor our use of open source software in an effort to avoid subjecting our solutions to conditions we do not intend, it is possible that not all instances of our open source code usage are properly reviewed. Further, although we believe that we have complied with our obligations under the various applicable licenses for open source software that we use such that we have not triggered any of these conditions, there is little or no legal precedent governing the interpretation or enforcement of many of the terms of these types of licenses. If an author or other third party that distributes open source software were to allege that we had not complied with the conditions of one or more of these licenses, we could be required to incur significant legal expenses defending against such allegations. If our defenses were not successful, we could be subject to significant damages, enjoined from the distribution of our solutions that contained open source software, and required to comply with the terms of the applicable license, which could disrupt the distribution and sale of some of our solutions. In addition, if we combine our proprietary software with open source software in an unintended manner, under some open source licenses we could be required to publicly release the source code of our proprietary software, offer our solutions that use the open source software for no cost, make available source code for modifications or derivative works we create based upon incorporating or using the open source software, and/or license such modifications or derivative works under the terms of the particular open source license.

In addition to risks related to license requirements, usage of open source software can lead to greater risks than use of third-party commercial software, as open source licensors generally do not provide technology support, maintenance, warranties or assurance of title or controls on the origin of the software.

If we lose access to third-party licenses, releases of our solutions could be delayed.

We believe that we will continue to rely, in part, on third-party licenses to enhance and differentiate our solutions. Third-party licensing arrangements are subject to a number of risks and uncertainties, including:

- undetected errors or unauthorized use of another person's code in the third party's software;
- disagreement over the scope of the license and other key terms, such as royalties payable and indemnification protection;
- infringement actions brought by third-parties;
- the creation of solutions by third parties that directly compete with our solutions; and
- termination or expiration of the license.

If we lose or are unable to maintain any of these third-party licenses or are required to modify software obtained under third-party licenses, it could delay the release of our solutions. Any delays could have a material adverse effect on our business, results of operations and financial condition.

Our business depends on maintaining and protecting the strength of our collection of brands.
The Citrix solution and service brands that we have developed have significantly contributed to the success of our business. Maintaining and enhancing the Citrix solution and service brands is critical to expanding our base of customers and partners. We may be subject to reputational risks and our brand loyalty may decline if others adopt the same or confusingly similar marks in an effort to misappropriate and profit on our brand name and do not provide the same level of quality as is delivered by our solutions and services. Also, others may rely on false comparative advertising and customers or potential customers could be influenced by false advertising. Additionally, we may be unable to use some of our brands in certain countries or unable to secure trademark rights in certain jurisdictions where we do business. In order to police, maintain, enhance and protect our brands, we may be required to make substantial investments that may not be successful. If we fail to police, maintain, enhance and protect the Citrix brands, if we incur excessive expenses in this effort or if customers or potential customers are confused by others' trademarks, our business, operating results, and financial condition may be materially and adversely affected.
RISKS RELATED TO OUR COMMON STOCK, OUR DEBT AND EXTERNAL FACTORS
Servicing our debt will require a significant amount of cash, which could adversely affect our business, financial condition and results of operations. We may not have sufficient cash flow from our business to make payments on our debt, settle conversions of our Convertible Notes or repurchase our Convertible Notes or 2027 Notes upon certain events.
We have aggregate indebtedness of approximately $1.90 billion that we have incurred in connection with the issuance of our unsecured senior notes due December 1, 2027, or the 2027 Notes, and our 0.500% Convertible Notes due April 15, 2019, or the Convertible Notes, and under our Credit Agreement, and we may incur additional indebtedness in the future. Our ability to make scheduled payments of the principal of, to pay interest on or to refinance our indebtedness, depends on our future performance, which is subject to general economic, financial, competitive and other factors beyond our control. Our business may not generate cash flow from operations in the future sufficient to service our debt and to make necessary capital expenditures. If we are unable to generate such cash flow, we may be required to adopt one or more alternatives, such as selling assets, reducing capital expenditures, restructuring debt or obtaining additional equity or debt financing on terms that may be onerous or highly dilutive. Our ability to refinance our indebtedness, as applicable, will depend on the capital markets and our financial condition at such time. We may not be able to sell assets, restructure our indebtedness or obtain additional equity or debt financing on terms that are acceptable to us or at all, which could result in a default on our debt obligations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies and Estimates" and Note 13 to our consolidated financial statements included in this Annual Report on Form 10-K for the year ended December 31, 2018 for information regarding our 2027 Notes, our Convertible Notes and our Credit Facility.
In addition, holders of our Convertible Notes have the right to require us to repurchase their Convertible Notes upon the occurrence of a fundamental change at a fundamental change repurchase price equal to 100% of the principal amount of the Convertible Notes to be repurchased, plus accrued and unpaid interest, if any. If a change in control repurchase event occurs with respect to the 2027 Notes, we will be required, subject to certain exceptions, to offer to repurchase the 2027 Notes at a repurchase price equal to 101% of the principal amount of the 2027 Notes repurchased, plus accrued and unpaid interest, if any. Further, upon conversion of the Convertible Notes, we are required to make cash payments for each $1,000 in principal amount of Convertible Notes converted of at least the lesser of $1,000 and the sum of the daily conversion values thereunder. In such events, we may not have enough available cash or be able to obtain financing to fund the required repurchase of the Convertible Notes or 2027 Notes or make cash payments upon conversion of the Convertible Notes, or making such payments could adversely affect our liquidity. As of October 15, 2018, we had received conversion notices from noteholders with respect to $273.0 million in aggregate principal amount of Convertible Notes requesting conversion. In accordance with the terms of the Convertible Notes, in the fourth quarter of 2018 we made cash payments of this aggregate principal amount and delivered 1.3 million newly issued shares of our common stock in respect of the remainder of our conversion obligation in excess of the aggregate principal amount of the Convertible Notes being redeemed, in full satisfaction of such converted notes. Commencing on October 15, 2018 until the close of business on the second scheduled trading day immediately preceding the April 15, 2019 maturity date, holders of the Convertible Notes may convert their notes in their discretion. In addition, our ability to repurchase the Convertible Notes or 2027 Notes or to pay cash upon conversion

of the Convertible Notes may be limited by law, by regulatory authority or by agreements governing our other indebtedness.

Further, we are required to comply with the covenants set forth in the indenture governing the Convertible Notes, the indenture governing the 2027 Notes and the Credit Agreement. In particular, the Credit Agreement requires us to maintain certain leverage and interest ratios and contains various affirmative and negative covenants, including covenants that limit or restrict our ability to grant liens, merge or consolidate, dispose of all or substantially all of our assets, change our business or incur subsidiary indebtedness. The indenture governing our 2027 Notes contains covenants limiting our ability and the ability of our subsidiaries to create certain liens, enter into certain sale and leaseback transactions, and consolidate or merge with, or sell, assign, convey, lease, transfer or otherwise dispose of all or substantially all of our assets, taken as a whole, to, another

person. If we fail to comply with these covenants or any other provision of the agreements governing our indebtedness and do not obtain a waiver from the lenders or noteholders, then, subject to applicable cure periods, our outstanding indebtedness may be declared immediately due and payable. Additionally, a default under an indenture or the Credit Agreement could lead to a default under the other agreements governing our current and any future indebtedness. If the repayment of the related indebtedness were to be accelerated, we may not have enough available cash or be able to obtain financing to repay the indebtedness.

Our indebtedness, combined with our other financial obligations and contractual commitments, could have other important consequences. For example, it could:

- make us more vulnerable to adverse changes in general U.S. and worldwide economic, industry and competitive conditions and adverse changes in government regulation;
- limit our flexibility in planning for, or reacting to, changes in our business and our industry;
- place us at a disadvantage compared to our competitors who have less debt; and
- limit our ability to borrow additional amounts to fund acquisitions, for working capital and for other general corporate purposes.

Any of these factors could materially and adversely affect our business, financial condition and results of operations. In addition, if we incur additional indebtedness, the risks related to our business and our ability to service or repay our indebtedness would increase. Also, changes by any rating agency to our credit rating may negatively impact the value and liquidity of both our debt and equity securities, as well as the potential costs associated with any potential refinancing of our indebtedness. Downgrades in our credit rating could also restrict our ability to obtain additional financing in the future and could affect the terms of any such financing.

The accounting method for convertible debt securities that may be settled in cash, such as the Convertible Notes, could have a material effect on our reported financial results.

Under FASB Accounting Standards Codification 470-20, Debt with Conversion and Other Options, or ASC 470-20, an entity must separately account for the liability and equity components of the convertible debt instruments (such as the Convertible Notes) that may be settled entirely or partially in cash upon conversion in a manner that reflects the issuer’s economic interest cost. The effect of ASC 470-20 on the accounting for the Convertible Notes is that the equity component is required to be included in the additional paid-in capital section of stockholders’ equity on our consolidated balance sheet, and the value of the equity component would be treated as original issue discount for purposes of accounting for the debt component of the Convertible Notes, which will result in non-cash charges to interest expense in our consolidated statement of income. As a result, we will report lower net income in our financial results as reported in accordance with U.S. GAAP because ASC 470-20 will require interest to include both the current period’s amortization of the debt discount and the instrument’s coupon interest, which could adversely affect our reported or future financial results.

In addition, under certain circumstances, convertible debt instruments (such as the Convertible Notes) that may be settled entirely or partly in cash are currently accounted for utilizing the treasury stock method, the effect of which is that the shares issuable upon conversion of the Convertible Notes are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the Convertible Notes exceeds their principal amount. Under the treasury stock method, for diluted earnings per share purposes, the transaction is accounted for as if the number of shares of common stock that would be necessary to settle such excess, if we elected to settle such excess in shares, are issued. We cannot be sure that the accounting standards in the future will continue to permit the use of the treasury stock method. If we are unable to use the treasury stock method in accounting for the shares issuable upon conversion of the Convertible Notes, then our diluted earnings per share would be adversely affected. Moreover, the warrants that we issued in connection with the pricing of the Convertible Notes would need to be included in the number of diluted shares reported if our stock price increases above the relevant exercise price on an average basis during the applicable period, which would negatively impact our diluted earnings per share.

Our portfolios of liquid securities and other investments may lose value or become impaired.

Our investment portfolio consists of agency securities, corporate securities, money market funds, municipal securities, government securities and commercial paper. Although we follow an established investment policy and seek to minimize the credit risk associated with investments by investing primarily in investment grade, highly liquid securities and by limiting exposure to any one issuer depending on credit quality, we cannot give assurances that the

assets in our investment portfolio will not lose value, become impaired, or suffer from illiquidity.

Changes in our tax rates or our exposure to additional income tax liabilities could affect our operating results and financial condition.

Our future effective tax rates could be favorably or unfavorably affected by changes in the valuation of our deferred tax assets and liabilities, the geographic mix of our revenue, or by changes in tax laws or their interpretation. Significant judgment

is required in determining our worldwide provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by tax authorities, including the IRS. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance, however, that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition. The Tax Cuts and Jobs Act of 2017, or the 2017 Tax Act, as well as new, evolving or revised tax laws and regulations globally, and any changes in the application or interpretation of these regulations may have an adverse effect on our business or on our results of operations. Additionally, the U.S. Treasury Department and other standard-setting bodies will continue to issue guidance and interpret how provisions of the 2017 Tax Act will be administered and applied that may significantly affect our results of operations in the period issued.

There can be no assurance that we will continue to return capital to our stockholders through the payment of cash dividends and/or the repurchase of our stock.

From time to time, our Board of Directors authorizes the payment of cash dividends or additional share repurchase authority under our ongoing stock repurchase program as part of our capital return to stockholders. The amount and timing of cash dividends and stock repurchases are subject to capital availability and our determination that such cash dividends or stock repurchases are in the best interest of our stockholders and are in compliance with all respective laws and our applicable agreements. Our ability to pay cash dividends or repurchase stock will depend upon, among other factors, our cash balances and potential future capital requirements for strategic transactions, debt service, capital expenditures, working capital and other general corporate purposes, as well as our results of operations, financial condition and other factors that we may deem relevant. Moreover, a reduction in, or the completion of, our stock repurchase program could have a negative effect on our stock price. We can provide no assurance that we will continue to pay cash dividends or repurchase stock at favorable prices, if at all.

Our stock price could be volatile, particularly during times of economic uncertainty and volatility in domestic and international stock markets, and you could lose the value of your investment.

Our stock price has been volatile and has fluctuated significantly in the past. The trading price of our stock is likely to continue to be volatile and subject to fluctuations in the future. Your investment in our stock could lose some or all of its value. Some of the factors that could significantly affect the market price of our stock include:

- actual or anticipated variations in operating and financial results, including the failure to meet key operational metrics;
- analyst reports or recommendations;
- rumors, announcements, or press articles regarding our or our competitors' operations, management, organization, financial condition, or financial statements; and
- other events or factors, many of which are beyond our control.

The stock market in general, The Nasdaq Global Select Market, and the market for software companies and technology companies in particular, have experienced extreme price and volume fluctuations. These fluctuations have often been unrelated or disproportionate to operating performance. These fluctuations may continue in the future and this could materially and adversely affect the market price of our stock, regardless of operating performance.

Changes or modifications in financial accounting standards may have a material adverse impact on our reported results of operations or financial condition.

A change or modification in accounting policies can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New pronouncements and varying interpretations of existing pronouncements have occurred with frequency and may occur in the future. Changes to existing rules, or changes to the interpretations of existing rules, could lead to changes in our accounting practices, and such changes could materially adversely affect our reported financial results or the way we conduct our business.

Natural disasters or other unanticipated catastrophes that result in a disruption of our operations could negatively impact our results of operations.

Our worldwide operations are dependent on our network infrastructure, internal technology systems and website. Significant portions of our computer equipment, intellectual property resources and personnel, including critical resources dedicated to research and development and administrative support functions are presently located at our corporate headquarters in Fort Lauderdale, Florida, an area of the country that is particularly prone to hurricanes, and

at our various locations in California, an area of the country that is particularly prone to earthquakes. We also have operations in various domestic and international locations that expose us to additional diverse risks. The occurrence of natural disasters, such as hurricanes, floods or earthquakes, or other unanticipated catastrophes, such as telecommunications failures, cyber-attacks, fires or terrorist attacks,

at any of the locations in which we or our key partners, suppliers and customers do business, could cause interruptions in our operations. For example, hurricanes have passed through southern Florida causing extensive damage to the region. In addition, even in the absence of direct damage to our operations, large disasters, terrorist attacks or other casualty events could have a significant impact on our partners', suppliers' and customers' businesses, which in turn could result in a negative impact on our results of operations. Extensive or multiple disruptions in our operations, or our partners', suppliers' or customers' businesses, due to natural disasters or other unanticipated catastrophes could have a material adverse effect on our results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

We have received no written comments regarding our periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more preceding the end of our 2018 fiscal year that remain unresolved.

ITEM 2. PROPERTIES

We lease and sublease office space in the Americas, which is comprised of the United States, Canada and Latin America, EMEA, which is comprised of Europe, the Middle East and Africa, and APJ, which is comprised of Asia-Pacific and Japan. The following table presents the location and square footage of our leased office space as of December 31, 2018:

	Square footage
Americas	786,857
EMEA	243,382
APJ	636,209
Total	1,666,448

In addition, we own land and buildings in Fort Lauderdale, Florida with approximately 317,000 square feet of office space used for our corporate headquarters and approximately 41,000 square feet of office space in Chalfont St. Peter, United Kingdom.

We believe that our existing facilities are adequate for our current needs. As additional space is needed in the future, we believe that suitable space will be available in the required locations on commercially reasonable terms.

ITEM 3. LEGAL PROCEEDINGS

Due to the nature of our business, we are subject to patent infringement claims, including current suits against us or one or more of our wholly-owned subsidiaries alleging infringement by various Citrix solutions and services. We believe that we have meritorious defenses to the allegations made in our pending cases and intend to vigorously defend these lawsuits; however, we are unable currently to determine the ultimate outcome of these or similar matters or the potential exposure to loss, if any. In addition, we are a defendant in various litigation matters generally arising out of the normal course of business. Although it is difficult to predict the ultimate outcomes of these cases, we believe that it is not reasonably possible that the ultimate outcomes will materially and adversely affect our business, financial position, results of operations or cash flows.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market for Common Stock and Dividend Policy

Our common stock is currently traded on The Nasdaq Global Select Market under the symbol CTXS. As of February 8, 2019, there were 471 holders of record of our common stock.

We currently intend to retain any earnings for use in our business, for investment in acquisitions to repurchase shares of our common stock, and to pay future dividends. Historically, we have not paid any cash dividends on our capital stock. However, on October 24, 2018, we announced that our Board of Directors approved a quarterly cash dividend of $0.35
per share which was paid on December 21, 2018 to all shareholders of record as of the close of business on December 7, 2018. Additionally, on January 23, 2019, we announced that our Board of Directors approved a quarterly cash dividend of $0.35 per share. This dividend is payable on March 22, 2019 to all shareholders of record as of the close of business on March 8, 2019.

Future dividend declarations, if any, as well as the record and payment dates for such dividends, are subject to the final
determination of our Board of Directors. Our Board of Directors will continue to review our capital allocation strategy for potential modifications and will determine whether to pay future dividends on a quarterly basis based on our financial performance, business outlook and other considerations.

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

Our Board of Directors has authorized an ongoing stock repurchase program, of which $1.7 billion was approved in November 2017 and $750.0 million was approved in October 2018. We may use the approved dollar authority to repurchase stock at any time until the approved amount is exhausted. The objective of the stock repurchase program is to improve stockholders' returns. At December 31, 2018, approximately $767.9 million was available to repurchase common stock pursuant to the stock repurchase program. All shares repurchased are recorded as treasury stock. A portion of the funds used to repurchase stock over the course of the program was provided by net proceeds from the Convertible Notes and 2027 Notes offerings, as well as proceeds from employee stock awards and the related tax benefit. We are authorized to make purchases of our common stock using general corporate funds through open market purchases, pursuant to a Rule 10b5-1 plan or in privately negotiated transactions.

The following table shows the monthly activity related to our stock repurchase program for the quarter ended December 31, 2018.

	Total Number of Shares Purchased [1]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate dollar value of Shares that may yet be Purchased under the Plans or Programs (in thousands)[2]
October 1, 2018 through October 31, 2018	52,998	$ 110.35	—	$ 1,147,896
November 1, 2018 through November 30, 2018	1,361,524	$ 107.84	1,297,589	$ 1,007,896
December 1, 2018 through December 31, 2018	2,299,135	$ 106.71	2,247,135	$ 767,896
Total	3,713,657	$ 107.17	3,544,724	$ 767,896

(1) Includes approximately 168,933 shares withheld from restricted stock units that vested in the fourth quarter of 2018 to satisfy minimum tax withholding obligations that arose on the vesting of restricted stock units.

(2) Shares withheld from restricted stock units that vested to satisfy minimum tax withholding obligations that arose on the vesting of such awards do not deplete the dollar amount available for purchases under the repurchase program.

Securities Authorized for Issuance Under Equity Compensation Plans

Information about our equity compensation plans is incorporated herein by reference to Item 12 of Part III of this Annual Report on Form 10-K.

ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data is derived from our consolidated financial statements. This data should be read in conjunction with the consolidated financial statements and notes thereto, and with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

	Year Ended December 31,				
	2018	2017(a)	2016(a)	2015(a)	2014(a)
	(In thousands, except per share data)				
Consolidated Statements of Income Data:					
Net revenues	$2,973,903	$2,824,686	$2,736,080	$2,646,154	$2,563,064
Cost of net revenues[b]	433,803	439,646	404,889	474,040	493,706
Gross margin	2,540,100	2,385,040	2,331,191	2,172,114	2,069,358
Operating expenses[c]	1,862,140	1,814,043	1,771,027	1,969,322	1,894,438
Income from operations	677,960	570,997	560,164	202,792	174,920
Interest income	40,030	27,808	16,686	11,675	9,421
Interest expense	(80,162)	(51,609)	(44,949)	(44,153)	(28,332)
Other (expense) income, net	(8,373)	3,150	(4,131)	(5,730)	(7,694)
Income from continuing operations before income taxes	629,455	550,346	527,770	164,584	148,315
Income tax expense (benefit)	53,788	528,361	57,915	(50,549)	(18,904)
Income from continuing operations	575,667	21,985	469,855	215,133	167,219
(Loss) income from discontinued operations, net of income tax expense	—	(42,704)	66,257	104,228	84,504
Net income (loss)	$575,667	$(20,719)	$536,112	$319,361	$251,723
Diluted earnings (loss) per share:					
Income from continuing operations	3.94	0.14	2.99	1.34	0.98
(Loss) income from discontinued operations	—	(0.27)	0.42	0.65	0.49
Diluted net earnings (loss) per share	$3.94	$(0.13)	$3.41		

Available-for-Sale:						
U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	$ 315,981	$ 330,046	$ 314,894	$ 318,381	$ 407,795	$ 403,855
Obligations of states and political subdivisions	380,009	379,997	286,293	290,714	242,748	246,958
Corporate bonds	66,550	68,448	45,345	45,683	69,341	69,363
Mortgage-backed securities	444,352	453,924	427,504	429,596	375,794	370,013
Other securities	6,328	6,507	17,588	17,700	12,092	12,138
	$ 1,213,220	$ 1,238,922	$ 1,091,624	$ 1,102,074	$ 1,107,770	$ 1,102,327

Table 11 Maturities and Yields of Available-for-Sale and Held-to-Maturity Securities Held at December 31, 2008 (in thousands, except percentages):

	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
Held-to-Maturity:	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
Obligations of states and political subdivisions	$ 10,414	7.50%	$ 11,627	7.22%	$ 240	6.44%	$ 293	6.56%	$ 22,574	7.33%
Mortgage-backed securities	175	6.40%	492	5.21%	237	4.90%	15	5.29%	919	5.36%
Total	$ 10,589	7.49%	$ 12,119	7.14%	$ 477	5.68%	$ 308	6.42%	$ 23,493	7.26%

	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
Available-for-Sale:	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
Obligations of U.S. government sponsored-enterprises and agencies	$ 73,546	4.48%	$ 256,500	4.04%	$		$		$ 330,046	4.14%
Obligations of states and political subdivisions	18,570	6.91%	111,778	5.89%	110,251	5.89%	139,398	5.93%	379,997	5.95%
Corporate bonds and other securities	14,439	4.12%	49,115	5.09%	11,401	7.10%			74,955	5.22%
Mortgage-backed securities	9,451	4.77%	341,472	4.99%	100,568	4.96%	2,433	5.51%	453,924	4.98%
Total	$ 116,006	4.85%	$ 758,865	4.81%	$ 222,220	5.67%	$ 141,831	5.92%	$ 1,238,922	5.07%

	One Year or Less		After One Year Through Five Years		Maturing After Five Years Through Ten Years		After Ten Years		Total	
Total Available-for-Sale and Held- to-Maturity Securities:	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
Obligations of U.S. government sponsored-enterprises and	$ 73,546	4.48%	$ 256,500	4.04%	$		$		$ 330,046	4.14%

agencies										
Obligations of states and political subdivisions	28,984	7.13%	123,405	6.02%	110,491	5.89%	139,691	5.93%	402,571	6.03%
Corporate bonds and other securities	14,439	4.12%	49,115	5.07%	11,401	7.10%			74,955	5.20%
Mortgage-backed securities	9,626	4.80%	341,964	5.00%	100,805	4.96%	2,448	5.50%	454,843	4.99%
Total	$ 126,595	5.07%	$ 770,984	4.85%	$ 222,697	5.53%	$ 142,139	5.92%	$ 1,262,415	5.11%

All yields are computed on a tax-equivalent basis assuming a marginal tax rate of 35%. Yields on available-for-sale securities are based on amortized cost. Maturities of mortgage-backed securities are based on contractual maturities and could differ due to prepayments of underlying mortgages. Maturities of other securities are reported at the sooner of maturity date or call date.

Table 12 Disclosure of Available-for-Sale and Held-to-Maturity Securities with Continuous Unrealized Loss

The following tables disclose, as of December 31, 2008 and 2007, our available-for-sale and held-to- maturity securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

	Less than 12 Months		12 Months or Longer		Total	
December 31, 2008	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Obligations of state and political subdivisions	$ 155,518	$ 5,288	$ 658	$ 24	$ 156,176	$ 5,312
Mortgage-backed securities	4,016	9	15,749	76	19,765	85
Corporate and other securities	19,701	377			19,701	377
Total	$ 179,235	$ 5,674	$ 16,407	$ 100	$ 195,642	$ 5,774

	Less than 12 Months		12 Months or Longer		Total	
December 31, 2007	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	$ 8,978	$ 28	$ 93,466	$ 290	$ 102,444	$ 318
Obligations of state and political subdivisions	40,622	353	26,521	412	67,143	765
Mortgage-backed securities	55,676	80	115,141	1,600	170,817	1,680
Corporate and other securities	7,021	60	5,231	19	12,252	79
Total	$ 112,297	$ 521	$ 240,359	$ 2,321	$ 352,656	$ 2,842

The number of investment positions in this unrealized loss position totaled 493 at December 31, 2008. We do not believe these unrealized losses are other than temporary as (1) we have the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value and (2) it is probable that we will be able to collect the amounts contractually due. The unrealized losses noted are interest rate related due to the level of short-term and intermediate interest rates at December 31, 2008. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by these agencies.

The portfolio had an overall tax equivalent yield of 5.13% at December 31, 2008. At December 31, 2008, the investment portfolio had a weighted average life of 4.66 years and modified duration of 3.95 years.

Deposits. Deposits held by subsidiary banks represent our primary source of funding. Total deposits were $2.583 billion as of December 31, 2008, as compared to $2.546 billion as of December 31, 2007 and $2.384 billion as

of December 31, 2006. Table 13 provides a breakdown of average deposits and rates paid over the past three years and the remaining maturity of time deposits of $100,000 or more:

Table 13 Composition of Average Deposits and Remaining Maturity of Time Deposits of $100,000 or More (in thousands, except percentages):

	2008		2007		2006	
	Average Balance	**Average Rate**	**Average Balance**	**Average Rate**	**Average Balance**	**Average Rate**
Noninterest-bearing deposits	$ 741,418		$ 649,642		$ 611,023	
Interest-bearing deposits						
Interest-bearing checking	591,959	0.91%	571,523	1.84%	563,573	1.62%
Savings and money market accounts	434,294	0.83	361,778	1.48	384,102	1.29
Time deposits under $100,000	401,335	3.11	431,955	4.34	414,511	3.67
Time deposits of $100,000 or more	347,570	3.35	370,991	4.68	339,865	4.01
Total interest-bearing deposits	1,775,158	1.87%	1,736,227	2.99%	1,702,051	2.52%
Total average deposits	$ 2,516,576		$ 2,385,869		$ 2,313,074	

	As of December 31, 2008
Three months or less	$ 150,405
Over three through six months	77,738
Over six through twelve months	79,378
Over twelve months	26,185
Total time deposits of $100,000 or more	$ 333,706

Short-Term Borrowings. Included in short-term borrowings were federal funds purchased and securities sold under repurchase agreements of $236 million, $166 million and $143 million at December 31, 2008, 2007, and 2006, respectively. Securities sold under repurchase agreements are generally with significant customers of the Company that require short-term liquidity for their funds. The average balance of federal funds purchased and securities sold under repurchase agreements was $179 million, $162 million and $121 million in 2008, 2007 and 2006 respectively. The average rate paid on federal funds purchased and securities sold under repurchase agreements was 1.20%, 4.07% and 4.69% in 2008, 2007 and 2006, respectively. The weighted average rate on federal funds purchased and securities sold under repurchase agreements was 0.41%, 2.87% and 4.77% at December 31, 2008, 2007 and 2006, respectively. The highest amount of federal funds purchased and securities sold under repurchase agreements at any month end during 2008, 2007 and 2006 was $236 million, $196 million and $143 million, respectively.

Capital Resources

We evaluate capital resources by our ability to maintain adequate regulatory capital ratios to do business in the banking industry. Issues related to capital resources arise primarily when we are growing at an accelerated rate but not retaining a significant amount of our profits or when we experience significant asset quality deterioration.

Total shareholders equity was $368.8 million, or 11.5% of total assets, at December 31, 2008, as compared to $335.5 million, or 10.9% of total assets, at December 31, 2007. During 2008, total shareholders equity averaged $348.3 million, or 11.4% of average assets, as compared to $311.8 million, or 10.8% of average assets, during 2007.

Banking regulators measure capital adequacy by means of the risk-based capital ratio and leverage ratio. The risk-based capital rules provide for the weighting of assets and off-balance-sheet commitments and contingencies according to prescribed risk categories ranging from 0% to 100%. Regulatory capital is then divided by risk-weighted assets to determine the risk-adjusted capital ratios. The leverage ratio is computed by dividing shareholders equity less intangible assets by quarter-to-date average assets less intangible assets. Regulatory minimums for total risk-based and leverage ratios are 8.00% and 3.00%, respectively. As of December 31, 2008, our total risk-based and leverage capital ratios were 17.04% and 9.68%, respectively, as compared to total risk-based and leverage capital ratios of 15.62% and 9.23% as of December 31, 2007. We believe by all measurements our capital ratios remain well above regulatory minimums.

Interest Rate Risk. Interest rate risk results when the maturity or repricing intervals of interest-earning assets and interest-bearing liabilities are different. Our exposure to interest rate risk is managed primarily through our strategy of selecting the types and terms of interest-earning assets and interest-bearing liabilities that generate favorable earnings while limiting the potential negative effects of changes in market interest rates. We use no off-balance-sheet financial instruments to manage interest rate risk.

Each of our subsidiary banks has an asset liability management committee that monitors interest rate risk and compliance with investment policies; there is also a holding company-wide committee that monitors the aggregate company s interest rate risk and compliance with investment policies. The Company and each subsidiary bank utilize an earnings simulation model as the primary quantitative tool in measuring the amount of interest rate risk associated with changing market rates. The model quantifies the effects of various interest rate scenarios on projected net interest income and net income over the next 12 months. The model measures the impact on net interest income relative to a base case scenario of hypothetical fluctuations in interest rates over the next 12 months. These simulations incorporate assumptions regarding balance sheet growth and mix, pricing and the repricing and maturity characteristics of the existing and projected balance sheet.

As of December 31, 2008, the model simulations projected that 100 and 200 basis point increases in interest rates would result in positive variances in net interest income of 1.20% and 2.56%, respectively, relative to the base case over the next 12 months, while decreases in interest rates of 50 and 100 basis points would result in negative variances in net interest income of 0.58% and 1.86%, respectively, relative to the base case over the next 12 months**.** These are good faith estimates and assume that the composition of our interest sensitive assets and liabilities existing at each year-end will remain constant over the relevant twelve month measurement period and that changes in market interest rates are instantaneous and sustained across the yield curve regardless of duration of pricing characteristics of specific assets or liabilities. Also, this analysis does not contemplate any actions that we might undertake in response to changes in market interest rates. We believe these estimates are not necessarily indicative of what actually could occur in the event of immediate interest rate increases or decreases of this magnitude. As interest-bearing assets and liabilities reprice in different time frames and proportions to market interest rate movements, various assumptions must be made based on historical relationships of these variables in reaching any conclusion. Since these correlations are based on competitive and market conditions, we anticipate that our future results will likely be different from the foregoing estimates, and such differences could be material.

Should we be unable to maintain a reasonable balance of maturities and repricing of our interest-earning assets and our interest-bearing liabilities, we could be required to dispose of our assets in an unfavorable manner or pay a higher than market rate to fund our activities. Our asset liability committees oversee and monitor this risk.

Liquidity

Liquidity is our ability to meet cash demands as they arise. Such needs can develop from loan demand, deposit withdrawals or acquisition opportunities. Potential obligations resulting from the issuance of standby letters of credit and commitments to fund future borrowings to our loan customers are other factors affecting our liquidity needs. Many of these obligations and commitments are expected to expire without being drawn upon; therefore the total commitment amounts do not necessarily represent future cash requirements affecting our liquidity position. The potential need for liquidity arising from these types of financial instruments is represented by the contractual notional amount of the instrument, as detailed in Tables 14 and 15. Asset liquidity is provided by cash and assets which are readily marketable or which will mature in the near future. Liquid assets include cash, federal funds sold, and short-term investments in time deposits in banks. Liquidity is also provided by access to funding sources, which include core depositors and correspondent banks that maintain accounts with and sell federal funds to our subsidiary banks. Other sources of funds include our ability to borrow from short-term sources, such as purchasing federal funds from correspondents and sales of securities under agreements to repurchase, which amounted to $235.6 million at December 31, 2008, and an unfunded $50.0 million line of credit established with a nonaffiliated bank which matures on December 31, 2009. First Financial Bank, N. A., Abilene also has federal funds purchased lines of credit with two non-affiliated banks totaling $60.0 million.

On December 19, 2008, the Company renewed its loan agreement, effective December 31, 2008, with The Frost National Bank. Under the loan agreement, as renewed and amended, the Company is permitted to draw up to $50.0 million on a revolving line of credit. Prior to December 31, 2009, interest is paid quarterly at Wall Street Journal Prime and the line of credit matures December 31, 2009. If a balance exists at December 31, 2009, the principal balance coverts to a term facility payable quarterly over five years and interest is paid quarterly at our election at Wall Street Journal Prime plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured for an outstanding balance less than or equal to $25.0 million and secured by the stock of a subsidiary bank should the balance exceed $25.0 million. Among other provisions in the credit agreement, the Company must satisfy certain financial covenants during the term of the loan agreement, including, without limitation, covenants that require the Company to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratio. In addition, the credit agreement contains certain operational covenants, that among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Since 1995, we have historically declared dividends as a percentage of our consolidated net income in a range of 37% (low) in 1995 to 53% (high) in 2003 and 2006. There was no outstanding balance under the line of credit as of December 31, 2008 or 2007.

Given the strong core deposit base and relatively low loan to deposit ratios maintained at our subsidiary banks, we consider our current liquidity position to be adequate to meet our short- and long-term liquidity needs.

In addition, we anticipate that any future acquisition of financial institutions, expansion of branch locations or offering of new products could also place a demand on our cash resources. Available cash at our parent company, which totaled $35.6 million at December 31, 2008, available dividends from subsidiary banks which totaled $32.4 million at December 31, 2008, utilization of available lines of credit, and future debt or equity offerings are expected to be the source of funding for these potential acquisitions or expansions. Existing cash resources at our subsidiary banks may also be used as a source of funding for these potential acquisitions or expansions.

Table 14 Contractual Obligations As of December 31, 2008 (in thousands):

		Payment Due by Period			
	Total Amounts	**Less than 1 year**	**2 3 years**	**4 5 years**	**Over 5 years**
Deposits with stated maturity dates	$ 710,020	$ 641,357	$ 59,489	$ 9,174	$
Operating Leases	1,591	558	804	217	12
Outsourcing Service Contracts	1,150	960	190		
Total Contractual Obligations	712,761	642,875	60,483	9,391	12

Amounts above for deposits do not include related accrued interest.

Off-Balance Sheet Arrangements. We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include unfunded lines of credit, commitments to extend credit and federal funds sold and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in our consolidated balance sheets.

Our exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for unfunded lines of credit, commitments to extend credit and standby letters of credit is represented by the contractual notional amount of these instruments. We generally use the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments.

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, as we deem necessary upon extension of credit, is based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

Standby letters of credit are conditional commitments we issue to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The average collateral value held on letters of credit usually exceeds the contract amount.

Table 15 Commitments As of December 31, 2008 (in thousands):

	Total Notional Amounts Committed	Less than 1 year	2 3 years	4 5 years	Over 5 years
Unfunded lines of credit	$ 290,796	$ 282,273	$ 1,944	$ 2,260	$ 4,319
Unfunded commitments to extend credit	57,268	38,380	7,103	3,897	7,888
Standby letters of credit	16,201	9,983	5,022	1,196	
Total Commercial Commitments	$ 364,265	$ 330,636	$ 14,069	$ 7,353	$ 12,207

We believe we have no other off-balance sheet arrangements or transactions with unconsolidated, special purpose entities that would expose us to liability that is not reflected on the face of the financial statements.

Parent Company Funding. Our ability to fund various operating expenses, dividends, and cash acquisitions is generally dependent on our own earnings (without giving effect to our subsidiaries), cash reserves and funds derived from our subsidiary banks. These funds historically have been produced by intercompany dividends and management fees that are limited to reimbursement of actual expenses. We anticipate that our recurring cash sources will continue to include dividends and management fees from our subsidiary banks. At December 31, 2008, approximately $32.4 million was available for the payment of intercompany dividends by the subsidiaries without the prior approval of regulatory agencies. Our subsidiaries paid aggregate dividends of $39.7 million in 2008 and $42.3 million in 2007.

Dividends. Our long-term dividend policy is to pay cash dividends to our shareholders of between 40% and 55% of net earnings while maintaining adequate capital to support growth. The cash dividend payout ratios have amounted to 52.4%, 52.9% and 53.1% of net earnings, respectively, in 2008, 2007 and 2006. Given our current capital position and projected earnings and asset growth rates, we do not anticipate any significant change in our current dividend policy. Also see Payments of Dividends .

Each state bank that is a member of the Federal Reserve System and each national banking association is required by federal law to obtain the prior approval of the Federal Reserve Board and the OCC, respectively, to declare and pay dividends if the total of all dividends declared in any calendar year would exceed the total of (1) such bank s net profits (as defined and interpreted by regulation) for that year plus (2) its retained net profits (as defined and interpreted by regulation) for the preceding two calendar years, less any required transfers to surplus. In addition, these banks may only pay dividends to the extent that retained net profits (including the portion transferred to surplus) exceed bad debts (as defined by regulation).

To pay dividends, we and our subsidiary banks must maintain adequate capital above regulatory guidelines. In addition, if the applicable regulatory authority believes that a bank under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice (which, depending on the financial condition of the bank, could include the payment of dividends), the authority may require, after notice and hearing, that such bank cease and desist from the unsafe practice. The Federal Reserve Board, the FDIC and the OCC have each indicated that paying dividends that deplete a bank s capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve Board, the OCC and the FDIC have issued policy statements that recommend that bank holding companies and insured banks should generally only pay dividends out of current operating earnings.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our management considers interest rate risk to be a significant market risk for us. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources Interest Rate Risk for disclosure regarding this market risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements begin on page F-1.

Quarterly Results of Operations (in thousands, except per share and common stock data):

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in fiscal 2008 and 2007. This information is derived from unaudited consolidated financial statements that include, in our opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

	2008			
	4th	3rd	2nd	1st
Summary Income Statement Information:				
Interest income	$ 39,239	$ 39,218	$ 38,951	$ 41,746
Interest expense	6,593	7,819	8,931	11,917
Net interest income	32,646	31,399	30,020	29,829
Provision for loan losses	3,683	1,765	1,441	1,068
Net interest income after provision for loan losses	28,963	29,634	28,579	28,761
Noninterest income	11,049	12,145	13,289	11,919
Net gain on securities transactions	346	146	166	393
Noninterest expense	22,532	23,385	23,009	22,661
Earnings before income taxes	17,826	18,540	19,025	18,412
Income tax expense	4,787	5,179	5,423	5,250
Net earnings	$ 13,039	$ 13,361	$ 13,602	$ 13,162
Per Share Data:				
Net earnings per share, basic	$ 0.63	$ 0.64	$ 0.65	$ 0.63
Net earnings per share, assuming dilution	0.62	0.64	0.65	0.63
Cash dividends declared	0.34	0.34	0.34	0.32
Book value at period-end	17.73	16.85	16.54	16.93
Common stock sales price: (1)				
High	56.32	67.00	47.12	42.16
Low	41.30	43.01	40.43	35.49
Close	55.21	51.88	45.81	40.98

	2007			
	4th	3rd	2nd	1st
Summary Income Statement Information:				
Interest income	$ 43,482	$ 42,556	$ 42,259	$ 41,072
Interest expense	14,229	14,816	15,013	14,499
Net interest income	29,253	27,740	27,246	26,573
Provision for loan losses	1,377	475	237	242
Net interest income after provision for loan losses	27,876	27,265	27,009	26,331
Noninterest income	12,320	11,996	12,972	10,836
Net gain on securities transactions	70	(5)		84
Noninterest expense	22,730	21,983	21,248	20,867
Earnings before income taxes	17,536	17,273	18,733	16,384
Income tax expense	5,030	5,022	5,463	4,922
Net earnings	$ 12,506	$ 12,251	$ 13,270	$ 11,462
Per Share Data:				
Net earnings per share, basic	$ 0.60	$ 0.59	$ 0.64	$ 0.55
Net earnings per share, assuming dilution	0.60	0.59	0.64	0.55
Cash dividends declared	0.32	0.32	0.32	0.30
Book value at period-end	16.16	15.51	14.76	14.85
Common stock sales price: (1)				
High	$ 42.62	$ 44.00	$ 42.71	$ 43.69
Low	35.53	35.19	37.33	39.79
Close	37.65	40.18	38.81	41.82

(1) These quotations reflect inter-dealer prices without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

As of December 31, 2008, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the

design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act Rule 15d-15. Our management, including the principal executive officer and principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal financial officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures under Rule 13a-14 (c) and Rule 15d-14 (c) of the Securities Exchange Act of 1934 are effective at the reasonable assurance level as of December 31, 2008.

Subsequent to our evaluation, there were no significant changes in internal controls over financial reporting or other factors that have materially affected, or is reasonably likely to materially affect, these internal controls.

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of First Financial Bankshares, Inc. and subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting. First Financial Bankshares, Inc. and subsidiaries internal control system was designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

First Financial Bankshares, Inc. and subsidiaries management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2008. In making this assessment, it used the criteria for effective internal control over financial reporting set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. Based on our assessment we believe that, as of December 31, 2008, the Company s internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f), is effective based on those criteria.

First Financial Bankshares, Inc. and subsidiaries independent auditors have issued an audit report, dated February 16, 2009, on the effectiveness of the Company s internal control over financial reporting as of December 31, 2008.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors and Shareholders of
First Financial Bankshares, Inc.

We have audited First Financial Bankshares, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). First Financial Bankshares, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, First Financial Bankshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2008 consolidated financial statements of First Financial Bankshares, Inc. and our report dated February 18, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
Dallas, Texas
February 18, 2009

ITEM 9B. OTHER INFORMATION

On February 23, 2009, the Board of Directors of the Company amended the Amended and Restated Bylaws, as amended (the Bylaws), of the Company to clarify the vote requirement for the election of the Company s directors. No other changes to the Company s Bylaws were made. A copy of the amendment to the Bylaws is attached as Exhibit 3.2 to this report.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is hereby incorporated by reference from our proxy statement for our 2009 annual meeting of shareholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is hereby incorporated by reference from our 2009 proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 related to security ownership of certain beneficial owners and management is hereby incorporated by reference from our 2009 proxy statement. The following chart gives aggregate information under our equity compensation plans as of December 31, 2008.

	Number of Securities To be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Far Left Column)
Equity compensation plans approved by security holders	226,264	$ 32.65	587,271
Equity compensation plans not approved by security holders			
Total	226,264	$ 32.65	587,271

The remainder of the information required by Item 12 is incorporated by reference from our 2009 proxy statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 is hereby incorporated by reference from our 2009 proxy statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 is hereby incorporated by reference from our 2009 proxy statement.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

(1) Financial Statements -

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2008 and 2007

Consolidated Statements of Earnings for the years ended December 31, 2008, 2007 and 2006

Consolidated Statements of Comprehensive Earnings for the years ended December 31, 2008, 2007 and 2006

Consolidated Statements of Shareholders Equity for the years ended December 31, 2008, 2007 and 2006

Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006

Notes to the Consolidated Financial Statements

(2) Financial Statement Schedules -

These schedules have been omitted because they are not required, are not applicable or have been included in our consolidated financial statements.

(3) Exhibits -

The information required by this Item 15(a)(3) is set forth in the Exhibit Index immediately following our signature pages. The exhibits listed herein will be furnished upon written request to J. Bruce Hildebrand, Executive Vice President, First Financial Bankshares, Inc., 400 Pine Street, Abilene, Texas 79601, and payment of a reasonable fee that will be limited to our reasonable expense in furnishing such exhibits.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FINANCIAL BANKSHARES, INC.

Date: February 24, 2009

By: /s/ F. SCOTT DUESER
F. SCOTT DUESER
Chairman of the Board, Director,
President and
Chief Executive Officer
(Principal Executive Officer)

The undersigned directors and officers of First Financial Bankshares, Inc. hereby constitute and appoint J. Bruce Hildebrand, with full power to act and with full power of substitution and resubstitution, our true and lawful attorney-in-fact with full power to execute in our name and behalf in the capacities indicated below any and all amendments to this report and to file the same, with all exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission and hereby ratify and confirm all that such attorney-in-fact or his substitute shall lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ F. SCOTT DUESER F. Scott Dueser	Chairman of the Board, Director, President, and Chief Executive Officer (Principal Executive Officer)	February 24, 2009
/s/ J. BRUCE HILDEBRAND J. Bruce Hildebrand	Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 24, 2009
/s/ TUCKER S. BRIDWELL Tucker S. Bridwell	Director	February 24, 2009
/s/ JOSEPH E. CANON Joseph E. Canon	Director	February 24, 2009
/s/ MAC A. COALSON Mac A. Coalson	Director	February 24, 2009
/s/ DAVID COPELAND David Copeland	Director	February 24, 2009

Name	Title	Date
/s/MURRAY EDWARDS Murray Edwards	Director	February 24, 2009
/s/ DERRELL E. JOHNSON Derrell E. Johnson	Director	February 24, 2009
/s/ KADE L. MATTHEWS Kade L. Matthews	Director	February 24, 2009
/s/ KENNETH T. MURPHY Kenneth T. Murphy	Director	February 24, 2009
/s/ DIAN GRAVES STAI Dian Graves Stai	Director	February 24, 2009
/s/ F. L. STEPHENS F. L. Stephens	Director	February 24, 2009
/s/ JOHNNY TROTTER Johnny Trotter	Director	February 24, 2009

Exhibits Index

The following exhibits are filed as part of this report:

3.1	Amended and Restated Certificate of Formation (incorporated by reference from Exhibit 3.1 of the Registrant s Form 10-Q Quarterly Report for the quarter ended March 31, 2006).
*3.2	Amended and Restated Bylaws, and all amendments thereto, of the Registrant.
4.1	Specimen certificate of First Financial Common Stock (incorporated by reference from Exhibit 3 of the Registrant s Amendment No. 1 to Form 8-A filed on Form 8-A/A No. 1 on January 7, 1994).
10.1	Deferred Compensation Agreement, dated October 28, 1992, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.1 of the Registrant s Form 10-K Annual Report for the year ended December 31, 2002).
10.2	Revised Deferred Compensation Agreement, dated December 28, 1995, between the Registrant and Kenneth T. Murphy (incorporated by reference from Exhibit 10.2 of the Registrant s Form 10-K Annual Report for the year ended December 31, 2002).
10.3	Executive Recognition Plan (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K Report filed July 3, 2006).
10.4	1992 Incentive Stock Option Plan (incorporated by reference from Exhibit 10.5 of the Registrant s Form 10-K Annual Report for the fiscal year ended December 31, 1998).
10.5	2002 Incentive Stock Option Plan (incorporated by reference from Appendix A of the Registrant s Schedule 14a Definitive Proxy Statement for the 2002 Annual Meeting of Shareholders).
10.6	Loan agreement dated December 31, 2004, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.1 of the Registrant s Form 8-K filed December 31, 2004).
10.7	First Amendment to Loan Agreement, dated December 28, 2005, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.2 of the Registrant s Form 8-K filed December 28, 2005).
10.8	Second Amendment to Loan Agreement, dated December 31, 2006, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.3 of the Registrant s Form 8-K filed December 31, 2006).
10.9	Third Amendment to Loan Agreement, dated December 31, 2007, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.4 of the Registrant s Form 8-K filed December 31, 2007).
10.10	Fourth Amendment to Loan Agreement, dated July 24, 2008, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.10 of the Registrant s Form 10-Q filed July 25, 2008).
10.11	

	Fifth Amendment to Loan Agreement, dated December 19, 2008, between First Financial Bankshares, Inc. and The Frost National Bank (incorporated by reference from Exhibit 10.6 of the Registrant s Form 8-K filed December 22, 2008).
*21.1	Subsidiaries of the Registrant.
*23.1	Consent of Ernst & Young LLP.
24.1	Power of Attorney (included on signature page of this Form 10-K).
*31.1	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Executive Officer of First Financial Bankshares, Inc.
*31.2	Rule 13a-14(a) / 15(d)-14(a) Certification of Chief Financial Officer of First Financial Bankshares, Inc.
*32.1	Section 1350 Certification of Chief Executive Officer of First Financial Bankshares, Inc.
*32.2	Section 1350 Certification of Chief Financial Officer of First Financial Bankshares, Inc.

* Filed herewith

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
First Financial Bankshares, Inc.

We have audited the accompanying consolidated balance sheets of First Financial Bankshares, Inc. (a Texas corporation) and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of earnings, comprehensive earnings, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Financial Bankshares, Inc. and subsidiaries at December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U. S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), First Financial Bankshares, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 18, 2009, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, Texas
February 18, 2009

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2008 and 2007

	2008	2007
ASSETS		
CASH AND DUE FROM BANKS	$ 137,569,957	$ 163,559,942
FEDERAL FUNDS SOLD	27,660,000	99,450,000
INTEREST-BEARING DEPOSITS IN BANKS	3,658,037	1,878,434
Total cash and cash equivalents	168,887,994	264,888,376
TRADING SECURITIES, at fair value	55,990,882	
SECURITIES HELD-TO-MATURITY (fair value of $24,072,925 in 2008 and $27,253,367 in 2007)	23,493,088	26,419,040
SECURITIES AVAILABLE-FOR-SALE, at fair value	1,238,921,868	1,094,492,701
LOANS:		
Held for investment	1,511,420,878	1,492,223,308
Held for sale	54,721,837	35,796,281
	1,566,142,715	1,528,019,589
Less- allowance for loan losses	(21,528,860)	(17,461,514)
Net loans	1,544,613,855	1,510,558,075
BANK PREMISES AND EQUIPMENT, net	65,675,138	61,670,159
INTANGIBLE ASSETS	64,002,968	65,207,169
OTHER ASSETS	50,798,861	47,073,892
Total assets	$ 3,212,384,654	$ 3,070,309,412
LIABILITIES AND SHAREHOLDERS EQUITY		
NONINTEREST-BEARING DEPOSITS	$ 797,077,004	$ 739,180,980
INTEREST-BEARING DEPOSITS	1,785,676,148	1,806,902,038
Total deposits	2,582,753,152	2,546,083,018

DIVIDENDS PAYABLE	7,071,342	6,645,590
SHORT-TERM BORROWINGS	235,598,268	166,266,426
OTHER LIABILITIES	18,179,664	15,818,916
Total liabilities	2,843,602,426	2,734,813,950
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Common stock, $0.01 par value; authorized 40,000,000 shares; 20,799,198 and 20,766,848 issued at December 31, 2008 and 2007, respectively	207,992	207,669
Capital surplus	268,087,449	267,136,338
Retained earnings	89,637,172	64,333,921
Treasury stock (shares at cost: 158,811 and 155,415 at December 31, 2008 and 2007, respectively)	(3,500,436)	(3,170,304)
Deferred Compensation	3,500,436	3,170,304
Accumulated other comprehensive earnings	10,849,615	3,817,534
Total shareholders equity	368,782,228	335,495,462
Total liabilities and shareholders equity	$ 3,212,384,654	$ 3,070,309,412

The accompanying notes are an integral part of these consolidated financial statements.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Consolidated Statements of Earnings
Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
INTEREST INCOME:			
Interest and fees on loans	$ 104,887,230	$ 114,333,665	$ 101,864,998
Interest on investment securities:			
Taxable	37,538,846	38,880,569	39,297,823
Exempt from federal income tax	14,191,012	12,393,019	10,350,154
Interest on trading securities	747,426		
Interest on federal funds sold and interest-bearing deposits in banks	1,789,516	3,761,708	2,980,973
Total interest income	159,154,030	169,368,961	154,493,948
INTEREST EXPENSE:			
Interest on deposits	33,110,183	51,979,999	42,972,105
Other	2,148,672	6,577,340	5,655,579
Total interest expense	35,258,855	58,557,339	48,627,684
Net interest income	123,895,175	110,811,622	105,866,264
PROVISION FOR LOAN LOSSES	7,956,798	2,331,172	2,061,088
Net interest income after provision for loan losses	115,938,377	108,480,450	103,805,176
NONINTEREST INCOME:			
Trust fees	9,440,936	8,746,756	7,664,810
Service charges on deposit accounts	22,596,535	22,919,519	22,449,963
ATM and credit card fees	8,904,182	7,520,988	6,213,964
Real estate mortgage operations	2,536,257	3,346,547	2,538,913
Net gain on securities transactions	1,051,822	149,891	62,091
Net gain on sale of student loans	1,675,420	1,913,407	2,141,477
Net gain (loss) on sale of other real estate	4,916	107,875	(9,947)
Other	3,243,057	3,567,888	3,606,731
Total noninterest income	49,453,125	48,272,871	44,668,002
NONINTEREST EXPENSE:			

Salaries and employee benefits	49,284,653	46,943,935	44,179,620
Net occupancy expense	6,734,968	5,893,468	5,985,527
Equipment expense	7,546,928	7,220,339	7,039,009
Printing, stationery and supplies	1,890,843	2,003,814	2,067,251
Correspondent bank service charges	1,168,863	1,153,015	1,352,793
Amortization of intangible assets	1,204,200	1,494,931	1,491,393
Other expenses	23,756,936	22,117,373	20,901,600
Total noninterest expense	91,587,391	86,826,875	83,017,193
EARNINGS BEFORE INCOME TAXES	73,804,111	69,926,446	65,455,985
INCOME TAX EXPENSE	20,639,825	20,436,841	19,426,769
NET EARNINGS	$ 53,164,286	$ 49,489,605	$ 46,029,216
NET EARNINGS PER SHARE, BASIC	$ 2.56	$ 2.38	$ 2.22
NET EARNINGS PER SHARE, ASSUMING DILUTION	$ 2.55	$ 2.38	$ 2.21

The accompanying notes are an integral part of these consolidated financial statements.

F-3

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Earnings
Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
NET EARNINGS	$ 53,164,286	$ 49,489,605	$ 46,029,216
OTHER ITEMS OF COMPREHENSIVE EARNINGS:			
Change in unrealized gain (loss) on investment securities available-for-sale, before income tax	16,322,499	16,042,662	3,979,897
Reclassification adjustment for realized gains on investment securities included in net earnings, before income tax	(1,051,822)	(149,891)	(62,091)
Minimum liability pension adjustment, before income tax	(4,452,089)	124,572	(174,063)
Total other items of comprehensive earnings	10,818,588	16,017,343	3,743,743
Income tax benefit (expense) related to:			
Investment securities	(5,344,737)	(5,562,470)	(1,371,232)
Minimum liability pension adjustment	1,558,231	(43,600)	60,922
	(3,786,506)	(5,606,070)	(1,310,310)
COMPREHENSIVE EARNINGS	$ 60,196,368	$ 59,900,878	$ 48,462,649

The accompanying notes are an integral part of these consolidated financial statements.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Consolidated Statements of Shareholders Equity
Years Ended December 31, 2008, 2007 and 2006

	Common Stock		Capital	Retained	Treasury Stock		Deferred	Accumulated Other Comprehensive Earnings	To Sharel
	Shares	Amount	Surplus	Earnings	Shares	Amounts	Compensation	(Losses)	Eq
CE, er 31,	20,714,401	$ 207,144,010	$ 58,712,508	$ 19,434,606	(145,322)	$ (2,592,413)	$ 2,592,413	$ (9,015,317)	$ 276,2
in par common om $10.00		(206,971,541)	206,971,541						
ings				46,029,216					46,0
suances	24,726	34,923	405,793						4
idends , $1.18 e				(24,460,222)					(24,4
m liability ent, net of ncome								(113,141)	(1
in ed gain ent in s e-for-sale, lated taxes								2,546,574	2,5
nal tax elated to deferred sation plan			24,996						
urchased ction with deferred sation					(7,865)	(319,093)	319,093		
tion			157,092						1
CE, er 31,	20,739,127	$ 207,392	$ 266,271,930	$ 41,003,600	(153,187)	$ (2,911,506)	$ 2,911,506	$ (6,581,884)	$ 300,9

ings				49,489,605					49,4
suances		27,721	277526,359						5
vidends , $1.26 e				(26,159,284)					(26,1
m liability ent, net of ncome								80,972	
in ed gain . ent in s e-for-sale, lated taxes								10,318,446	10,3
nal tax elated to . deferred sation plan			117,844						1
urchased ction with . deferred sation .					(2,228)	(258,798)	258,798		
otion			220,205						2
CE, er 31,	20,766,848	$ 207,669	$ 267,136,338	$ 64,333,921	(155,415)	$ (3,170,304)	$ 3,170,304	$ 3,817,534	$ 335,4
ings				53,164,286					53,1
suances	32,350	323	608,568						6
vidends , $1.34 e				(27,861,035)					(27,8
m liability ent, net of ncome								(2,893,859)	(2,8
in ed gain . ent in s e-for-sale, lated taxes								9,925,940	9,9
			116,801						1

nal tax elated to . deferred sation plan urchased ction with . deferred sation .					(3,396)	(330,132)	330,132		
otion			225,742						2
CE, er 31,	20,799,198	$ 207,992	$ 268,087,449	$ 89,637,172	(158,811)	$ (3,500,436)	$ 3,500,436	$ 10,849,615	$ 368,7

The accompanying notes are an integral part of these consolidated financial statements.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	$ 53,164,286	$ 49,489,605	$ 46,029,216
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:			
Depreciation and amortization	8,013,684	7,817,931	7,954,560
Provision for loan losses	7,956,798	2,331,172	2,061,088
Securities premium amortization (discount accretion), net	715,366	(636,173)	215,998
Gain on sale of assets, net	(2,788,408)	(2,102,712)	(2,234,154)
Deferred federal income tax expense (benefit)	(122,877)	464,397	(26,625)
Trading security activity, net	(55,990,882)		
Loans originated for resale	(186,070,970)	(190,037,588)	(170,602,938)
Proceeds from sale of loans held for resale	168,774,668	193,554,563	174,179,850
Change in other assets	(565,325)	(1,629,455)	(9,951,982)
Change in other liabilities	(3,581,285)	(4,461,115)	233,852
Total adjustments	(63,659,231)	5,301,020	1,829,649
Net cash provided by (used in) operating activities	(10,494,945)	54,790,625	47,858,865
CASH FLOWS FROM INVESTING ACTIVITIES:			
Activity in available-for-sale securities:			
Sales	89,439,313	38,531,378	18,513,440
Maturities	199,925,169	881,288,653	1,858,293,402
Purchases	(421,585,072)	(898,748,116)	(1,978,123,309)
Activity in held-to-maturity securities:			
Maturities	2,923,808	1,570,217	26,173,833
Purchases		(1,000,000)	
Net increase in loans	(25,689,003)	(159,437,929)	(87,566,639)
Purchases of bank premises and equipment and computer software	(11,777,805)	(8,330,954)	(7,370,681)
Proceeds from sale of other assets	2,082,569	2,567,705	707,035
Net cash used in investing activities	(164,681,021)	(143,559,046)	(169,372,919)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase in noninterest-bearing deposits	57,896,024	53,845,237	62,179,901
Net increase (decrease) in interest-bearing deposits	(21,225,890)	108,213,734	(44,432,986)
Net increase in short-term borrowings	69,331,842	23,022,079	69,005,371

Common stock transactions:			
Proceeds of stock issuances	608,891	526,636	440,716
Dividends paid	(27,435,283)	(24,927,542)	(24,011,155)
Net cash provided by financing activities	79,175,584	160,680,144	63,181,847
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(96,000,382)	71,911,723	(58,332,207)
CASH AND CASH EQUIVALENTS, beginning of year	264,888,376	192,976,653	251,308,860
CASH AND CASH EQUIVALENTS, end of year	$ 168,887,994	$ 264,888,376	$ 192,976,653

The accompanying notes are an integral part of these consolidated financial statements.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Nature of Operations

First Financial Bankshares, Inc. (a Texas corporation) (Bankshares , Company , we or us) is a financial holding company which owns (through its wholly-owned Delaware subsidiary) all of the capital stock of ten banks located in Texas as of December 31, 2008. Those subsidiary banks are First Financial Bank, National Association, Abilene; Hereford State Bank; First Financial Bank, National Association, Sweetwater; First Financial Bank, National Association, Eastland; First Financial Bank, National Association, Cleburne; First Financial Bank, National Association, Stephenville; San Angelo National Bank; Weatherford National Bank; First Financial Bank, National Association, Southlake and First Financial Bank, National Association, Mineral Wells. Each subsidiary bank s primary source of revenue is providing loans and banking services to consumers and commercial customers in the market area in which the subsidiary is located. In addition, the Company also owns First Financial Investments of Delaware, Inc., First Financial Trust & Asset Management Company, National Association, First Financial Insurance Agency, Inc., First Financial Investments, Inc. and First Technology Services, Inc., an information technology subsidiary.

A summary of significant accounting policies of Bankshares and subsidiaries (collectively, the Company) applied in the preparation of the accompanying consolidated financial statements follows. The accounting principles followed by the Company and the methods of applying them are in conformity with both U. S. generally accepted accounting principles and prevailing practices of the banking industry.

Stock Transactions

On April 25, 2006, the shareholders of the Company approved an amendment to our Corporate Charter at the Annual Shareholders Meeting to change the par value of our common stock from $10.00 to $0.01 per share. In the second quarter of 2006, the Company transferred appropriate amounts from common stock to capital surplus in the consolidated financial statements to reflect this change in par value.

On April 24, 2006, the Company s Board of Directors authorized the repurchase of up to 500,000 shares of common stock over the next three years. The plan authorizes management to repurchase the stock at such time as repurchases are considered beneficial to stockholders. Any repurchases of the stock will be through the open market or in privately negotiated transactions in accordance with applicable laws and regulations. No stock has been repurchased under this plan as of December 31, 2008.

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with U. S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of investment securities, the valuation of foreclosed real estate, deferred income tax assets, and the fair value of financial instruments.

Consolidation

The accompanying consolidated financial statements include the accounts of Bankshares and its subsidiaries, all of which are wholly-owned. All significant intercompany accounts and transactions have been eliminated. Certain reclassifications have been made to 2006 and 2007 financial statements to conform to the 2008 presentation.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

Investment Securities

Management classifies debt and equity securities as held-to-maturity, available-for-sale, or trading based on its intent. Debt securities that management has the positive intent and ability to hold to maturity are classified as held-to-maturity and recorded at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income using the interest method. Securities not classified as held-to-maturity or trading are classified as available-for-sale and recorded at estimated fair value, adjusted for amortization of premiums and accretion of discounts, with all unrealized gains and unrealized losses judged to be temporary, net of deferred income taxes, excluded from earnings and reported as a separate component of shareholders equity. Available for-sale securities that have unrealized losses that are judged other than temporary are included in gain (loss) on sale of securities and a new cost basis is established. Securities classified as trading are recorded at estimated fair value with unrealized gains and losses included in earnings.

Effective January 1, 2008, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements . We also adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) No. FAS 157-3 which provide additional guidance on valuation and disclosures. Fair values are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and yield curves. Fair values for our investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments or an estimate of fair value by using a range of fair value estimates in the market place as a result of the illiquid market specific to the type of security.

When the fair value of a security is below its amortized cost, and depending on the length of time the condition exists and the extent the fair market value is below amortized cost, additional analysis is performed to determine whether an other than temporary impairment condition exists. Available-for-sale and held- to-maturity securities are analyzed quarterly for possible other than temporary impairment. The analysis considers (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Often, the information available to conduct these assessments is limited and rapidly changing, making estimates of fair value subject to judgment. If actual information or conditions are different than estimated, the extent of the impairment of the security may be different than previously estimated, which could have a material effect on the Company s results of operations and financial condition.

Loans and Allowance for Loan Losses

Loans are stated at the amount of unpaid principal, reduced by unearned income and an allowance for loan losses. Interest on loans is calculated by using the simple interest method on daily balances of the principal amounts outstanding. The Company defers and amortizes net loan origination fees and costs as an adjustment to yield. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes the collectibility of the principal is unlikely.

The allowance is an amount management believes will be adequate to absorb estimated inherent losses on existing loans that are deemed uncollectible based upon management s review and evaluation of the loan portfolio. The allowance for loan losses is comprised of three elements: (i) specific reserves determined in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS 118 based on probable losses on specific classified loans; (ii) general reserve determined in accordance with SFAS No. 5 Accounting for Contingencies, that consider historical loss rates; and (iii) a qualitative reserve determined in accordance with SFAS 5 based upon general economic conditions and other qualitative risk factors both internal and external to the Company. The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Management s periodic evaluation of the adequacy of the allowance is based on general economic conditions, the financial condition of borrowers, the value and liquidity of collateral, delinquency, prior loan loss experience, and the results of periodic reviews of the portfolio. For purposes of

determining our general reserve, the loan portfolio, less cash secured loans, government

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

guaranteed loans and classified loans, is multiplied by the Company s historical loss rate. Our methodology is constructed so that specific allocations are increased in accordance with deterioration in credit quality and a corresponding increase in risk of loss. In addition, we adjust our allowance for qualitative factors such as current local economic conditions and trends, changes in lending staff, policies and procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans. This additional allocation based on qualitative factors serves to compensate for additional areas of uncertainty inherent in our portfolio. Accrual of interest is discontinued on a loan and payments applied to principal when management believes, after considering economic and business conditions and collection efforts, the borrower s financial condition is such that collection of interest is doubtful. Generally all loans past due greater than 90 days, based on contractual terms, are placed on non-accrual.

The Company s policy requires measurement of the allowance for an impaired collateral dependent loan based on the fair value of the collateral. Other loan impairments are measured based on the present value of expected future cash flows or the loan s observable market price. At December 31, 2008 and 2007, all significant impaired loans have been determined to be collateral dependent and the allowance for loss has been measured utilizing the estimated fair value of the collateral.

The Company originates (1) mortgage loans primarily for sale in the secondary market and (2) student loans for sale to the Department of Education or another financial institution. Accordingly, these loans are classified as held for sale and are carried at the lower of cost or fair value. The mortgage loans sales contracts contain indemnification clauses should the loans default, generally in the first sixty to ninety days. The student loans are guaranteed by an agency of the U. S. Government.

Other Real Estate

Other real estate is foreclosed property held pending disposition and is valued at fair value, less estimated costs to sell, or the recorded investment in the related loan. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Company s recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating and holding expenses of such properties, net of related income, and gains and losses on their disposition are included in noninterest expense.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed principally on a straight-line basis over the estimated useful lives of the related assets. Leasehold improvements are amortized over the life of the respective lease or the estimated useful lives of the improvements, whichever is shorter.

Business Combinations, Goodwill and Other Intangible Assets

The Company accounts for all business combinations under the purchase method of accounting. Tangible and intangible assets and liabilities of the acquired entity are recorded at fair value on the purchase date. Intangible assets with finite useful lives continue to be amortized and goodwill and intangible assets with indefinite lives are not amortized, but rather tested annually for impairment as of June 30 each year. There was no impairment recorded for the years ended December 31, 2008, 2007 and 2006.

Other identifiable intangible assets recorded by the Company represent the future benefit associated with the acquisition of the core deposits and are being amortized over seven years, utilizing a method that approximates the expected attrition of the deposits.

The carrying amount of goodwill and other intangible assets arising from acquisitions that qualify as an asset purchase for federal income tax purposes amounting to approximately $39,755,000 and $41,883,000, respectively, at December 31, 2008 and 2007, is deductible for federal income tax purposes.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

Securities Sold Under Agreements To Repurchase

Securities sold under agreements to repurchase, which are classified as short-term borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of the cash received in connection with the transaction. The Company may be required to provide additional collateral based on the estimated fair value of the underlying securities.

Segment Reporting

The Company has determined that its banking subsidiaries meet the aggregation criteria of SFAS No. 131, Segment Disclosures and Related Information since each of its community banks offers similar products and services, operates in a similar manner, has similar customers and reports to the same regulatory authority, and therefore operates one line of business (community banking) located in a single geographic area (Texas).

Statements of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, including interest bearing deposits, and federal funds sold.

Accumulated Other Comprehensive Income (Loss)

Unrealized gains on the Company s available-for-sale securities (after applicable income tax expense) totaling $16,706,000 and $6,780,000 at December 31, 2008 and 2007, respectively, and the minimum pension liability adjustment (after applicable income tax benefit) totaling $5,856,000 and $2,963,000 at December 31, 2008 and 2007, respectively, are included in accumulated other comprehensive income (loss).

Income Taxes

The Company s provision for income taxes is based on income before income taxes adjusted for permanent differences between financial reporting and taxable income. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Stock Based Compensation

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. SFAS No. 123R, Share-Based Payment, became effective January 1, 2006 and requires companies to recognize in the statement of earnings the grant-date fair value of stock options issued to employees. The Company recorded stock option expense totaling $226,000, $220,000 and $157,000 for the years ended December 31, 2008, 2007 and 2006, respectively, using the modified prospective method for transition to the new rules whereby grants after the implementation date, as well as unvested awards granted prior to the implementation date, are measured and accounted for under SFAS No. 123R.

Advertising Costs

Advertising costs are expensed as incurred.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

Per Share Data

Net earnings per share (EPS) are computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the period. The Company calculates dilutive EPS assuming all outstanding options to purchase common stock have been exercised at the beginning of the year (or the time of issuance, if later.) The dilutive effect of the outstanding options is reflected by application of the treasury stock method, whereby the proceeds from the exercised options are assumed to be used to purchase common stock at the average market price during the period. The following table reconciles the computation of basic EPS to dilutive EPS:

	Net Earnings	Weighted Average Shares	Per Share Amount
For the year ended December 31, 2008			
Net earnings per share, basic	$53,164,286	20,787,243	$ 2.56
Effect of stock options		54,120	(0.01)
Net earnings per share, assuming dilution	$53,164,286	20,841,363	$ 2.55
For the year ended December 31, 2007:			
Net earnings per share, basic	$49,489,605	20,757,868	$ 2.38
Effect of stock options		42,242	
Net earnings per share, assuming dilution	$49,489,605	20,800,110	$ 2.38
For the year ended December 31, 2006:			
Net earnings per share, basic	$46,029,216	20,725,432	$ 2.22
Effect of stock options		62,137	(0.01)
Net earnings per share, assuming dilution	$46,029,216	20,787,569	$ 2.21

New Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations a replacement of FASB No. 141. SFAS 141R replaces SFAS 141, Business Combinations, and applies to all transaction and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case,

nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS 5, Accounting for Contingencies. SFAS 141R is expected to have a significant impact on the Company s accounting for business combinations closing on or after January 1, 2009.

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133. SFAS 161 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities, to amend and expand the disclosure requirements of SFAS 133 to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under SFAS 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity s financial position, results of operations and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for the Company on January 1, 2009 and is not expected to have a significant impact on the Company s financial position, results of operations or cash flows.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This FSP clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP was effective for the Company upon issuance, including prior periods for which financial statements have not been issued; and, therefore was effective for the Company s financial statements in 2008. Adoption of FSP No. FAS 157-3 did not have a significant impact on the Company s financial position, results of operations or cash flows.

2. CASH AND SECURITIES:

As of December 31, 2008, trading securities totaled $56.0 million. The trading securities portfolio is a government securities money market fund comprised primarily of U.S. government agency securities and repurchase agreements collateralized by U.S. government agency securities. The trading securities are carried at estimated fair value with unrealized gains and losses included in earnings. The Company did not hold trading securities in 2007.

The amortized cost, estimated fair values, and gross unrealized gains and losses of the Company s held-to-maturity and available-for-sale securities as of December 31, 2008 and 2007 are as follows:

	December 31, 2008			
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Securities held-to-maturity:				
Obligations of state and political subdivisions	$ 22,574,235	$ 644,537	$ (62,624)	$ 23,156,148
Mortgage-backed securities	918,853	9,954	(12,030)	916,777
Total debt securities held-to-maturity	$ 23,493,088	$ 654,491	$ (74,654)	$ 24,072,925
Securities available-for-sale:				
Obligations of U.S. government sponsored-enterprises and agencies	$ 315,981,202	$ 14,064,387	$	$ 330,045,589
Obligations of state and political subdivisions	380,008,865	5,238,612	(5,250,230)	379,997,247
Corporate bonds and other	72,878,148	2,453,858	(376,519)	74,955,487
Mortgage-backed securities	444,351,476	9,644,561	(72,492)	453,923,545

Total securities available-for-sale	$ 1,213,219,691	$ 31,401,418	$ (5,699,241)	$ 1,238,921,868

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

	December 31, 2007			
	Amortized Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Estimated Fair Value
Securities held-to-maturity:				
Obligations of state and political subdivisions	$ 25,041,674	$ 847,037	$ (28,210)	$ 25,860,501
Other	4,000			4,000
Mortgage-backed securities	1,373,366	19,542	(4,042)	1,388,866
Total debt securities held-to-maturity	$ 26,419,040	$ 866,579	$ (32,252)	$ 27,253,367
Securities available-for-sale:				
U.S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	$ 314,893,622	$ 3,804,878	$ (317,678)	$ 318,380,822
Obligations of state and political subdivisions	286,292,954	5,157,715	(736,804)	290,713,865
Corporate bonds and other	55,352,211	528,497	(79,125)	55,801,583
Mortgage-backed securities	427,504,026	3,768,693	(1,676,288)	429,596,431
Total securities available-for-sale	$ 1,084,042,813	$ 13,259,783	$ (2,809,895)	$ 1,094,492,701

The Company invests in mortgage-backed securities that have expected maturities that differ from their contractual maturities. These differences arise because borrowers may have the right to call or prepay obligations with or without a prepayment penalty. These securities include collateralized mortgage obligations (CMOs) and other asset backed securities. The expected maturities of these securities at December 31, 2008 and 2007, were computed by using scheduled amortization of balances and historical prepayment rates. At December 31, 2008 and 2007, the Company did not hold any CMOs that entail higher risks than standard mortgage-backed securities.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

The amortized cost and estimated fair value of debt securities at December 31, 2008, by contractual and expected maturity, are shown below (in thousands):

	Held-to-Maturity		Available-for-Sale	
	Amortized Cost Basis	Estimated Fair Value	Amortized Cost Basis	Estimated Fair Value
Due within one year	$ 10,414	$ 10,551	$ 105,437	$ 106,555
Due after one year through five years	11,627	12,105	400,721	417,393
Due after five years through ten years	240	236	118,673	121,652
Due after ten years	293	264	144,037	139,398
Mortgage-backed securities	919	917	444,352	453,924
Total	$ 23,493	$ 24,073	$ 1,213,220	$ 1,238,922

The following table discloses, as of December 31, 2008 and 2007, the Company s investment securities that have been in a continuous unrealized-loss position for less than 12 months and those that have been in a continuous unrealized-loss position for 12 or more months (in thousands):

	Less than 12 Months		12 Months or Longer		Total	
December 31, 2008	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Obligations of state and political subdivisions	$ 155,518	$ 5,288	658	$ 24	$ 156,176	$ 5,312
Mortgage-backed securities	4,016	9	15,749	76	19,765	85
Corporate bonds	19,701	377			19,701	377
Total	$ 179,235	$ 5,674	$ 16,407	$ 100	$ 195,642	$ 5,774

	Less than 12 Months		12 Months or Longer		Total	
December 31, 2007	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U. S. Treasury securities and obligations of U.S. government sponsored-enterprises and agencies	$ 8,978	$ 28	$ 93,466	$ 290	$ 102,444	$ 318
Obligations of state and political subdivisions	40,622	353	26,521	412	67,143	765
Mortgage-backed securities	55,676	80	115,141	1,600	170,817	1,680
Corporate bonds	7,021	60	5,231	19	12,252	79
Total	$ 112,297	$ 521	$ 240,359	$ 2,321	$ 352,656	$ 2,842

The number of investment positions in this unrealized loss position totaled 493 at December 31, 2008. We do not believe these unrealized losses are other than temporary as (1) the Company has the ability and intent to hold the investments to maturity, or a period of time sufficient to allow for a recovery in market value and, (2) it is probable that the Company will be able to collect the amounts contractually due. The unrealized losses noted are interest rate related due to short-term and intermediate interest rates at December 31, 2008. We have reviewed the ratings of the issuers and have not identified any issues related to the ultimate repayment of principal as a result of credit concerns on these securities. Our mortgage related securities are backed by GNMA, FNMA and FHLMC or are collateralized by securities backed by the agencies.

Securities, carried at approximately $730,328,000 and $640,744,000 at December 31, 2008 and 2007, respectively, were pledged as collateral for public or trust fund deposits and for other purposes required or permitted by law.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

During 2008, 2007, and 2006, sales of investment securities that were classified as available-for-sale totaled approximately $89,439,000, $38,531,000, and $18,513,000 respectively. Gross realized gains from 2008 securities sales were approximately $1,052,000. There were no losses on securities sales in 2008. Gross realized gains and losses for 2007 sales were approximately $243,000 and $93,000, respectively. Gross realized gains and losses for 2006 sales were approximately $104,000 and $42,000, respectively. The specific identification method was used to determine cost in computing the realized gains and losses.

Certain subsidiary banks may be required at times to maintain reserve balances with the Federal Reserve Bank. At December 31, 2008, the subsidiary banks met reserve balance requirements with vault cash and were not required to maintain reserve balances with the Federal Reserve Bank. At December 31, 2007, such required reserve balances totaled approximately $10,127,000.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES:

Major classifications of loans are as follows:

	December 31, 2008	December 31, 2007
Commercial, financial and agricultural	$ 485,706,651	$ 493,478,236
Real estate construction	158,000,276	196,250,070
Real estate mortgage	678,787,848	626,145,282
Consumer	243,647,940	212,146,001
Total loans	$ 1,566,142,715	$ 1,528,019,589

Included in real estate-mortgage and consumer loans above are $2.9 million and $51.8 million, respectively, in loans held for sale at December 31, 2008 and $3.5 million and $32.3 million, respectively, in loans held for sale at December 31, 2007 in which the carrying amounts approximate market.

The Company s recorded investment in impaired loans and the related valuation allowance are as follows:

December 31, 2008		December 31, 2007	
Recorded Investment	Valuation Allowance	Recorded Investment	Valuation Allowance
$9,893,144	$2,040,323	$3,189,067	$477,873

The average recorded investment in impaired loans for the years ended December 31, 2008, 2007, and 2006 was approximately $6,541,000, $3,359,000, and $3,526,000 respectively. The Company had approximately $12,531,000, $4,731,000 and $4,111,000 in nonperforming assets at December 31, 2008, 2007 and 2006, respectively. No additional funds are committed to be advanced in connection with impaired loans.

Interest payments received on impaired loans are recorded as interest income unless collections of the remaining recorded investment are doubtful, at which time payments received are recorded as reductions of principal. The Company recognized interest income on impaired loans of approximately $409,000, $100,000 and $91,000 during the years ended December 31, 2008, 2007, and 2006, respectively. If interest on impaired loans had been recognized on a full accrual basis during the years ended December 31, 2008, 2007, and 2006, respectively, such income would have approximated $624,000, $358,000 and $396,000.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

The allowance for loan losses as of December 31, 2008 and 2007, is presented below. Management has evaluated the adequacy of the allowance for loan losses by estimating the losses in various categories of the loan portfolio which are identified below:

	2008	2007
Allowance for loan losses provided for:		
Loans specifically evaluated as impaired	$ 2,040,323	$ 477,873
Remaining portfolio	19,488,537	16,983,641
Total allowance for loan losses	$ 21,528,860	$ 17,461,514

Changes in the allowance for loan losses are summarized as follows:

		December 31,	
	2008	2007	2006
Balance at beginning of year	$ 17,461,514	$ 16,200,804	$ 14,719,140
Add:			
Provision for loan losses	7,956,798	2,331,172	2,061,088
Loan recoveries	825,427	727,189	1,241,991
Deduct:			
Loan charge-offs	(4,714,879)	(1,797,651)	(1,821,415)
Balance at end of year	$ 21,528,860	$ 17,461,514	$ 16,200,804

An analysis of the changes in loans to officers, directors, principal shareholders, or associates of such persons for the year ended December 31, 2008 (determined as of each respective year-end) follows:

	Beginning Balance	Additional Loans	Payments	Ending Balance
Year ended December 31, 2008	$41,326,683	$38,336,949	$49,745,431	$29,918,201

In the opinion of management, those loans are on substantially the same terms, including interest rates and collateral requirements, as those prevailing at the time for comparable transactions with unaffiliated persons.

Certain of our subsidiary banks have established lines of credit with the Federal Home Loan Bank of Dallas to provide liquidity and meet pledging requirements for those customers eligible to have securities pledged to secure certain uninsured deposits. At December 31, 2008, approximately $196,158,000 in loans held by these subsidiaries were subject to blanket liens as security for letters of credit issued under these lines of credit.

During the years ended December 31, 2008 and 2007, the Company sold student loans totaling $62.7 million and $63.9 million, respectively, recognizing net profits of $1.7 million and $1.9 million, respectively, to a financial institution of which an executive officer of one of our wholly owned subsidiary banks was a board member. In the opinion of management, these loan sales are on substantially the same terms as those prevailing at the time for comparable transactions with unaffiliated persons.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

4. BANK PREMISES AND EQUIPMENT:

The following is a summary of bank premises and equipment:

	Useful Life	December 31, 2008	December 31, 2007
Land		$14,932,113	$14,887,261
Buildings	20 to 40 years	66,157,568	61,616,881
Furniture and equipment	3 to 10 years	38,476,890	35,050,420
Leasehold improvements	Lesser of lease term or 5 to 15 years	4,033,457	4,002,984
		123,600,028	115,557,546
Less- accumulated depreciation and amortization		(57,924,890)	(53,887,387)
		$65,675,138	$61,670,159

Depreciation expense for the years ended December 31, 2008, 2007 and 2006 amounted to $6,080,000, $5,789,000, and $5,964,000, respectively and is included in the captions net occupancy expense and equipment expense in the accompanying consolidated statements of earnings.

The Company is lessor for portions of its banking premises. Total rental income for all leases included in net occupancy expense is approximately $1,686,000, $1,663,000 and $1,644,000, for the years ended December 31, 2008, 2007, and 2006, respectively.

5. DEPOSITS

Time deposits of $100,000 or more totaled approximately $333,706,000 and $352,216,000 at December 31, 2008 and 2007, respectively. Interest expense on these deposits was approximately $11,643,000, $17,363,000, and $13,642,000 during 2008, 2007, and 2006, respectively.

At December 31, 2008, the scheduled maturities of time deposits (in thousands) were, as follows:

Year ending December 31,	
2009	$ 641,357
2010	48,781
2011	10,708
2012	6,382
2013	2,792

Deposits received from related parties at December 31, 2008 totaled $47,269,000.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

6. LINE OF CREDIT

On December 19, 2008, the Company renewed its loan agreement, effective December 31, 2008, with The Frost National Bank. Under the loan agreement, as renewed and amended, the Company is permitted to draw up to $50.0 million on a revolving line of credit. Prior to December 31, 2009, interest is paid quarterly at Wall Street Journal Prime and the line of credit matures December 31, 2009. If a balance exists at December 31, 2009, the principal balance converts to a term facility payable quarterly over five years and interest is paid quarterly at the election of the Registrant at Wall Street Journal Prime plus 50 basis points or LIBOR plus 250 basis points. The line of credit is unsecured for an outstanding balance equal to or under $25.0 million and secured by the stock of a subsidiary bank should the balance exceed $25.0 million. Among other provisions in the credit agreement, the Company must satisfy certain financial covenants during the term of the loan agreement, including without limitation, covenants that require the Company to maintain certain capital, tangible net worth, loan loss reserve, non-performing asset and cash flow coverage ratio. In addition, the credit agreement contains certain operational covenants, that among others, restricts the payment of dividends above 55% of consolidated net income, limits the incurrence of debt (excluding any amounts acquired in an acquisition) and prohibits the disposal of assets except in the ordinary course of business. Management believes the Company was in compliance with the financial covenants at December 31, 2008 and 2007. There was no outstanding balance under the line of credit as of December 31, 2008 or 2007.

7. INCOME TAXES:

The Company files a consolidated federal income tax return. Income tax expense is comprised of the following:

	Year Ended December 31,		
	2008	2007	2006
Current federal income tax	$ 20,465,138	$ 19,681,877	$ 19,334,533
Current state income tax	297,564	290,567	118,861
Deferred federal income tax expense (benefit)	(122,877)	464,397	(26,625)
Income tax expense	$ 20,639,825	$ 20,436,841	$ 19,426,769

Income tax expense, as a percentage of pretax earnings, differs from the statutory federal income tax rate as follows:

	As a Percent of Pretax Earnings		
	2008	2007	2006
Statutory federal income tax rate	35.0%	35.0%	35.0%
Reductions in tax rate resulting from interest income exempt from federal income tax	(7.6)%	(6.6)%	(5.8)%
Effect of state income tax	0.4%	0.4%	0.2%
ESOP tax credit	(0.3)%	(0.4)%	(0.4)%
Other	0.5%	0.8%	0.7%
Effective income tax rate	28.0%	29.2%	29.7%

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

The approximate effects of each type of difference that gave rise to the Company s deferred tax assets and liabilities at December 31, 2008 and 2007 are as follows:

	2008	2007
Deferred tax assets:		
Tax basis of loans in excess of financial statement basis	$ 7,605,608	$ 5,873,531
Minimum liability in defined benefit plan	3,153,659	1,595,422
Recognized for financial reporting purposes but not for tax purposes:		
Deferred compensation	1,445,556	1,324,188
Write-downs and adjustments to other real estate owned and repossessed assets	21,451	
Other deferred tax assets	305,199	256,674
Total deferred tax assets	12,531,473	9,049,815
Deferred tax liabilities:		
Financial statement basis of fixed assets in excess of tax basis	1,548,749	967,135
Intangible asset amortization deductible for tax purposes, but not for financial reporting purposes	4,839,242	4,075,928
Recognized for financial reporting purposes but not for tax purposes:		
Accretion on investment securities	1,247,474	1,050,873
Pension plan contributions	854,134	621,140
Net unrealized gain on investment securities Available-for-sale	8,995,762	3,651,026
Other deferred tax liabilities	328,619	302,598
Total deferred tax liabilities	17,813,980	10,668,700
Net deferred tax asset (liability)	$ (5,282,507)	$ (1,618,885)

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109, effective January 1, 2007. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of cumulative benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Adoption of Interpretation 48 did not have a significant impact on the Company s financial statements. The Company files income tax returns in the U.S. federal jurisdiction and several U.S. state

jurisdictions. We are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2005.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

8. FAIR VALUE DISCLOSURES:

SFAS 157, which became effective in 2008, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

SFAS 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, SFAS 157 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include 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, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 Inputs Significant unobservable inputs that reflect an entity s own assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. While management believes the Company s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Investment Securities Available for Sale and Trading Securities classified as available for sale and trading are reported at fair value utilizing Level 1 and Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may

include dealer

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

quotes, market spreads, cash flows, the U. S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayments speeds, credit information and the bond s terms and conditions, among other things.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of December 31, 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Investment securities available for sale	$22,681	$1,216,241	$	$1,238,922
Trading investment securities	55,991			55,991

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis include the following at December 31, 2008:

Impaired Loans Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 input based on the discounting of the collateral. At December 31, 2008, impaired loans with a carrying value of $9.9 million were reduced by specific valuation allowance totaling $1.9 million resulting in a net fair value of $8.0 million, based on Level 3 inputs.

Loans Held for Sale Loans held for sale are reported at the lower of cost or fair value. In determining whether the fair value of loans held for sale is less than cost when quoted market prices are not available, the Company considers investor commitments/contracts. These loans are considered Level 2 of the fair value hierarchy. At December 31, 2008, the Company s mortgage loans held for sale and student loans held for sale were recorded at cost as fair value exceeded cost.

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring and non-recurring basis include goodwill and other intangible assets and other non-financial long-lived assets. SFAS 157 will be applicable to these fair value measurements beginning January 1, 2009.

Under SFAS 107, the Company is required to disclose the estimated fair value of other financial instrument assets and liabilities that are not subject to the requirements of SFAS 157. For the Company, as for most financial institutions, substantially all of its assets and liabilities are considered financial instruments as defined. Many of the Company s financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction.

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

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

The estimated fair values and carrying values of all financial instruments covered by SFAS 157 and SFAS 107 at December 31, 2008 and 2007, were as follows:

	2008		2007	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Cash and due from banks	$ 137,569,957	$ 137,569,957	$ 163,559,942	$ 163,559,942
Federal funds sold	27,660,000	27,660,000	99,450,000	99,450,000
Interest-bearing deposits in banks	3,658,037	3,658,037	1,878,434	1,878,434
Trading securities	55,990,882	55,990,882		
Held to maturity securities	23,493,088	24,072,925	26,419,040	27,253,367
Available for sale securities	1,238,921,868	1,238,921,868	1,094,492,701	1,094,492,701
Net loans	1,544,613,855	1,572,986,026	1,510,558,075	1,518,677,572
Accrued interest receivable	21,101,632	21,101,632	21,834,040	21,834,040
Deposits with stated maturities	710,019,705	715,204,080	774,033,645	778,371,624
Deposits with no stated maturities	1,872,733,447	1,872,733,447	1,772,049,373	1,772,049,373
Short term borrowings	235,598,268	235,598,268	166,266,426	166,266,426
Accrued interest payable	2,281,142	2,281,142	4,654,496	4,654,496

Financial instruments actively traded in a secondary market have been valued using quoted available market prices. Financial instruments with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities. Financial instrument assets with variable rates and financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value. Changes in assumptions or estimation methodologies may have a material effect on these estimated fair values.

The carrying value and the estimated fair value of the Company s contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

Reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates which must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

9. COMMITMENTS AND CONTINGENCIES:

The Company is engaged in legal actions arising from the normal course of business. In management s opinion, the Company has adequate legal defenses with respect to these actions, and the resolution of these matters will have no material adverse effects upon the results of operations or financial condition of the Company.

The Company leases a portion of its bank premises and equipment under operating leases. At December 31, 2008, future minimum lease commitments were: 2009 $558,000; 2010 $430,000; 2011 - $374,000; 2012 $194,000; 2013 $23,000 and thereafter $12,000.

10. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK:

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include unfunded lines of credit, commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

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

	Contract or Notional Amount at December 31, 2008
Financial instruments whose contract amounts represent credit risk:	
Unfunded lines of credit	$ 290,796,000
Unfunded commitments to extend credit	57,268,000
Standby letters of credit	16,201,000
	$ 364,265,000

Unfunded lines of credit and commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management s credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment, livestock, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The average collateral value held on letters of credit usually exceeds the contract amount.

The Company has no other off-balance sheet arrangements or transactions that would expose the Company to liability that is not reflected on the face of the financial statements.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

11. CONCENTRATION OF CREDIT RISK:

The Company grants commercial, retail, agriculture and residential real estate loans to customers primarily in North Central and West Texas. Although the Company has a diversified loan portfolio, a substantial portion of its debtors ability to honor their contracts is dependent upon this local economic sector. In addition, the Company holds mortgage related securities which are backed by GNMA, FNMA or FHLMC or are collateralized by securities backed by these agencies.

12. PENSION AND PROFIT SHARING PLANS:

The Company s defined benefit pension plan was frozen effective January 1, 2004 whereby no additional years of service accrue to participants, unless the pension plan is reinstated at a future date. The pension plan covered substantially all of the Company s employees. The benefits were based on years of service and a percentage of the employee s qualifying compensation during the final years of employment. The Company s funding policy was and is to contribute annually the amount necessary to satisfy the Internal Revenue Service s funding standards. Contributions to the pension plan, prior to freezing the plan, were intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. As a result of freezing the pension plan, we did not expect contributions or pension expense to be significant in future years. However, as a result of the Pension Protection Act of 2006, the Company will be required to contribute amounts in future years to fund any shortfalls. The Company evaluated the provisions of the Act as well as Internal Revenue Service s funding standards to develop a preliminary plan for funding in future years. The Company made a contribution totaling $800,000 and $1.5 million in 2008 and 2007, respectively, and is continuing to evaluate future funding amounts.

Using an actuarial measurement date of December 31, 2008 and September 30, 2007, respectively, benefit obligation activity and fair value of plan assets for the years ended December 31, 2008 and 2007, and a statement of the funded status as of December 31, 2008 and 2007, are as follows:

	2008	2007
Reconciliation of benefit obligations:		
Benefit obligation at January 1	$ 19,612,417	$ 18,471,240
Interest cost on projected benefit obligation	1,389,106	1,111,110
Actuarial loss	(1,349,082)	942,799
Benefits paid	(1,232,200)	(912,732)
Benefit obligation at December 31	18,420,241	19,612,417
Reconciliation of fair value of plan assets:		
Fair value of plan assets at January 1	16,828,739	14,372,733
Actual return on plan assets	(4,546,363)	1,868,738
Employer contributions	800,000	1,500,000
Benefits paid	(1,232,200)	(912,732)
Fair value of plan assets at December 31	11,850,176	16,828,739
Funded status	$ (6,570,065)	$ (2,783,678)

Reconciliation of funded status to accrued pension liability:		
Funded status at December 31	$ (6,570,065)	$ (2,783,678)
Unrecognized loss from past experience different than that assumed and effects of changes in assumptions	9,333,269	4,881,178
Additional minimum liability recorded	(9,333,269)	(4,881,178)
Accrued pension liability	$ (6,570,065)	$ (2,783,678)

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

In September 2006, SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Post-retirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R) was issued which required an employer to recognize the overfunded or underfunded status of defined benefit post-retirement benefit plans as an asset or a liability in its balance sheet. The funded status is measured as the difference between plan assets at fair value and the benefit obligation. An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses. The Company had previously recognized the funded status of its pension plans in prior financial statements. The requirement to measure plan assets and benefit obligations as of the date of the year-end statement of financial position was effective for the Company s 2008 financial statements. The impact of this change was not significant to the Company s financial position or results of operations.

Net periodic pension cost for the years ended December 31, 2008, 2007, and 2006, included:

	Year Ended December 31,		
	2008	2007	2006
Service cost benefits earned during the period	$	$	$
Interest cost on projected benefit obligation	1,389,106	1,111,110	1,045,011
Expected return on plan assets	(1,503,104)	(998,838)	(901,938)
Amortization of unrecognized net loss	248,294	197,470	193,780
Net periodic pension cost	$ 134,296	$ 309,742	$ 336,853

The following table sets forth the rates used in the actuarial calculations of the present value of benefit obligations and net periodic pension cost and the rate of return on plan assets:

	2008	2007	2006
Weighted average discount rate	6.50%	5.85%	5.85%
Rate of increase in future compensation levels			
Expected long-term rate of return on assets	7.25%	6.50%	6.50%

The expected long-term rate of return on plan assets is based on historical returns and expectations of future returns based on asset mix, after consultation with our investment advisors and actuaries. The weighted average discount rate is estimated based on setting a discount rate to establish an obligation for pension benefits equivalent to an amount that, if invested in high quality fixed income securities, would produce a return that matches the expected benefit payment stream.

The major type of plan assets in the pension plan and the targeted allocation percentage as of December 31, 2008 and 2007 is as follows:

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

	December 31, 2008 Allocation	December 31, 2007 Allocation	Targeted Allocation
Equity securities	66%	71%	75%
Debt securities	32%	23%	25%
Cash and equivalents	2%	6%	

The range and weighted average final maturities of debt securities held in the pension plan as of December 31, 2008 are 2 to 13 years and approximately 5.8 years, respectively.

First Financial Trust & Asset Management Company, National Association, a wholly owned subsidiary of the Company, manages the pension plan assets as well as the profit sharing plan assets (see below). The investment strategy and targeted allocations are based on similar strategies First Financial Trust & Asset Management Company, National Association employs for most of its managed accounts whereby appropriate diversification is achieved. First Financial Trust & Asset Management Company, National Association is prohibited from holding investments deemed to be high risk by the Office of the Comptroller of the Currency.

An estimate of the undiscounted projected future payments to eligible participants for the next five years and the following five years in the aggregate is as follows (dollars in thousands):

Year Ending December 31,	
2009	$1,109
2010	1,182
2011	1,319
2012	1,359
2013	1,422
2014 to 2018	8,133

As of December 31, 2008 and 2007, the pension plan s assets included Company common stock valued at approximately $1,134,000 and $773,000, respectively.

The Company also provides a profit sharing plan, which covers substantially all full-time employees. The profit sharing plan is a defined contribution plan and allows employees to contribute a percentage of their base annual salary. Employees are fully vested to the extent of their contributions and become fully vested in the Company s contributions over a six-year vesting period. Costs related to the Company s defined contribution plan totaled approximately $3,406,000, $3,219,000, and $2,116,000 in 2008, 2007 and 2006, respectively, and are included in salaries and employee benefits in the accompanying consolidated statements of earnings. As of December 31, 2008 and 2007, the profit sharing plan s assets included Company common stock valued at approximately $29,578,000 and $20,709,000, respectively.

In 2004, after freezing our pension plan, we added a safe harbor match to the 401(k) plan. We match a maximum of 4% on employee deferrals of 5% of their employee compensation. Total expense for this matching in 2008, 2007 and 2006 was $1,133,000, $1,127,000 and $1,041,000, respectively, and is included in salaries and employee benefits in the statements of earnings.

The Company has a directors deferred compensation plan whereby the directors may elect to defer up to 100% of their directors fees. All deferred compensation is invested in the Company s common stock held in a rabbi trust. The stock is held in nominee name of the trustee, and the principal and earnings of the trust are held separate and apart from other funds of the Company, and are used exclusively for the uses and purposes of the deferred compensation agreement. The accounts of the trust have been consolidated in the financial statements of the Company.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

13. DIVIDENDS FROM SUBSIDIARIES:

At December 31, 2008, approximately $32.4 million was available for the declaration of dividends by the Company s subsidiary banks without the prior approval of regulatory agencies.

14. REGULATORY MATTERS:

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and each of its subsidiaries to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes as of December 31, 2008 and 2007, that Company and each of its subsidiaries meet all capital adequacy requirements to which they are subject.

As of December 31, 2008 and 2007, the most recent notification from each respective subsidiary s primary regulator categorized each of the Company s subsidiaries as well-capitalized, except that Hereford State Bank s 2007 total risk-based capital ratio was 9.92% versus the well capitalized minimum of 10%. To be categorized as well-capitalized, the subsidiaries must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table.

There are no conditions or events since that notification that management believes have changed the institutions categories. Bankshares and its significant subsidiaries actual capital amounts and ratios are presented in the table below:

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

	Actual		For Capital Adequacy Purposes:		To Be Well Capitalized Under Prompt Corrective Action Provisions:	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	$321,024,000	17%	≥$150,747,000	≥8%	N/A	
First Financial Bank-Abilene	$ 78,509,000	13%	≥$48,079,000	≥8%	≥$60,098,000	≥10
San Angelo National Bank	$ 36,167,000	21%	≥$13,957,000	≥8%	≥$17,447,000	≥10
Weatherford National Bank	$ 26,954,000	14%	≥$15,594,000	≥8%	≥$19,493,000	≥10
First Financial Bank-Stephenville	$ 28,948,000	14%	≥$17,075,000	≥8%	≥$21,344,000	≥10
First Financial Bank-Southlake	$ 26,962,000	15%	≥$14,386,000	≥8%	≥$17,983,000	≥10
Tier1 Capital (to Risk-Weighted Assets):						
Consolidated	$299,415,000	16%	≥$75,373,000	≥4%	N/A	
First Financial Bank-Abilene	$ 72,654,000	12%	≥$24,039,000	≥4%	≥$36,059,000	≥6
San Angelo National Bank	$ 34,390,000	20%	≥$6,979,000	≥4%	≥$10,468,000	≥6
Weatherford National Bank	$ 24,917,000	13%	≥$7,797,000	≥4%	≥$11,696,000	≥6
First Financial Bank-Stephenville	$ 26,477,000	12%	≥$8,538,000	≥4%	≥$12,806,000	≥6
First Financial Bank-Southlake	$ 24,700,000	14%	≥$7,193,000	≥4%	≥$10,790,000	≥6
Tier1 Capital (to Average Assets):						
Consolidated	$299,415,000	10%	≥$92,818,000	≥3%	N/A	
First Financial Bank-Abilene	$ 72,654,000	7%	≥$31,276,000	≥3%	≥$52,126,000	≥5
San Angelo National Bank	$ 34,390,000	11%	≥$9,518,000	≥3%	≥$15,863,000	≥5
Weatherford National Bank	$ 24,917,000	8%	≥$10,123,000	≥3%	≥$16,872,000	≥5
First Financial Bank-Stephenville	$ 26,477,000	9%	≥$9,604,000	≥3%	≥$16,006,000	≥5

First Financial Bank-Southlake	$ 24,700,000	7%	≥$7,965,000	≥3%	≥$13,275,000	≥5

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

	Actual		For Capital Adequacy Purposes:		To Be Well Capitalized Under Prompt Corrective Action Provisions:	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2007:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	$284,250,000	16%	≥$145,546,000	≥8%	N/A	
First Financial Bank-Abilene	$ 71,985,000	12%	≥$46,696,000	≥8%	≥$58,370,000	≥10%
San Angelo National Bank	$ 31,915,000	18%	≥$14,289,000	≥8%	≥$17,861,000	≥10%
Weatherford National Bank	$ 24,211,000	14%	≥$14,294,000	≥8%	≥$17,868,000	≥10%
First Financial Bank-Stephenville	$ 26,118,000	12%	≥$17,154,000	≥8%	≥$21,443,000	≥10%
First Financial Bank-Southlake	$ 24,613,000	13%	≥$15,461,000	≥8%	≥$19,326,000	≥10%
Tier1 Capital (to Risk-Weighted Assets):						
Consolidated	$266,738,000	15%	≥$72,773,000	≥4%	N/A	
First Financial Bank-Abilene	$ 67,201,000	12%	≥$23,348,000	≥4%	≥$35,022,000	≥6%
San Angelo National Bank	$ 30,418,000	17%	≥$7,144,000	≥4%	≥$10,717,000	≥6%
Weatherford National Bank	$ 22,505,000	13%	≥$7,147,000	≥4%	≥$10,721,000	≥6%
First Financial Bank-Stephenville	$ 23,814,000	11%	≥$8,577,000	≥4%	≥$12,866,000	≥6%
First Financial Bank-Southlake	$ 22,516,000	12%	≥$7,730,000	≥4%	≥$11,596,000	≥6%
Tier1 Capital (to Average Assets):						
Consolidated	$266,738,000	9%	≥$86,669,000	≥3%	N/A	
First Financial Bank-Abilene	$ 67,201,000	7%	≥$28,574,000	≥3%	≥$47,624,000	≥5%
San Angelo National Bank	$ 30,418,000	10%	≥$9,342,000	≥3%	≥$15,571,000	≥5%
Weatherford National Bank	$ 22,505,000	7%	≥$10,134,000	≥3%	≥$16,891,000	≥5%
First Financial Bank-Stephenville	$ 23,814,000	8%	≥$9,260,000	≥3%	≥$15,433,000	≥5%

First Financial Bank-Southlake	$	22,516,000	8%	≥$8,294,000	≥3%	≥$13,824,000	≥5%

In connection with our Trust Company s application to obtain our trust charter, we are required to maintain tangible net assets of $2.0 million at all times. As of December 31, 2008, our Trust Company had tangible net assets totaling $3.5 million.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

15. STOCK OPTION PLAN:

The Company has an incentive stock plan to provide for the granting of options to senior management of the Company at prices not less than market at the date of grant. At December 31, 2008, the Company had allocated 813,535 shares of stock for issuance under the plan. The plan provides that options granted are exercisable after two years from date of grant at a rate of 20% each year cumulatively during the 10-year term of the option. An analysis of stock option activity for the year ended December 31, 2008 is presented in the table and narrative below:

	Shares	Weighted-Average Ex. Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding, beginning of year	266,174	$ 25.23		
Granted				
Exercised	(32,350)	18.82		
Cancelled	(7,560)	33.53		
Outstanding, end of year	226,264	32.65	6.17	5,105
Exercisable at end of year	79,670	25.20	3.61	1,751

The options outstanding at December 31, 2008, had exercise prices ranging between $12.48 and $40.98. Stock options have been adjusted retroactively for the effects of stock dividends and splits.

The following table summarizes information concerning outstanding and vested stock options as of December 31, 2008:

Exercise Price	Number Outstanding	Remaining Contracted Life (Years)	Number Vested
$12.48	12,431	1.24	12,431
18.30	1,667	3.06	1,667
23.10	48,612	4.35	34,778
33.08	78,954	6.07	30,794
40.98	84,600	8.09	

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

From inception of the plan until December 31, 2005, the Company accounted for this plan under APB 25 under which no compensation cost has been recognized for options granted. Effective January 1, 2006, the Company accounted for this plan under SFAS No. 123R whereby the fair value of options is recognized as compensation expense over the vesting period. The fair value of the options granted in 2007, was estimated using the Black-Scholes options pricing model with the following weighted-average assumptions: risk-free interest rate of 4.26%; expected dividend yield of 3.39%; expected life of 5.61 years; and expected volatility of 18.4%.

The weighted-average grant-date fair value of options granted during the year ended December 31, 2007 was $7.31. There were no grants during 2008 or 2006. The total intrinsic value of options exercised during the years ended December 31, 2008, 2007 and 2006, was $1,394,000, $1,126,000 and $495,000 respectively.

As of December 31, 2008, there was $539,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.8 years. The total fair value of shares vested during the years ended December 31, 2008, 2007, and 2006 was $175,000, $181,000 and $103,000 respectively.

The aggregate intrinsic value of vested stock options at December 31, 2008 totaled $2,391,000.

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

16. CONDENSED FINANCIAL INFORMATION PARENT COMPANY:

Condensed Balance Sheets-December 31, 2008 and 2007

	2008	2007
ASSETS		
Cash in subsidiary bank	$ 13,932,456	$ 6,855,875
Cash in unaffiliated bank	4,881	4,859
Interest-bearing deposits in subsidiary banks	21,644,609	29,760,871
Total cash and cash equivalents	35,581,946	36,621,605
Securities available-for-sale, at fair value	10,258,875	
Investment in and advances to subsidiaries, at equity	329,357,364	305,194,582
Intangible assets	723,375	723,375
Other assets	879,436	589,828
Total assets	$ 376,800,996	$ 343,129,390
LIABILITIES AND SHAREHOLDERS EQUITY		
Total liabilities	$ 8,018,768	$ 7,633,928
Shareholders equity:		
Common stock	207,992	207,669
Capital surplus	268,087,449	267,136,338
Retained earnings	89,637,172	64,333,921
Accumulated other comprehensive earnings	10,849,615	3,817,534
Total shareholders equity	368,782,228	335,495,462
Total liabilities and shareholders equity	$ 376,800,996	$ 343,129,390

Condensed Statements of Earnings-
For the Years Ended December 31, 2008, 2007, and 2006

	2008	2007	2006
Income:			
Cash dividends from subsidiaries	$ 39,675,000	$ 42,275,000	$ 39,726,766
Excess of earnings over dividends of subsidiary banks	14,762,316	8,219,675	7,660,591
Other income	1,589,525	1,737,370	1,052,705
	56,026,841	52,232,045	48,440,062

Expenses:			
Salaries and employee benefits	2,094,244	1,936,884	1,783,904
Other operating expenses	1,850,361	1,690,594	1,704,905
	3,944,605	3,627,478	3,488,809
Earnings before income taxes	52,082,236	48,604,567	44,951,253
Income tax benefit	1,082,050	885,038	1,077,963
Net earnings	$ 53,164,286	$ 49,489,605	$ 46,029,216

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

Condensed Statements of Cash Flows-
For the Years Ended December 31, 2008, 2007, and 2006

	2008	2007	2006
Cash flows from operating activities:			
Net earnings	$ 53,164,286	$ 49,489,605	$ 46,029,216
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Excess of earnings over dividends of subsidiary banks	(14,762,316)	(8,219,675)	(7,660,591)
Depreciation	25,011	39,501	54,268
Decrease (increase) in other assets	(238,202)	(182,548)	329,034
Increase (decrease) in liabilities	(282,479)	(514,736)	277,742
Net cash provided by operating activities	37,906,300	40,612,147	39,029,669
Cash flows from investing activities:			
Purchase of available for sale securities	(10,151,310)		
Purchases of bank premises and equipment	(46,170)	(12,268)	(9,441)
Repayment from (of advances related to) investment in and advances to subsidiaries	(1,922,087)	500,000	(3,300,000)
Net cash provided by (used in) investing activities	(12,119,567)	487,732	(3,309,441)
Cash flows from financing activities:			
Proceeds of stock issuances	608,891	526,636	440,716
Cash dividends paid	(27,435,283)	(24,927,542)	(24,011,155)
Net cash used in financing activities	(26,826,392)	(24,400,906)	(23,570,439)
Net increase (decrease) in cash and cash equivalents	(1,039,659)	16,698,973	12,149,789
Cash and cash equivalents, beginning of year	36,621,605	19,922,632	7,772,843
Cash and cash equivalents, end of year	$ 35,581,946	$ 36,621,605	$ 19,922,632

FIRST FINANCIAL BANKSHARES, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2008, 2007 and 2006

17. CASH FLOW INFORMATION:

Supplemental information on cash flows and noncash transactions is as follows:

	Year Ended December 31,		
	2008	2007	2006
Supplemental cash flow information:			
Interest paid	$37,632,209	$58,269,719	$47,598,695
Federal income taxes paid	20,026,772	20,537,026	19,130,331
Schedule of noncash investing and financing activities:			
Assets acquired through foreclosure	2,648,147	3,412,077	421,531
Loans to finance the sale of other real estate		969,500	
Investment securities purchased but not settled	778,142	4,161,418	4,285,000