

UNITED SECURITY BANCSHARES
Form 10-K
March 16, 2007

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

FORM 10-K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006.**
- 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: 000-32987

UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA

91-2112732

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

1525 East Shaw Ave., Fresno, California

93710

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code (559) 248-4943

Securities registered pursuant to Section 12(b) of the Act: Common Stock, no par value on Nasdaq

(Title of Class)

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

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Act.

Yes No

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 for the past 90 days.

Yes No

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

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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

Aggregate market value of the Common Stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter - June 30, 2006: \$176,056,726

Shares outstanding as of February 28, 2007: 12,263,126

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Definitive Proxy Statement for the 2007 Meeting of Shareholders is incorporated by reference into Part III.

Part III, Items 10, 11, 12, 13 and 14

UNITED SECURITY BANCSHARES

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PART 1

Certain matters discussed or incorporated by reference in this Annual Report of Form 10-K including, but not limited to, those described in Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations, are forward-looking statements as defined under the Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, among others, (1) competitive pressure in the banking industry increases significantly; (2) changes in the interest rate environment which may reduce margins and devalue assets; (3) general economic conditions, either nationally or regionally, are less favorable than expected, resulting in, among other things, a deterioration in credit quality; (4) changes in the regulatory environment; (5) changes in business conditions and inflation; (6) changes in securities markets; (7) asset/liability matching risks and liquidity risks; (8) loss of key personnel; and (9) operational interruptions including data processing systems failure and fraud. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

Item 1 - Business

General

United Security Bancshares (the Company) is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company's stock is listed on NASDAQ under the symbol UBFO. United Security Bank (the Bank) is a wholly-owned bank subsidiary of the Company and was formed in 1987. United Security Bancshares Capital Trust I (the Trust) was formed during June of 2001 as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. The Trust was originally formed as a subsidiary of the Company, but was deconsolidated during 2004 pursuant to the adoption of FIN 46 (as revised), Consolidation of Variable Interest Entities. At present, the Company does not engage in any material business activities other than ownership of the Bank.

United Security Bank

On June 12, 2001, the Bank became the wholly owned subsidiary of United Security Bancshares, through a tax-free holding company reorganization, accounted for on a basis similar to the pooling of interest method. In the transaction, each share of Bank stock was exchanged for a share of Company stock on a one-to-one basis.

The Bank is a California state-chartered bank headquartered in Fresno, California. It is also a member of the Federal Reserve System (Fed member). The Bank originally commenced business on December 21, 1987 as a national bank and, during the fourth quarter of 1998, filed an application with the California Department of Financial Institutions and other regulatory authorities to become a state-chartered bank. The shareholders approved the conversion in January of 1999, and the Bank was granted approval to operate as a state-chartered bank on February 3, 1999. The Bank's operations are currently subject to federal and state laws applicable to state-chartered, Fed member banks and its deposits are insured up to the applicable limits by the Federal Deposit Insurance Corporation (the FDIC). The Bank is also subject to the Federal Deposit Insurance Act and regulatory reporting requirements of the FDIC. As a state-chartered bank and a member of the Federal Reserve System, the Bank is subject to supervision and regular examinations by the Board of Governors of the Federal Reserve System (the FRB) and the California Department of Financial Institutions (the DFI). In addition, the Bank is required to file reports with the FRB and provide such additional information as the FRB may require.

Effective August 25, 1995, the Bank consummated a merger with Golden Oak Bank, a two branch California state chartered bank located in Oakhurst, California, with assets of approximately \$45 million at the date of merger. The merger was accounted for as a pooling of interests.

During February of 1997, the Bank completed the purchase of the deposits and certain assets of two branches of Wells Fargo Bank located in Caruthers and San Joaquin, both located in Fresno County. This brought the total branches operated at that time by the Bank to six and the total assets to approximately \$190 million. The Bank paid a premium of approximately \$1.2 million to purchase deposit accounts totaling approximately \$33.4 million. The Bank also purchased cash balances as well as certain fixed assets of the branch operations.

During October of 1997, the Bank completed the purchase from Bank of America of two of its branches located in Firebaugh and Coalinga, both located in Fresno County. The acquisition brought the total branches operated by the Bank to eight at that time and the total assets to approximately \$238 million. The premium paid by the Bank totaled approximately \$3.0 million and the amount of deposits totaled approximately \$44.4 million. The transaction included the receipt of cash balances of approximately \$1.0 million and the purchase of premises and equipment totaling approximately \$600,000.

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USB Investment Trust Inc. was incorporated effective December 31, 2001 as a special purpose real estate investment trust (REIT) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust. For further discussion of the REIT, refer to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations Income Taxes.

Effective April 23, 2004, the Company completed a merger with Taft National Bank headquartered in Taft, California. Taft National Bank (Taft) was merged into United Security Bank and Taft's two branches operate as branches of United Security Bank. The total consideration paid to Taft shareholders was 241,447 shares of the Company's Common Stock valued at just over \$6 million. In the merger, the Company acquired \$15.4 million in cash and short-term investments, \$23.3 million in loans, and \$48.2 million in deposits. This transaction was accounted for using the purchase method of accounting, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities. The consolidated statement of income for the year ended December 31, 2004 includes the operations of Taft from the date of the acquisition to December 31, 2004.

On October 6, 2006 the Company announced the signing of a definitive merger agreement providing for the merger of Legacy Bank, N.A. with and into United Security Bank, a wholly owned subsidiary of the Company. Legacy Bank operates one banking office in Campbell, California serving small business and retail banking clients. The merger was completed February 16, 2007 and after that date, Legacy Bank's branch office began operating as a branch office of United Security Bank. As of February 16, 2007, Legacy Bank had total assets of \$78.5 million and deposits of \$69.6 million. (See Note 22 to the Company's consolidated financial statements contained herein for details of the merger).

At December 31, 2006, the Company operated ten full-service bank branches and one construction lending office; with seven branches in Fresno County, two branches in Kern County, and one branch in Madera County. The Bank operates three branches (including its main office) and one construction lending office in Fresno and one branch each, in Oakhurst, Caruthers, San Joaquin, Firebaugh, Coalinga, Bakersfield, and Taft. In addition, the Company and Bank have administrative headquarters, which were relocated during November 2006 to 2126 Inyo Street, Fresno, California, 93721.

At December 31, 2006, the consolidated Company had approximately \$678.3 million in total assets, \$491.2 million in net loans, \$587.1 million in deposits, and \$66.0 million in shareholders' equity.

The following discussion of the Company's services should be read in conjunction with MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Bank Services

As a state-chartered commercial bank, United Security Bank offers a full range of commercial banking services primarily to the business and professional community and individuals located in Fresno, Madera, and Kern Counties. The Bank will also offer a full range of banking services in Santa Clara County with its recent purchase of Legacy Bank in Campbell, California.

The Bank offers a wide range of deposit instruments including personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal (NOW) accounts, money market accounts and time certificates of deposit. Most of the Bank's deposits are attracted from individuals and from small and medium-sized business-related sources.

The Bank also engages in a full complement of lending activities, including real estate mortgage, commercial and industrial, real estate construction, as well as agricultural, lease financing, and consumer loans, with particular emphasis on short and medium-term obligations. The Bank's loan portfolio is not concentrated in any one industry, although approximately 60% of the Bank's loans are secured by real estate. A loan may be secured (in whole or in part) by real estate even though the purpose of the loan is not to facilitate the purchase or development of real estate. At December 31, 2006, the Bank had loans (net of unearned fees) outstanding of \$499.6 million, which represented approximately 85% of the Bank's total deposits and approximately 74% of its total assets.

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Real estate mortgage loans are secured by deeds of trust primarily on commercial property. Repayment of real estate mortgage loans is generally from the cash flow of the borrower. Commercial and industrial loans have a high degree of industry diversification. Loans may be originated in the Company's market area, or participated with other financial institutions outside the Company's market area. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral. The remainder are unsecured; however extensions of credit are predicated on the financial capacity of the borrower to repay the extension of credit. Repayment of commercial loans is generally from the cash flow of the borrower. Real estate construction loans consist of loans to residential contractors, which are secured by single-family residential properties. All real estate loans have established equity requirements. Repayment of real estate construction loans is generally from long-term mortgages with other lending institutions. Agricultural loans are generally secured by land, equipment, inventory and receivables. Repayment of agricultural loans is from the expected cash flow of the borrower.

In the normal course of business, the Bank makes various loan commitments and incurs certain contingent liabilities. At December 31, 2006 and 2005, loan commitments and letters of credit of the Bank aggregated \$193.1 million and \$197.8 million, respectively. Of the \$193.1 million in loan commitments outstanding at December 31, 2006, \$165.0 million or 85 % were for loans with maturities of one year or less. Due to the nature of the business of the Bank's customers, there are no seasonal patterns or absolute predictability to the utilization of unused loan commitments; therefore the Bank is unable to forecast the extent to which these commitments will be exercised within the current year. The Bank does not believe that any such utilization will constitute a material liquidity demand.

In addition to the loan and deposit services discussed above, the Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include online banking, safe deposit boxes, ATM services, payroll direct deposit, cashier's checks, traveler's checks, money orders, and foreign drafts. The Bank does not operate a trust department; however, it makes arrangements with its correspondent bank to offer trust services to its customers on request. Most of the Bank's business originates within Fresno, Madera, and Kern Counties. Neither the Bank's business or liquidity is seasonal, and there has been no material effect upon the Bank's capital expenditures, earnings or competitive position as a result of federal, state or local environmental regulation.

Competition and Market Share

The banking business in California generally, and in the market area served by the Company specifically, is highly competitive with respect to both loans and deposits. The Company competes for loans and deposits with other commercial banks, savings and loan associations, finance companies, money market funds, credit unions and other financial institutions, including a number that are substantially larger than the Company. Deregulation of the banking industry, increased competition from non-bank entities for the cash balances of individuals and businesses, and continuing developments in the computer and communications industries have had, and most likely will continue to have, a significant impact on the Company's competitive position. With the enactment of interstate banking legislation in California, bank holding companies headquartered outside of California will continue to enter the California market and provide competition for the Company. Additionally, with the Gramm-Leach-Bliley Act of 1999, traditional competitive barriers between insurance companies, securities underwriters, and commercial banks have been eased, allowing a greater number of financial intermediaries to offer a wider assortment of financial services. Many of the major commercial banks operating in the Company's market areas offer certain services such as trust and international banking services, which the Company does not offer directly. In addition, banks with larger capitalization have larger lending limits and are thereby able to serve larger customers.

The Company's primary market area at December 31, 2006 was located in Fresno, Madera, and Kern Counties, in which approximately 32 FDIC-insured financial institutions compete for business. Santa Clara County has been added during 2007 with the Legacy Bank acquisition, in which approximately 52 FDIC-insured financial institutions compete for business. The following table sets forth information regarding deposit market share and ranking by county as of June 30, 2006, which is the most current information available.

| | <u>Rank</u> | <u>Share</u> |
|--|------------------|--------------|
| Fresno County | 8 th | 5.06% |
| Madera County | 8 th | 4.49% |
| Kern County | 13 th | 1.20% |
| Total of Fresno, Madera, Kern Counties | 9 th | 3.65% |
| Santa Clara County | 30 th | 0.14% |

Supervision and Regulation

The Company

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the BHC Act), and is registered as such with the FRB. A bank holding company is required to file with the FRB annual reports and other information regarding its business operations and those of its subsidiaries and is also subject to examination by the FRB.

The BHC Act requires, among other things, prior approval before acquiring, directly or indirectly, ownership or control of any voting shares of any bank, if after such acquisition it would directly or indirectly own or control more than 5% of the voting stock of that bank, unless it already owns a majority of the voting stock of that bank. The BHC Act also provides that the FRB shall not approve any acquisition that would result in or further the creation of a monopoly, or the effect of which may be substantially to lessen competition, unless the anticompetitive effects of the proposed transaction are clearly outweighed by the probable effect in meeting the convenience and needs of the community served.

Furthermore, under the BHC Act, a bank holding company is, with limited exceptions, prohibited from (i) acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or (ii) engaging in any activity other than managing or controlling banks. With the prior approval of the FRB, however, a bank holding company may own shares of a company engaged in activities which the FRB has determined to be so closely related to banking or managing or controlling banks as to be proper incident thereto.

The BHC Act requires a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. It is the FRB's policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting a subsidiary bank. Under certain conditions, the FRB may conclude that certain actions of a bank holding company, such as payment of cash dividends, would constitute unsafe and unsound banking practices because they violate the FRB's source of strength doctrine.

A bank holding company and its subsidiaries are prohibited from certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services by it, its holding company or other subsidiaries, or on a promise by its customer not to obtain services from a competitor. In addition, federal law imposes certain restrictions between the Company and its subsidiaries, including the Bank. As an affiliate of the Bank, the Company is subject, with certain exceptions, to provisions of federal law imposing limitations on, and requiring collateral for, extensions of credit by the Bank to its affiliates.

In 1999 the Gramm-Leach-Bliley Act (the GLBA) was enacted. The GLBA became effective in March of 2000 and is a financial services modernization law that, among other things, facilitates broad new affiliations among securities firms, insurance companies and bank holding companies by repealing the 66-year old provisions of the Glass-Steagall Act. The GLBA allows the formation of financial holding companies (FHCs), which are bank holding companies with substantially expanded powers. A bank holding company must acquire the approval of the FRB to become a FHC. Under these expanded powers, affiliations may occur between bank holding companies, securities firms and insurance companies, subject to a blend of umbrella supervision and regulation of the newly formed consolidated entity by the Federal Reserve, oversight of the FHC's bank and thrift subsidiaries by their primary federal and state banking regulators and financial regulation of the FHC's nonbank subsidiaries by their respective specialized regulators. The Company has not applied to become a FHC.

As a public company, United Security Bancshares is subject to the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act amends the Securities and Exchange Act of 1934, and is intended to protect investors by, among other things, improving the reliability of financial reporting, increasing management accountability, and increasing the independence of Directors and the Company's external accountants (see *Recent Legislation and Other Changes*).

The Company is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended, which include but are not limited to the filing of annual, quarterly and other current reports with the SEC.

The Bank

The Bank as a state-chartered bank is subject to regulation, supervision and regular examination by the California Department of Financial Institutions. In addition, The Bank is also a member of the Federal Reserve System and, as such, is subject to applicable provisions of the Federal Reserve Act and regulations issued thereunder and, is subject to regulation, supervision and regular examination by the Federal Reserve Bank. The Bank is subject to California law, insofar as they are not preempted by federal banking law. Deposits of the Bank are insured by the FDIC up to the applicable limits in an amount up to \$100,000 per customer, and, as such, the Bank is subject to the regulations of the FDIC and the Federal Deposit Insurance Act. As a consequence of the extensive regulation of commercial banking activities in California and the United

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States, the Bank's business is particularly susceptible to changes in California and federal legislation and regulation, which may have the effect of increasing the cost of doing business, limiting permissible activities or increasing competition.

Various other requirements and restrictions under the laws of the United States and the State of California affect the operations of the Bank. Federal and California statutes and regulations relate to many aspects of the Bank's operations, including capital requirements and disclosure requirements to depositors and borrowers, requirements to maintain reserves against deposits, limitations on interest rates payable on deposits, loans, investments, and restrictions on borrowings and on payment of dividends. The DFI regulates the number and location of branch offices of a state-chartered bank, and may permit a bank to maintain branches only to the extent allowable under state law for state banks. California law presently permits a bank to locate a branch in any locality in the state. Additionally, California law exempts banks from California usury laws.

Effect of Governmental Policies and Recent Legislation

Banking has traditionally been a business that depends on rate differentials. In general, the difference between the interest rate paid by the Company on its deposits and other borrowings and the interest rate received on loans extended to its customers and securities held in the Company's portfolio comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors which are beyond the control of the Company. Accordingly, the earnings and growth of the Company are subject to the influence of domestic and foreign economic conditions, including, but not limited to, inflation, recession and unemployment.

The earnings and growth of the Company are affected not only by general economic conditions, both domestic and foreign, but also by the monetary and fiscal policies of the United States government and its agencies, particularly the Federal Reserve Board (FRB). The FRB implements national monetary policies (with objectives such as to curb inflation and combat recession) by its open market operations in United States Government securities, by adjusting the required level of reserves for financial institutions subject to reserve requirements, and by varying the discount rates applicable to borrowing by banks which are members of the Federal Reserve System. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits and also affect interest rates charged on loans and paid on deposits. The nature and impact that future changes in fiscal or monetary policies or economic controls may have on the Company's business and earnings cannot be predicted. In addition, adverse economic conditions could make a higher provision for loan losses a prudent course and could cause higher loan charge-offs, thus adversely affecting the Company's net income.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of banks and other financial institutions are frequently made in Congress, in the California legislature and before various bank regulatory agencies. The likelihood of any major change and the impact such change may have on the Company is impossible to predict. Certain of the potentially significant changes which have been enacted recently and other which are currently under consideration by Congress or various regulatory agencies or professional agencies are discussed below.

Recent Legislation and Other Changes

Federal and state laws affecting banking are enacted from time to time, and similarly federal and state regulations affecting banking are also adopted from time to time. The following include some of the recent laws and regulations affecting banking.

On February 8, 2006, the President signed The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) into law. The Federal Deposit Insurance Reform Conforming Amendments Act of 2005, which the President signed into law on February 15, 2006, contains necessary technical and conforming changes to implement deposit insurance reform, as well as a number of study and survey requirements. The Reform Act provides for the following changes:

Merging the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new fund, the Deposit Insurance Fund (DIF). This change was made effective March 31, 2006.

Increasing the coverage limit for retirement accounts to \$250,000 and indexing the coverage limit for retirement accounts to inflation as with the general deposit insurance coverage limit. This change was made effective April 1, 2006.

Establishing a range of 1.15 percent to 1.50 percent within which the FDIC Board of Directors may set the Designated Reserve Ratio (DRR).

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Allowing the FDIC to manage the pace at which the reserve ratio varies within this range.

1. If the reserve ratio falls below 1.15 percent or is expected to within 6 months the FDIC must adopt a restoration plan that provides that the DIF will return to 1.15 percent generally within 5 years.
2. If the reserve ratio exceeds 1.35 percent, the FDIC must generally dividend to DIF members half of the amount above the amount necessary to maintain the DIF at 1.35 percent, unless the FDIC Board, considering statutory factors, suspends the dividends.
3. If the reserve ratio exceeds 1.5 percent, the FDIC must generally dividend to DIF members all amounts above the amount necessary to maintain the DIF at 1.5 percent.

Eliminating the restrictions on premium rates based on the DRR and granting the FDIC Board the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the reserve ratio.

Granting a one-time initial assessment credit (of approximately \$4.7 billion) to recognize institutions' past contributions to the fund.

The Federal Reserve Board in February 2006 approved a final rule that expands the definition of a small bank holding company under its Small Bank Holding Company Policy Statement and the Board's risk-based and leverage capital guidelines for bank holding companies. The policy statement facilitates the transfer of ownership of small community banks by permitting debt levels at small bank holding companies that are higher than what would typically be permitted for larger small bank holding companies. In its revisions to the Policy Statement, the Federal Reserve Board has raised the small bank holding company asset size threshold from \$150 million to \$500 million and amended the related qualitative criteria for determining eligibility as a small bank holding company for the purposes of the policy statement and the capital guidelines.

The FDIC finalized its interim final rule, with changes, that amended its deposit insurance regulations to implement applicable revisions to the Federal Deposit Insurance Act made by the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005. The final rule provides for consideration of inflation adjustments to increase the current standard maximum deposit insurance amount of \$100,000 on a five-year cycle beginning in 2010; increases the deposit insurance limit for certain retirement accounts from \$100,000 to \$250,000, also subject to inflation adjustments; and provides per-participant insurance coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits. The final rule is effective on October 12, 2006.

The Board of Governors of the Federal Reserve System amended Regulation E, which implements the Electronic Fund Transfer Act, and the official staff commentary to the regulation, which interprets the requirements of Regulation E to become effective on July 1, 2006. The final rule provides that Regulation E covers payroll card accounts that are established directly or indirectly through an employer, and to which transfers of the consumer's salary, wages, or other employee compensation are made on a recurring basis. The final rule also provides financial institutions with an alternative to providing periodic statements for payroll card accounts if they make account information available to consumers by specified means.

The federal financial regulatory agencies in September 2006 issued final guidance to address the risks posed by nontraditional residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest, including interest-only mortgages and payment option adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments later. The lack of principal amortization and the potential for negative amortization and features that compound risks (such as no document loans and simultaneous second mortgages) elevate the concern of the federal banking agencies for nontraditional mortgage products. The guidelines require depository institutions to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity, to recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. The guidelines also express the need for depository institutions to have strong risk management standards, capital levels commensurate with the risk, an allowance for loan and lease losses that reflects the collectibility of the portfolio, and the need to make sure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation in December 2006 issued final guidance on sound risk management practices for concentrations in commercial real estate lending. The agencies observed that the commercial real estate is an area in which some banks are becoming increasingly concentrated, especially with small- to medium- sized banks that face strong competition in their other business lines. The agencies support banks serving a vital role in their communities by supplying credit for business and real estate development. However, the agencies are concerned that rising commercial real estate loan concentrations may expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in commercial real estate markets. The guidance provides supervisory criteria, including numerical indicators to assist in identifying institutions with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny, but such criteria are not limits

on commercial real estate lending.

The federal financial regulatory agencies in December 2006 issued a new interagency policy statement on the allowance for loan and lease losses (ALLL) along with supplemental frequently asked questions. The policy statement revises and replaces a 1993 policy statement on the ALLL. The agencies issued the revised policy statement in view of today's uncertain economic environment and the presence of concentrations in untested loan products in the loan portfolios of insured depository institutions. The policy statement has also been revised to conform to generally accepted accounting principles (GAAP) and post-1993 supervisory guidance. The 1993 policy statement described the responsibilities of the boards of directors, management, and banking examiners regarding the ALLL; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. The policy statement reiterates that each institution has a responsibility for developing, maintaining and documenting a comprehensive, systematic, and consistently applied process appropriate to its size and the nature, scope, and risk of its lending activities for determining the amounts of the ALLL and the provision for loan and lease losses and states that each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment and relevant supervisory guidance.

The policy statement also restates that insured depository institutions must maintain an ALLL at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio, and that estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. The policy statement states that prudent, conservative, but not excessive, loan loss allowances that represent management's best estimate from within an acceptable range of estimated losses are appropriate.

In California, effective January 1, 2007, a new law Financial Code Section 854.1 recognizes the ability of mortgage brokers to obtain the benefit of non interest-bearing accounts on trust funds deposited in a commercial bank. The provision applies to real estate brokers who collect payments or provide services in connection with a loan secured by a lien on real property and permits a mortgage broker to earn interest on an interest-bearing account at a financial institution. Interest on funds received by a real estate broker who collects payments or provides services for an institutional investor in connection with a loan secured by commercial real property may inure to the broker, if agreed to in writing by the broker and the institutional investor. For purposes of this law, commercial real property means real estate improved with other than a one-to-four family residence.

A new California law makes it easier for California banks to accept deposits from local government agencies. Under the old law, local agency deposits over \$100,000 had to be secured by collateral. Pursuant to the enactment of Assembly Bill 2011, banks would be able to acquire surplus public deposits exceeding \$100,000 without pledging collateral if they participate in a deposit placement service where excess amounts are placed in certificates of deposit at other institutions within a network. Such a network (of which currently there is only one available in the market) permits the entire amount of a customer's deposit to be FDIC-insured, and the bank taking the original deposit retains the benefit of the full amount of the deposit for lending or other purposes. AB 2011 clarifies that a local agency may deposit up to 30% of its surplus funds in certificates of deposit at a bank, savings association, savings bank, or credit union that participates in such a deposit-sharing network. Since the entire amount of the deposits would be FDIC-insured, a bank would not be required to pledge collateral. The bill permits agencies to make these deposits until January 1, 2012.

The Federal Reserve Board in November 2005 approved amendments to Regulation CC that define remotely created checks and create transfer and presentment warranties that shift liability for an unauthorized remotely created check to the institution where it is first deposited. In place of a signature, a remotely created check generally bears a statement that the customer authorized the check or bears the customer's printed or typed name, such as when a debtor authorizes a credit card company to create a remotely created check by telephone so that the debtor may pay a credit card bill in a timely manner. Since the remotely created checks are vulnerable to fraud Regulation CC creates transfer and presentment warranties under which any bank that transfers or presents a remotely created check would warrant that the check is authorized by the person on whose account the check is drawn. The warranties would apply only to banks and would ultimately shift liability for losses attributable to an unauthorized remotely created check to the depository bank. These amendments would not affect the rights of checking account customers, as they are not liable for unauthorized checks drawn on their accounts. The amendments to Regulation CC become effective on July 1, 2006.

On August 2, 2005, the OCC, FDIC, and the Board of Governors of the Federal Reserve System adopted a final rule to revise their Community Reinvestment Act (CRA) regulations. The effective date of the final rule is September 1, 2005. Major points of the final rule include:

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increasing the asset-size threshold for a small bank to \$1 billion. Small banks are not subject to certain data collection and reporting requirements and are eligible for evaluation under the small bank lending test.

creating a new category of intermediate small banks for purposes of evaluation under the CRA. Intermediate small banks are those with at least \$250 million but less than \$1 billion in assets. The overall CRA rating for an intermediate small bank will be based both on the rating from the small bank lending test and the rating from a new community development test..

Revising the definition of community development to increase the number and kinds of rural tracts in which bank activities are eligible for community development consideration.

Revising the regulation to address the impact on a bank's CRA rating of evidence of discrimination or other illegal credit practices. In May 2005, the FRB adopted a final rule to amend Regulation DD and the related official staff interpretations, to improve the uniformity and adequacy of information to consumers about certain services provided by banks to their deposit customers. These services are commonly referred to as bounced-check protection or courtesy overdraft protection services (overdraft services). These amendments become effective on July 1, 2006. These amendments require banks to disclose information about overdraft fees on periodic statements and account-opening disclosures, and to include certain disclosures in advertisements for overdraft services. Regulation DD generally requires that banks disclose the amount of any fee that may be imposed in connection with the account and the conditions under which a fee may be imposed. The final rule amends the official staff interpretations to state that, in satisfying this requirement with respect to fees for overdraft services, a bank must specify the categories of transactions for which an overdraft fee may be imposed.

The Federal Reserve Board issued a final rule on March 1, 2005 that amends Regulation H and Regulation Y to limit restricted core capital elements (including trust preferred securities) which count as Tier 1 capital to 25 percent of all core capital elements, net of goodwill less any associated deferred tax liability. Internationally active bank holding companies, defined as those with consolidated assets greater than \$250 billion or on-balance-sheet foreign exposure greater than \$10 billion, will be subject to a 15 percent limit, but they may include qualifying mandatory convertible preferred securities up to the generally applicable 25 percent limit. Amounts of restricted core capital elements in excess of these limits generally may be included in Tier 2 capital. The final rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits.

During July 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The purpose of the Sarbanes-Oxley Act is to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.

The Sarbanes-Oxley Act amends the Securities Exchange Act of 1934 to prohibit a registered public accounting firm from performing specified nonaudit services contemporaneously with a mandatory audit. The Sarbanes-Oxley Act also vests the audit committee of an issuer with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It requires each committee member to be a member of the board of directors of the issuer, and to be otherwise independent. The Sarbanes-Oxley Act further requires the chief executive officer and chief financial officer of an issuer to make certain certifications as to each annual or quarterly report filed with the SEC.

In addition, the Sarbanes-Oxley Act requires officers to forfeit certain bonuses and profits under certain circumstances. Specifically, if an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer as a result of misconduct with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall be required to reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.

The Sarbanes-Oxley Act also instructs the SEC to require by rule:

disclosure of all material off-balance sheet transactions and relationships that may have a material effect upon the financial status of an issuer; and

the presentation of non GAAP pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles.

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The Sarbanes-Oxley Act also prohibits insider transactions in the Company's stock during lock out periods of the Company's pension plans, and any profits on such insider transactions are to be disgorged. In addition, there is a prohibition of company loans to its executives, except in certain circumstances. The Sarbanes-Oxley Act also provides for mandated internal control report and assessment with the annual report and an attestation and a report on such report by the Company's auditor. The SEC is also required to issue a code of ethics for senior financial officers of the company. Further, the Sarbanes-Oxley Act adds a criminal penalty of fines and imprisonment of up to 10 years for securities fraud.

It is impossible to predict what effect the enactment of certain of the above-mentioned legislation will have on the Company. Moreover, it is likely that other bills affecting the business of banks may be introduced in the future by the United States Congress or California legislature.

Employees

At December 31, 2006, the Company employed 136 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

Available Information

The Company files period reports and other reports under the Securities and Exchange Act of 1934 with the Securities and Exchange Commission (SEC). These reports, as well as the Company's Code of Ethics, are posted and are available at no cost on the Company's website at <http://www.unitedsecuritybank.com> as soon as reasonably practical after the Company files such reports with the SEC. The Company's periodic and other reports filed with the SEC are also available at the SEC's website (<http://www.sec.gov>).

Item 1A. Risk Factors

There are risk factors that may affect the Company's business and impact the results of operations, some of which are beyond the control of the Company.

The Company's financial performance is subject to interest rate risk.

The Company's operations are greatly influenced by general economic conditions and by related monetary and fiscal policies of the federal government. Deposit flows and the funding costs are influenced by interest rates of competing investments and general market rates of interest. Lending activities are affected by the demand for loans, which in turn is affected by the interest rates at which such financing may be offered and by other factors affecting the availability of funds.

The Company's performance is substantially dependent on net interest income, which is the difference between the interest income received from interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities. To reduce the Company's exposure to interest rate fluctuations, management seeks to manage the balances of interest sensitive assets and liabilities, and maintain appropriate maturity and repricing parameters for these assets and liabilities. A mismatch between the amount of rate sensitive assets and rate sensitive liabilities in any time period may expose the Company to interest rate risk. Generally, if rate sensitive assets exceed rate sensitive liabilities, the net interest margin will be positively impacted during a rising rate environment and negatively impacted during a declining rate environment. When rate sensitive liabilities exceed rate sensitive assets, the net interest margin will generally be positively impacted during a declining rate environment and negatively impacted during a rising rate environment.

Increases in the level of interest rates may reduce the overall level of loans originated by the Company, and, thus, the amount of loan and commitment fees earned, as well as the market value of investment securities and other interest-earning assets. Moreover, fluctuations in interest rates may also result in disintermediation, which is the flow of funds away from depository institutions into direct investments, such as corporate securities and other investment vehicles which, because of the absence of federal deposit insurance, generally pay higher rates of return than depository institutions.

The deterioration of local economic conditions in the Company's market area could hurt profitability.

The Company's operations are located primarily in Fresno, Madera, and Kern Counties and are concentrated in Fresno County and surrounding areas. As a result of this geographic concentration, the Company's financial results depend largely upon economic conditions in these areas. The local economy in the Company's market areas rely heavily on agriculture, real estate, professional and business services, manufacturing, trade and tourism. A significant economic downturn such as that experienced after the September 11, 2001 tragedy in any or all of these industries could result in a decline in the local economy in general, which could in turn negatively impact the Company's operations and financial condition. Poor economic conditions could cause the Company to incur losses associated with higher default rates and decreased collateral values in the loan portfolio.

Concentrations in commercial and industrial loans, real estate-secured commercial loans, and real estate construction loans, may expose the Company to increased lending risks, especially in the event of a recession.

The Company has significant concentrations in commercial real estate and real estate construction loans. As of December 31, 2006, 14.3%, and 33.7% of the Company's loan portfolio was concentrated in these two categories, respectively. In addition, the Company has many commercial loans to businesses in the construction and real estate industry. There has been a relatively rapid increase in real estate values in the Company's market area in recent years, and the occurrence of a real estate recession affecting these market areas would likely reduce the security for many of the Company's loans and adversely affect the ability of many of borrowers to repay loan balances due the Company and require increased provisions to the allowance for loan losses. Therefore, the Company's financial condition and results of operations may be adversely affected by a decline in the value of the real estate securing the Company's loans.

The Company faces strong competition, which may adversely affect its operating results.

In recent years, competition for bank customers, the source of deposits and loans for the Company, has greatly intensified. This competition includes:

larger regional and national banks and other FDIC insured depository institutions in many of the communities the Company serves;

finance companies, investment banking and brokerage firms, and insurance companies that offer bank-like products;

credit unions, which can offer highly competitive rates on loans and deposits because they receive tax advantages not available to commercial banks; and

technology-based financial institutions including large national and super-regional banks offering on-line deposit, bill payment, and mortgage loan application services.

Some of the financial services organizations with which the Company competes are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions. As a result, these nonbank competitors have certain advantages over the Company in accessing funding and in providing various banking-related services.

By virtue of their larger capital position, regional and national banks have substantially larger lending limits than the Company, and can provide certain services to their customers which the Company is not able to offer directly, such as trust and international services. Many of these larger banks also operate with greater economies of scale which result in lower operating costs than the Company on a per-unit basis.

Other existing single or multi-branch community banks, or new community bank start-ups, have marketing strategies similar to United Security Bancshares. These other community banks can open new branches in the communities the Company serves and compete directly for customers who want the high level of service community banks offer. Other community banks also compete for the same management personnel and the same potential acquisition and merger candidates. Ultimately, competition can drive down the Company's interest margins and reduce profitability, as well as make it more difficult for the Company to achieve its growth objectives.

The Company's growth and expansion strategy may not prove to be successful and as a result, its market value and profitability may suffer.

The Company plans to grow operations within its market area and expand into new market areas when it makes strategic business sense, however the Company's capacity to manage any such growth will depend primarily on the ability to attract and retain qualified personnel, monitor operations, maintain earnings and control costs. The Company expects to continue to grow its assets and deposits, the products and services which it offers and accordingly the scale of its operations. The Company's ability to manage growth successfully will depend on the ability to maintain cost controls and asset quality while attracting additional loans and deposits on favorable terms. If the Company grows too quickly and is not able to control costs and maintain asset quality, this rapid growth could materially adversely affect the financial performance of the Company. The future successful growth of the Company will depend on the ability of its officers and other key employees to continue to implement and improve operational, credit, financial, management and other internal risk controls and processes, reporting systems and procedures, and to manage a growing number of customer relationships. The Company may not successfully implement improvements to management information and control systems, and control procedures and processes, in an efficient or timely manner and may discover deficiencies in existing systems and controls. In particular, the Company's controls and procedures must be able to accommodate an increase in expected loan volume and the infrastructure that comes with growth. Thus, the Company's growth strategy may divert management from existing businesses and may require the Company to incur additional expenditures to expand its administrative and operational infrastructure. If the Company is unable to manage future expansion in its operations, it may experience compliance and operational problems, need to slow the pace of growth, or need to incur additional expenditures beyond current projections to support such growth, any one of which could adversely affect the Company's business and profitability.

The loss of any of the Company's executive officers or key personnel could be damaging to the business.

The Company depends upon the skills and reputations of its executive officers and key employees for its future success. The loss of any of these key persons or the inability to attract and retain other key personnel could adversely affect the Company's business operations.

The Company could experience loan losses, which exceed the overall allowance for loan losses.

The risk of credit losses on loans and leases varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower, and, in the case of collateralized loans, the value and marketability of the collateral. The Company maintains an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and determinations about the ultimate collectibility of the loan portfolio and provides an allowance for losses based upon a percentage of the outstanding balances and for specific loans where their collectibility is considered to be questionable.

As of December 31, 2006, the Company's allowance for loan losses was approximately \$8.4 million representing 1.67% of gross outstanding loans. Although management believes that the allowance is adequate, there can be no absolute assurance that it will be sufficient to cover future loan losses. Although the Company uses the best information available to make determinations with respect to adequacy of the allowance for loan losses, future adjustments may be necessary if economic conditions change substantially from the assumptions used or if negative developments occur with respect to non-performing or performing loans. If management's assumptions or conclusions prove to be incorrect and the allowance for loan losses is not adequate to absorb future losses, or if Company's regulatory agencies require an increase in the allowance for loan losses, the Company's earnings, and potentially its capital, could be significantly and adversely impacted.

The Company may become subject to environmental liability risk associated with lending activities.

A significant portion of the Company's loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Company may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Company to incur substantial expenses and may materially reduce the affected property's value or limit the ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although the Company has policies and procedures to perform an environmental review before initiating any foreclosure action on nonresidential real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Company's financial condition and results of operations.

The regulatory environment under which the Company operates may have an adverse impact on the banking industry.

The Company is subject to extensive regulatory supervision and oversight from both federal and state authorities. Regulatory oversight of the Company is provided by the Federal Reserve Bank (FRB) and the California Department of Financial Institutions (DFI). Future legislation and government may adversely impact the Company and the commercial banking industry in general. Future regulatory changes may also alter the structure and competitive relationship among financial institutions.

The Company may be exposed to compliance risk resulting from violations or nonconformity with laws, rules, regulations, internal policies and procedures, or ethical standards set forth by regulatory authorities. The Company may also be subject to compliance risk in situations where laws or rules governing certain products or activities of the Company's customers may be uncertain or untested. Compliance risk exposes the Company to fines, civil money penalties, payment of damages, and the potential voiding of contracts. Compliance risk can result in diminished reputation, reduced franchise value, limited business opportunities, and reduced growth potential.

If the Company lost a significant portion of its low-cost core deposits, it would negatively impact profitability.

The Company's profitability depends in part on its success in attracting and retaining a stable base of low-cost deposits. As of December 31, 2006, noninterest-bearing checking accounts comprised 37.1% of the Company's deposit base, and interest-bearing checking and money market accounts comprised an additional 8.3% and 23.1%, respectively. The Company considers these deposits to be core deposits. If the Company lost a significant portion of these low-cost deposits, it would negatively impact its profitability and long-term growth objectives. While Management generally does not believe these deposits are sensitive to interest-rate fluctuations, the competition for these deposits in the Company's market area is strong and if the Company were to lose a significant portion of these low-cost deposits, it would negatively affect business operations.

The Company's Internal controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based, in part, on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect the Company's business, results of operations and financial condition.

The Company's information systems may experience an interruption or breach in security.

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in customer relationship management, general ledger, deposit, loan and other systems. While the Company has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that we can prevent any such failures, interruptions or security breaches or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of the Company's information systems could damage our reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose it to civil litigation and possible financial liability, any of which could have a material adverse effect on the Company's financial condition and results of operations.

The Company continually encounters technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Company's operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to the company's customers and even if such products and services are implemented, the Company may incur substantial costs in doing so. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Company's business, financial condition and results of operations.

The Company relies on dividends from its subsidiaries for most of its revenue.

United Security Bancshares is a separate and distinct legal entity from its subsidiaries. The Company receives substantially all of its revenue from dividends from its subsidiary, United Security Bank. These dividends are the principal source of funds to pay dividends on common stock and interest on the Company's junior subordinated debt. Various federal and/or state laws and regulations limit the amount of dividends that United Security Bank and certain non-bank subsidiaries may pay to United Security Bancshares. Also, United Security Bancshares' right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event United Security Bank is unable to pay dividends to United Security Bancshares, the Company may not be able to service debt, pay obligations or pay dividends on common stock. The inability to receive dividends from United Security Bank could have a material adverse effect on United Security Bancshares' business, financial condition and results of operations.

The holders of the Company's junior subordinated debentures have rights that are senior to those of the Company's shareholders.

On June 28, 2001, the Company issued \$15.5 million of floating rate junior subordinated debentures in connection with a \$15.0 million trust preferred securities issuance by its subsidiary, United Security Bancshares Capital Trust I. The junior subordinated debentures mature in July 2031.

The Company conditionally guarantees payments of the principal and interest on the trust preferred securities. The Company's junior subordinated debentures are senior to holders of common stock. As a result, the Company must make payments on the junior subordinated debentures (and the related trust preferred securities) before any dividends can be paid on our common stock and, in the event of bankruptcy, dissolution or liquidation, the holders of the debentures must be satisfied before any distributions can be made to the holders of common stock. The Company has the right to defer distributions on our junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time no dividends may be paid to holders of common stock.

Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact the Company's business.

Severe weather, natural disasters, including but not limited to earthquakes and droughts, acts of war or terrorism and other adverse external events could have a significant impact on the Company's ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. Severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, there can be no assurance of the effectiveness of such policies and procedures, and the occurrence of any such event could have a material adverse effect on the Company's business, financial condition and results of operations.

Item 1B. - Unresolved Staff Comments

The Company had no unresolved staff comments at December 31, 2006.

Item 2 - Properties

The Bank's Main bank branch is located at 2151 West Shaw Avenue, Fresno, California. The Company owns the building and leases the land under a sublease dated December 1, 1986 between Central Bank and USB. The current sublessor under the master ground lease is Bank of the West, which acquired the position through the purchase of Central Bank. The lessor under the ground lease (Master Lease) is Thomas F. Hinds. The lease expires on December 31, 2015 and the Company has options to extend the term for four (4) ten-year periods and one seven (7) year period.

The Company leases the banking premises of approximately 6,450 square feet for its second of three Fresno branches at 7088 N. First Ave, Fresno, California., under a lease which commenced August 2005 for a term of ten years expiring in July 2015. The branch was previously located at 1041 E. Shaw Avenue, Fresno, California, under a lease extension expiring February 28, 2005. The lease was renewed until August 2005. The new location currently provides space for the relocated branch as well as the Real Estate Construction Department and the Indirect Consumer Lending Department.

The Company leases the Oakhurst bank branch located at the Old Mill Village Shopping Center, 40074 Highway 49, and Oakhurst, California, which was completed during April of 1999. The Company had originally maintained two branches in the Oakhurst area, and at this time consolidated its two Oakhurst branches into the new facility. The current facility, which consists of approximately 5,000 square feet, will be leased for a term of 15 years ending April 2014, and there are two five-year options to extend the lease term after that date.

The Company owns the Caruthers bank branch located at 13356 South Henderson, Caruthers, California, which consists of approximately 5,000 square feet of floor space. The branch was purchased during May 2005 for \$425,000, at which time the operating lease under which the Company had been occupying the premises was canceled. The branch was originally acquired from Wells Fargo Bank in February 1997 under a lease, which expired January 19, 2006 with extensions to January 19, 2021.

The Company owns the San Joaquin branch facilities located at 21574 Manning Avenue, San Joaquin, California. The new bank branch is approximately 2,500 square feet.

The Company owns the Firebaugh bank branch located at 1067 O Street, Firebaugh, California, which was purchased from Bank of America during October 1997. The premises are comprised of approximately 4,666 square feet of office space situated on land totaling approximately one-third of an acre.

The Company owns the Coalinga bank branch located at 145 East Durian, Coalinga, California, which was also purchased from Bank of America during October 1997. The office building has a total of 6,184 square feet of interior floor space situated on approximately 0.45 acres of land.

The Company leases the Convention Center branch located at 855 M Street, Suite 130, Fresno, California. Total space leased is approximately 4,520 square feet, and was occupied during March 2004. The fifteen-year lease expires in March 2019. There are no extension provisions.

The Company owns the Taft branch office premises located at 523 Cascade Place, Taft, California. The branch facilities consist of approximately 9,200 square feet of office space. The Taft premises were previously leased and were purchased during July 2005 at a cost of \$1.0 million. The Taft branch facilities were acquired during April 2004 as the result of the merger with Taft National Bank, under a lease agreement expiring in November 2007.

The Company owns the branch facilities located at 3404 Coffee Road, Bakersfield, California, which has approximately 6,130 square feet of office space located on 1.15 acres. The Bakersfield branch facilities were acquired during April 2004 as the result of the merger with Taft National Bank.

During September 2006, the Company sold its administrative headquarters at 1525 E. Shaw Avenue in Fresno, California in preparation for a move to the Company's new administrative headquarters located in downtown Fresno during mid-November 2006. The Company rented the East Shaw premises during the two months for transition purposes pending its move to the new administrative location. Proceeds from the sale totaled \$1.5 million for the building and certain furniture and fixtures. The total carrying value of the building and furniture sold amounted to \$498,000, resulting in a realized gain of \$1.0 million during the third quarter of 2006.

The Company owns its new administrative headquarters at 2126 Inyo Street, Fresno, California, which it occupied during the fourth quarter of 2006. The facility consists of approximately 21,400 square feet. A portion of the premises has been subleased to a third-party under a lease term of approximately seven years.

Item 3 - Legal Proceedings

From time to time, the Company is party to claims and legal proceedings arising in the ordinary course of business. At this time, the management of the Company is not aware of any material pending litigation proceedings to which it is a party or has recently been party to, which will have a material adverse effect on the financial condition or results of operations of the Company.

Item 4 - Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of shareholders during the fourth quarter of 2006.

PART II

Item 5 - Market for the Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities**Trading History**

The Company became a NASDAQ National Market listed company on May 31, 2001, then became a Global Select listed company during 2006, and trades under the symbol UBFO.

The Company currently has four market makers for its common stock. These include, Stone & Youngberg, LLC, Howe Barnes Hoeffler & Arnett, Sandler O'Neill & Partners, and Hill Thompson, Magid & Company. The Company is aware of two other securities dealers: Smith Barney and Dean Witter Reynolds Inc., which periodically act as brokers in the Company's stock.

On March 28, 2006, the Company announced a 2-for-1 stock split of the Company's no-par common stock payable May 1, 2006 effected in the form of a 100% stock dividend. Share information for all periods presented in this 10-K have been restated to reflect the effect of the stock split.

During June 2006, the Company was included in the Russell 2000 Stock Index. The inclusion of the Company's stock in the index has provided additional exposure for the Company in equity markets, and increased the transaction volume during the second half of 2006.

The following table sets forth the high and low closing sales prices by quarter for the Company's common stock, for the years ended December 31, 2006 and 2005.

| Quarter | Closing Prices | | |
|------------------|----------------|----------|-----------|
| | High | Low | Volume |
| 4th Quarter 2006 | \$ 26.06 | \$ 21.54 | 632,400 |
| 3rd Quarter 2006 | \$ 24.41 | \$ 20.26 | 1,124,600 |
| 2nd Quarter 2006 | \$ 24.87 | \$ 21.39 | 1,456,300 |
| 1st Quarter 2006 | \$ 22.65 | \$ 15.26 | 389,000 |
| 4th Quarter 2005 | \$ 16.35 | \$ 13.98 | 248,600 |
| 3rd Quarter 2005 | \$ 14.49 | \$ 12.80 | 290,800 |
| 2nd Quarter 2005 | \$ 13.25 | \$ 11.50 | 401,600 |
| 1st Quarter 2005 | \$ 12.75 | \$ 11.52 | 317,200 |

At January 31, 2007, there were approximately 707 record holders of common stock of the Company. This does not reflect the number of persons or entities who hold their stock in nominee or street name through various brokerage firms.

Dividends

The Company's shareholders are entitled to cash dividends when and as declared by the Company's Board of Directors out of funds legally available therefore. Dividends paid to shareholders by the Company are subject to restrictions set forth in California General Corporation Law, which provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal the amount of the proposed distribution. As a bank holding company without significant assets other than its equity position in the Bank, the Company's ability to pay dividends to its shareholders depends primarily upon dividends it receives from the Bank. Such dividends paid by the Bank to the Company are subject to certain limitations. See Management's Discussion and Analysis of Financial and Results of Operations - Regulatory Matters.

The Company paid cash dividends to shareholders of \$0.10 per share on January 25, 2006, and \$0.11 per share on April 19, 2006, July 19, 2006 and October 25, 2006. During the previous year, the Company paid cash dividends to shareholders of \$0.08 per share on January 19, 2005, and \$0.09 per share on April 20, 2005, July 20, 2005 and October 19, 2005.

The amount and payment of dividends by the Company to shareholders are set by the Company's Board of Directors with numerous factors involved including the Company's earnings, financial condition and the need for capital for expanded growth and general economic conditions. No assurance can be given that cash or stock dividends will be paid in the future.

Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth securities authorized for issuance under equity compensation plans as for December 31, 2006.

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (column a) | 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 column (a)) |
|--|--|---|---|
| Equity compensation plans approved by security holders | 297,500 | \$ 12.90 | 326,500 |
| Equity compensation plans not approved by security holders | N/A | N/A | N/A |
| Total | 297,500 | \$ 12.90 | 326,500 |

A complete description of the above plans is included in Note 11 of the Company's Financial Statements in Item 8 of this Annual Report on Form 10K, and is hereby incorporated by reference.

Purchases of Equity Securities by Affiliates and Associated Purchasers

| Period | Total Number Of Shares Purchased | Weighted Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan or Program | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs |
|----------------------------------|----------------------------------|---------------------------------------|--|--|
| 10/01/06 to 10/31/06 | 5,500 | \$ 24.57 | 5,500 | 247,478 |
| 11/01/06 to 11/30/06 | 2,391 | \$ 25.45 | 2,391 | 245,087 |
| 12/01/06 to 12/31/06 | 2,694 | \$ 23.82 | 2,694 | 242,393 |
| Total fourth quarter 2006 | 10,585 | \$ 24.58 | 10,585 | |

On August 30, 2001 the Company announced that its Board of Directors approved a plan to repurchase, as conditions warrant, up to 280,000 shares (560,000 shares adjusted for May 2006 stock split) of the Company's common stock on the open market or in privately negotiated transactions. The duration of the program was open-ended and the timing of purchases was dependent on market conditions. A total of 215,423 shares (430,846 shares adjusted for May 2006 stock split) had been repurchased under that plan as of December 31, 2003, at a total cost of \$3.7 million.

Then, on February 25, 2004 the Company announced another stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares (553,000 shares adjusted for May 2006 stock split) of the Company's common stock on the open market or in privately negotiated transactions. As with the first plan, the duration of the new program is open-ended and the timing of purchases will depend on market conditions.

Concurrent with the approval of the new repurchase plan, the Board terminated the 2001 repurchase plan and canceled the remaining 64,577 shares (129,154 shares adjusted for May 2006 stock split) yet to be purchased under the earlier plan.

Financial Performance

The following performance graph does not constitute soliciting material and should not be deemed filed incorporated by reference into any other Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent the Company specifically incorporates the performance graph by reference therein.

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| <i>Index</i> | <i>Period Ending</i> | | | | | |
|----------------------------|----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | 12/31/01 | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 |
| United Security Bancshares | 100.00 | 108.19 | 169.81 | 162.82 | 200.11 | 323.00 |
| Russell 2000 | 100.00 | 79.52 | 117.09 | 138.55 | 144.86 | 171.47 |
| Russell 3000 | 100.00 | 78.46 | 102.83 | 115.11 | 122.16 | 141.35 |
| SNL \$500M-\$1B Bank Index | 100.00 | 127.67 | 184.09 | 208.62 | 217.57 | 247.44 |

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Item 6 - Selected Financial Data

The following table sets forth certain selected financial data for the Bank for each of the years in the five-year periods ended December 31, 2006 and should be read in conjunction with the more detailed information and financial statements contained elsewhere herein (in thousands except per share data and ratios).

| <i>(in thousands except per share data and ratios)</i> | December 31, | | | | |
|--|--------------|------------|------------|------------|------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Summary of Year-to-Date Earnings: | | | | | |
| Interest income and loan fees | \$ 47,356 | \$ 38,898 | \$ 30,874 | \$ 27,050 | \$ 28,716 |
| Interest expense | 14,175 | 9,658 | 6,433 | 7,260 | 11,516 |
| Net interest income | 33,181 | 29,240 | 24,441 | 19,790 | 17,200 |
| Provision for credit losses | 880 | 1,140 | 1,145 | 1,713 | 1,963 |
| Net interest income after Provision for credit losses | 32,301 | 28,100 | 23,296 | 18,077 | 15,237 |
| Noninterest income | 9,031 | 6,280 | 4,742 | 6,148 | 5,368 |
| Noninterest expense | 19,937 | 16,982 | 14,667 | 11,855 | 10,860 |
| Income before taxes on income | 21,395 | 17,398 | 13,371 | 12,370 | 9,745 |
| Taxes on income | 8,035 | 6,390 | 4,966 | 4,664 | 2,912 |
| Net Income | \$ 13,360 | \$ 11,008 | \$ 8,405 | \$ 7,706 | \$ 6,833 |
| Per Share Data: | | | | | |
| Net Income Basic | \$ 1.18 | \$ 0.97 | \$ 0.75 | \$ 0.71 | \$ 0.64 |
| Net Income Diluted | \$ 1.17 | \$ 0.96 | \$ 0.74 | \$ 0.70 | \$ 0.63 |
| Average shares outstanding Basic | 11,344,385 | 11,369,848 | 11,260,512 | 10,919,852 | 10,801,502 |
| Average shares outstanding - Diluted | 11,462,313 | 11,453,152 | 11,334,486 | 11,023,340 | 10,974,076 |
| Cash dividends paid | \$ 0.43 | \$ 0.35 | \$ 0.325 | \$ 0.285 | \$ 0.255 |
| Financial Position at Period-end: | | | | | |
| Total assets | \$ 678,314 | \$ 628,859 | \$ 611,696 | \$ 506,588 | \$ 519,316 |
| Total net loans and leases | 491,204 | 409,409 | 390,334 | 338,716 | 343,042 |
| Total deposits | 587,127 | 546,460 | 536,672 | 440,444 | 423,987 |
| Total shareholders equity | 66,042 | 59,014 | 53,236 | 45,036 | 40,561 |
| Book value per share | \$ 5.84 | \$ 5.19 | \$ 4.69 | \$ 4.09 | \$ 3.75 |
| Selected Financial Ratios: | | | | | |
| Return on average assets | 2.04% | 1.76% | 1.52% | 1.51% | 1.37% |
| Return on average shareholders equity | 20.99% | 19.46% | 16.81% | 17.80% | 17.64% |
| Average shareholders equity to average assets | 9.70% | 9.02% | 9.01% | 8.48% | 7.76% |
| Allowance for credit losses as a percentage of total nonperforming loans | 64.13% | 55.62% | 42.51% | 32.58% | 36.00% |
| Net charge-offs to average loans | 0.05% | 0.15% | 0.12% | 0.34% | 0.25% |
| Allowance for credit losses as a percentage of period-end loans | 1.67% | 1.86% | 1.82% | 1.76% | 1.59% |
| Dividend payout ratio | 38.18% | 38.50% | 43.16% | 40.07% | 40.94% |

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, but are not limited to, those described in Management's Discussion and Analysis of Financial Condition and Results of Operations. Such risks and uncertainties include, but are not limited to, the following factors: i) competitive pressures in the banking industry and changes in the regulatory environment; ii) exposure to changes in the interest rate environment and the resulting impact on the Company's interest rate sensitive assets and liabilities; iii) decline in the health of the economy nationally or regionally which could reduce the demand for loans or reduce the value of real estate collateral securing most of the Company's loans; iv) credit quality deterioration that could cause an increase in the provision for loan losses; v) Asset/Liability matching risks and liquidity risks; volatility and devaluation in the securities markets; vi) uncertainties related to closing and integration of the recent Legacy merger, and vii) expected cost savings from recent acquisitions are not realized. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

The Company

On June 12, 2001, the United Security Bank (the *Bank*) became the wholly owned subsidiary of United Security Bancshares (the *Company*) through a tax free holding company reorganization, accounted for on a basis similar to the pooling of interest method. In the transaction, each share of Bank stock was exchanged for a share of Company stock on a one-to-one basis. No additional equity was issued as part of this transaction. In the following discussion, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares (including the Bank).

On June 28, 2001, United Security Bancshares Capital Trust I (the *Trust*) was formed as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. On July 16, 2001, the Trust completed the issuance of \$15 million in Trust Preferred securities, and concurrently, the Trust used the proceeds from that offering to purchase Junior Subordinated Debentures of the Company. The Company contributed \$13.7 million of the \$14.5 million in net proceeds received from the Trust to the Bank to increase its regulatory capital and used the rest for the Company's business.

Effective December 31, 2001, United Security Bank formed a subsidiary Real Estate Investment Trust (*REIT*) through which preferred stock was offered to private investors, to raise capital for the bank in accordance with the laws and regulations in effect at the time. The principal business purpose of the REIT was to provide an efficient and economical means to raise capital. The REIT also provided state tax benefits beginning in 2002. On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003 (*For further discussion see Income Taxes section of Results of Operations contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations*).

Effective April 23, 2004, the Company announced the completion of a merger with Taft National Bank headquartered in Taft, California. Taft National Bank (*Taft*) was merged into United Security Bank and Taft's two branches began operating as branches of United Security Bank. The total consideration paid to Taft shareholders was 241,447 shares of the Company's common stock valued at just over approximately \$6 million. As a result of the merger, the Company acquired \$15.4 million in cash and short-term investments, \$23.3 million in loans, and \$48.2 million in deposits. This transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities. The consolidated statements of income include the operations of Taft from the date of the acquisition forward.

During August 2005, the Bank formed a new subsidiary named United Security Emerging Capital Fund (the *Fund*) for the purpose of providing investment capital for Low-Income Communities (*LICs*). The new subsidiary was formed as a Community Development Entity (*CDE*) and as such, must be certified by the Community Development Financial Institutions Fund of the United States Department of the Treasury in order to apply for New Market Tax Credits (*NMTC*). The Fund submitted an application to the Department of the Treasury to become certified as a CDE in August 2005 and was approved in February 2006. Subsequent to that application, the Fund submitted an application to apply for an allocation of New Market Tax Credits in September 2005. The Fund was not awarded funding from the Department of Treasury during the 2006 allocation process, but applied for the 2007 allocation of New Market Tax Credits in August 2006. If the Fund's NMTC application is approved, the Fund can attract investments and make loans and investments in *LICs* and thereby qualify its investors to receive Federal Income Tax Credits. The maximum that can be applied for under the New Markets Tax Credit program by any one CDE is \$150 million, and the Bank is subject to an investment limitation of 10% of its risk-based capital. Federal new market tax credits would be applied over a seven-year period, 5% for the first three years, and 6% for the next four years for a total of 39%.

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On October 6, 2006 the Company signed a definitive merger agreement to provide for the merger of Legacy Bank, N.A. with and into United Security Bank, a wholly owned subsidiary of the Company. Legacy Bank which began operations in 2003 currently operates one banking office in Campbell, California serving small business and retail banking clients. With its small business and retail banking focus, Legacy Bank provides a unique opportunity for United Security Bank to serve a loyal and growing small business niche and individual client base in the San Jose area. Upon completion of the merger during February 2007, Legacy Bank's branch office began operating as a branch office of United Security Bank. As of the date of the merger (February 16, 2007), Legacy Bank had total assets of \$78.5 million (including net loans of \$62.5 million, investment securities of \$7.4 million, and cash and equivalents of \$5.9 million), and deposits of \$69.6 million.

As a result of the merger, the Company issued shares of its stock in a tax free exchange for all of the Legacy Bank common shares. The total value of the transaction is approximately \$21.5 million. Shareholders of Legacy Bank are entitled to receive merger consideration consisting of approximately 976,594 shares of common stock of the Company. The shareholders of Legacy Bank who elected cash, and were allocated cash, will receive cash for their shares based on a value of approximately \$12.86 per share and those who elected to receive stock, and were allocated common stock in United Security Bancshares, will receive approximately .58 shares of the Company's common stock for each Legacy Bank common share. The merger is expected to be accretive to the Company in 2007. The merger transaction was accounted for using the purchase accounting method, and will result in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy based on the fair value of those assets and liabilities. (For terms of the merger, see Note 22 to the Company's consolidated financial statements).

With the recent acquisition of Legacy Bank during February 2007, the Company currently has eleven banking branches and one construction lending office, which provide financial services in Fresno, Madera, Kern, and Santa Clara counties. As a community-oriented bank, the Company continues to seek ways to better meet its customers' needs for financial services, and to expand its business opportunities in today's ever-changing financial services environment. The Company's strategy is to be a better low-cost provider of services to its customer base while enlarging its market area and corresponding customer base to further its ability to provide those services.

Trends Affecting Results of Operations and Financial Position

The Company's overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact results of operations, but also the composition of the Company's balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth.

The following table summarizes the year-to-date averages of the components of interest-bearing assets as a percentage of total interest bearing assets, and the components of interest-bearing liabilities as a percentage of total interest-bearing liabilities:

| | YTD Average 12/31/06 | YTD Average 12/31/05 | YTD Average 12/31/04 |
|---|----------------------------|----------------------------|----------------------------|
| Loans | 80.26% | 72.50% | 75.12% |
| Investment securities | 15.65% | 19.81% | 18.58% |
| Interest-bearing deposits in other banks | 1.33% | 1.36% | 1.57% |
| Federal funds sold | 2.76% | 6.33% | 4.73% |
| Total earning assets | 100.00% | 100.00% | 100.00% |
| NOW accounts | 11.21% | 12.14% | 11.54% |
| Money market accounts | 31.56% | 28.63% | 23.85% |
| Savings accounts | 8.02% | 8.45% | 7.65% |
| Time deposits | 44.72% | 46.78% | 52.77% |
| Other borrowings | 0.96% | 0.32% | 0.22% |
| Junior subordinated debt | 3.53% | 3.68% | 3.97% |
| Total interest-bearing liabilities | 100.00% | 100.00% | 100.00% |

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The Company continues its business development efforts throughout its market area, and as a result, has realized substantial increases in loan volume during the year ended December 31, 2006. The Company experienced increases of \$82.7 million in loans, while other interest earning assets, including investment securities and federal funds sold, declined during the period, as loan growth exceeded deposit growth during the year. The Company experienced growth in all loan categories except lease financing, with growth being strongest in commercial and industrial loans, commercial real estate loans real estate, and agricultural loans. Deposit growth totaled \$40.7 million during the year ended December 31, 2006, with much of that growth in money market accounts and time deposits over \$100,000, as depositors were attracted to those deposit categories by higher yields.

With continued increases in market rates of interest experienced since mid-2004, the Company has realized substantial increases in net interest margins throughout 2005 and 2006. Interest rates have stabilized during the fourth quarter of 2006, and the Company anticipates stable interest rates in the near future, with possible rate declines during 2007. The Company's net interest margin was 5.67% for the year ended December 31, 2006, as compared to 5.26% for the year ended December 31, 2005, and 4.90% for the year ended December 31, 2004. With approximately 59% of the loan portfolio in floating rate instruments at December 31, 2006, benefits of rising rates continue to be realized almost immediately on loan yields. Loans yielded 9.13% during the year ended December 31, 2006 as compared to 8.21% and 7.12% for the years ended December 31, 2005 and 2004, respectively. The Company continues to experience pricing pressures on deposits, especially money market accounts and time deposits, as lagging deposit rates played catch-up during 2005 and 2006. The Company's average cost of funds was 3.24% for the year ended December 31, 2006 as compared to 2.30% and 1.67% for the years ended December 31, 2005 and 2004, respectively.

Noninterest income was enhanced during the year ended December 31, 2006 as the result of gains realized by the Company that are infrequent or nonrecurring in nature. The Company realized a nonrecurring \$1.9 million gain on the sale of an investment in correspondent bank stock during the first quarter of 2006, and recorded \$477,000 in noninterest income during the second quarter of 2006 as the result of death-benefit proceeds from the Company's bank-owned life insurance. Then, in the third quarter of 2006, the Company realized a \$1.0 million gain on the sale of its administrative headquarters, and relocated to a new administrative headquarters located in downtown Fresno during the fourth quarter of 2006.

Noninterest income from customer service fees declined during the year ended December 31, 2006 as compared to the year ended December 31, 2005. This decline was primarily the result of temporary decreases in ATM income as the Company changed service providers for a portion of its ATM network, combined with minor decreases in overdraft and business analysis fees. It is not anticipated that the decline in ATM fee income is permanent, and the Company anticipates attaining close to previous fee income levels during future periods. During the year ended December 31, 2006, the Company realized a loss totaling \$75,000 on the ineffective portion of its interest rate swap agreement pursuant to SFAS No. 133 (See Note 18 to the Company's consolidated financial statements).

The Company continues its efforts to hire and retain qualified staff as part of its strategic growth strategy. As a result, the Company experienced increased salary expense during the year ended December 31, 2006, including nearly \$97,000 in recruitment fees, and \$248,000 in compensation expense for stock options resulting from the adoption of SFAS 123R on January 1, 2006. Additional noninterest expenses were incurred during the year ended December 31, 2006 as the result of \$2.2 million in costs associated with an OREO property the Company is in the process of liquidating. Partial sale of the OREO property was completed during the third quarter of 2006, and the remainder is expected to be completed during 2007.

The Company has maintained a strong balance sheet, with sustained loan growth and sound deposit growth. While total assets have grown nearly \$49.5 million between December 31, 2005 and December 31, 2006, the loan portfolio has grown even faster with increases of \$82.7 million experienced during 2006. With the increased loan growth, average loans comprised approximately 80% of overall average earning assets during the period. In total, average core deposits, including NOW accounts, money market accounts, and savings accounts, continue to comprise a high percentage of total interest-bearing liabilities for the year ended December 31, 2006 as compared to the averages for the previous year. Time deposits continue to decline as a percentage of total average interest-bearing liabilities, representing 44.7% of interest-bearing liabilities for the ended December 31, 2006 as compared to 46.8% and 52.8% for the years ended December 31, 2005 and 2004, respectively. With increases experienced in interest-bearing checking accounts and time deposits during the second half of 2006, the Company has gone from a net borrower of funds to a net seller of funds, with \$14.3 million in federal funds sold at December 31, 2006.

The Company continues to emphasize relationship banking and core deposit growth, and has focused greater attention on its market area of Fresno, Madera, and Kern Counties. The San Joaquin Valley and other California markets continue to benefit from construction lending and commercial loan demand from small and medium size businesses, although commercial and residential real estate markets have softened somewhat during the later part of 2006. On average, loans have increased nearly \$67.1 million between twelve-month periods ended December 31, 2005 and December 31, 2006, and total loans at period-end have increased \$82.7 million between December 31, 2005 and December 31, 2006. Growth continues primarily in commercial and industrial loans, and commercial real estate loans with increases of \$42.5 million, and \$28.1 million in those two categories between December 31, 2005 and December 31, 2006. Additional but modest growth of \$10.2 million was also experienced in agricultural loans during the year ended December 31, 2006. In the future, the Company will continue to maintain an emphasis on its core lending strengths of commercial real estate and construction lending, as well as small business financing, while expanding

opportunities in agricultural, installment, and other loan categories when possible.

The Company continually evaluates its strategic business plan as economic and market factors change in its market area. Growth and increasing market share will be of primary importance during 2007 and beyond. The Company is excited about its recent merger with Legacy Bank located in Campbell, California. This new acquisition brings additional opportunities in a dynamic new market, and will enable the Company to expand its ability to serve Legacy's current clients and increase lending capabilities in the market area of Santa Clara County. The Company will continue to develop new business in its Convention Center Branch opened in Downtown Fresno during April 2004, as well in the two Kern County branches acquired during April 2004 as the result of the merger with Taft National Bank. During the third quarter of 2005, the Company relocated its East Shaw branch, as well as the Construction and Consumer Loan Departments, located in Fresno, to a new location in north Fresno, which has enhanced its business presence in that rapidly growing area. During the fourth quarter of 2006, the Company relocated its administrative headquarters to downtown Fresno, thus increasing its presence there. During the third quarter of 2006, the Company initiated a new banking program with a major bank in Mexico, which is directed at the Central Valley's growing Hispanic community. This new program, called Promesa Latina will allow customers to perform a variety of banking services, including money transfers to Mexico. Market rates of interest will also be an important factor in the Company's ongoing strategic planning process, as it is predicted that we are near the end of an interest rate cycle, with the potential of falling interest rates during 2007.

Application of Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with generally accepted accounting principles and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques.

The most significant accounting policies followed by the Company are presented in Note 1 to the Company's consolidated financial statements included herein. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses to be the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

Allowance for Credit Losses

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for loan losses and a discussion of the factors driving changes in the amount of the allowance for loan losses is included in the Asset Quality and Allowance for Credit Losses section of this financial review.

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If the loan portfolio were to increase by 10% proportionally throughout all loan classifications, the additional estimated provision to the allowance that would be required, based on the percentage loss allocations utilized at December 31, 2006, would be approximately \$410,000 pretax (\$238,000 net of tax). This estimate is comprised of an additional \$45,000 (\$26,000 net of tax) for criticized loans (those classified as special mention or worse and excluding those considered impaired under SFAS No. 114), and an additional \$365,000 (\$212,000 net of tax) for the remainder of the loan portfolio that is performing.

Other Real Estate Owned

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of the book value of the loan, or fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense. The fair market valuation of such properties is based upon estimates, and as such, is subject to change as circumstances in the Company's market area, or general economic trends, change.

Goodwill

Business combinations involving the Company's acquisition of the equity interests or net assets of another enterprise or the assumption of net liabilities in an acquisition of branches constituting a business may give rise to goodwill. The acquisition of Taft National Bank during April 2004 gave rise to goodwill totaling approximately \$750,000, and the recent acquisition of Legacy Bank will result in goodwill related to the transaction, the amount of which has not yet been determined. Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed in transactions accounted for under the purchase method of accounting. The value of goodwill is ultimately derived from the Company's ability to generate net earnings after the acquisition. A decline in net earnings could be indicative of a decline in the fair value of goodwill and result in impairment. For that reason, goodwill is assessed for impairment at a reporting unit level at least annually. While the Company believes all assumptions utilized in its assessment of goodwill for impairment are reasonable and appropriate, changes in earnings, the effective tax rate, historical earnings multiples and the cost of capital could all cause different results for the calculation of the present value of future cash flows.

Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred taxes are measured using current tax rates applied to such taxable income in the years in which those temporary differences are expected to be recovered. If the Company's future income is not sufficient to apply the deferred tax assets within the tax years to which they may be applied, the deferred tax asset may not be realized and the Company's income will be reduced.

On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and took no such benefit in the 4th quarter. The Company continues to review the information available from the FTB and its financial advisors and believes that the Company's position has merit. The Company will pursue its tax claims and defend its use of these entities and transactions. At this time, the Company cannot predict the ultimate outcome. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income would be approximately \$755,000, excluding any possible penalties and interest.

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit. The FTB concluded its audit during January 2006. At that time the FTB submitted a closing letter to the Company, which included proposed assessments related to the tax benefits taken for the REIT during 2002 (*see further discussion see Note 9, Taxes on Income contained in Item 8 of this Form 10-K*). The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (*City National v. Franchise Tax Board*). The case is ongoing and may take several years to complete. The Company cannot reasonably determine at this time what the ultimate outcome of the City National case or the FTB audit will be.

Stock-Based Compensation

For all years presented in the Consolidated Financial Statements prior to 2006, the Company accounted for stock options under the provisions of APB No. 25. Accordingly, no compensation expense related to the issuance of stock options is reflected in the income statements prior to 2006. Pro forma disclosures of the impact of compensation expense (and related tax benefit) associated with stock options are included in Note 10 in the Notes to the Consolidated Financial Statements. The pro forma amounts are calculated on the estimated fair value of the options at the date of the grant, based on assumptions made during the year of the grant. Those assumptions are outlined in Note 10. Stock Options in the Company's Notes to Financial Statements.

On January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004) (SFAS 123(R)), Share-Based Payment, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using Accounting Principles Board Opinion No. 25 and requires that such transactions be accounted for using a fair value-based method. The Company adopted the requirements of SFAS No. 123R using the modified-prospective method during the first quarter of 2006. SFAS No. 123R requires the Company to recognize as compensation expense, the fair value of stock options granted to employees and Directors of the Company beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date. The pretax compensation expense recognized during 2006 totaled \$248,000.

Impairment of Investment Securities

Investment securities classified as available for sale (AFS) are carried at fair value and the impact of changes in fair value are recorded on the Company's consolidated balance sheet as an unrealized gain or loss in Accumulated other comprehensive income (loss), a separate component of shareholders' equity. Securities classified as AFS or held to maturity (HTM) are subject to review to identify when a decline in value is other than temporary. Factors considered in determining whether a decline in value is other than temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event or to a change in interest rate; our ability and intent to hold the investment for a period of time that will allow for a recovery of value; and the financial condition and near-term prospects of the issuer. When it is determined that a decline in value is other than temporary, the carrying value of the security is reduced to its estimated fair value, with a corresponding charge to earnings. At December 31, 2006, the Company did not have any investment securities considered other than temporarily impaired.

Revenue recognition

The Company's primary sources of revenue are interest income from loans and investment securities. Interest income is generally recorded on an accrual basis, unless the collection of such income is not reasonably assured or cannot be reasonably estimated. Pursuant to SFAS No. 91,

Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, nonrefundable fees and costs associated with originating or acquiring loans are recognized as a yield adjustment to the related loans by amortizing them into income over the term of the loan using a method which approximates the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

For loans placed on nonaccrual status, the accrued and unpaid interest receivable may be reversed at management's discretion based upon management's assessment of collectibility, and interest is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan.

Results of Operations

For the year ended December 31, 2006, the Company reported net income of \$13.4 million or \$1.18 per share (\$1.17 diluted) as compared to \$11.0 million or \$0.97 per share (\$0.96 diluted) for the year ended December 31, 2005, and \$8.4 million or \$0.75 per share (\$0.74 diluted) for the year ended December 31, 2004. Net income for 2006 increased \$2.4 million from the previous year as the result of increased volume in earning assets combined with an increase in net interest margin in 2006, as well as from additional unusual or non-recurring gains and operating expenses discussed elsewhere in this Management's Discussion and Analysis of Financial Condition and Results of Operations. Net income increased \$2.6 million between December 31, 2004 and December 31, 2005 as the result of increased volume in earning assets combined with an increase in market rates of interest throughout much of 2005.

The Company's return on average assets was 2.04 % for the year ended December 31, 2006 as compared to 1.76 % and 1.52 % for the same twelve-month periods of 2005 and 2004, respectively. The Company's return on average equity was 20.99% for the year ended December 31, 2006 as compared to 19.46 % and 16.81 % for the same twelve-month periods of 2005 and 2004, respectively.

Net Interest Income

Net interest income, the most significant component of earnings, is the difference between the interest and fees received on earning assets and the interest paid on interest-bearing liabilities. Earning assets consist primarily of loans, and to a lesser extent, investments in securities issued by federal, state and local authorities, and corporations, as well as interest-bearing deposits and overnight funds with other financial institutions. These earning assets are funded by a combination of interest-bearing and noninterest-bearing liabilities, primarily customer deposits and short-term and long-term borrowings.

Net interest income before provision for credit losses totaled \$33.2 million for the year ended December 31, 2006 as compared to \$29.2 million for the year ended December 31, 2005, and \$24.4 million for the year ended December 31, 2004. This represents an increase of \$3.9 million or 13.5 % between the years ended December 31, 2005 and 2006, as compared to an increase of \$4.8 million or 19.6% between 2004 and 2005. As with net income, the increase in net interest income between 2005 and 2006 is the result of increased volume in earning assets combined with a substantial increase in market rates of interest throughout the first half of 2006.

Table 1. Distribution of Average Assets, Liabilities and Shareholders' Equity:

Interest rates and interest differentials

Years Ended December 31, 2006, 2005, and 2004

| <i>(Dollars in thousands)</i> | 2006 | | | 2005 | | | 2004 | | |
|--|-------------------|------------------|--------------|-------------------|------------------|--------------|-------------------|------------------|--------------|
| | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| Assets: | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans (1) | \$ 469,959 | \$ 42,902 | 9.13% | \$ 402,820 | \$ 33,078 | 8.21% | \$ 374,748 | \$ 26,684 | 7.12% |
| Investment Securities taxable | 89,378 | 3,254 | 3.64% | 107,761 | 4,163 | 3.86% | 90,473 | 3,433 | 3.79% |
| Investment Securities nontaxable (2) | 2,226 | 108 | 4.85% | 2,261 | 112 | 4.95% | 2,242 | 123 | 5.49% |
| Interest on deposits in other banks | 7,771 | 324 | 4.17% | 7,539 | 308 | 4.09% | 7,845 | 310 | 3.95% |
| Federal funds sold and reverse repos | 16,166 | 768 | 4.75% | 35,139 | 1,237 | 3.52% | 23,616 | 324 | 1.37% |
| Total interest-earning assets | 585,500 | \$ 47,356 | 8.09% | 555,520 | \$ 38,898 | 7.00% | 498,924 | \$ 30,874 | 6.19% |
| Allowance for possible loan losses | (8,067) | | | (7,608) | | | (7,013) | | |
| Noninterest-bearing assets: | | | | | | | | | |
| Cash and due from banks | 26,426 | | | 29,940 | | | 24,141 | | |
| Premises and equipment, net | 12,706 | | | 9,551 | | | 6,608 | | |
| Accrued interest receivable | 3,597 | | | 2,661 | | | 2,141 | | |
| Other real estate owned | 3,354 | | | 1,639 | | | 2,417 | | |
| Other assets | 32,570 | | | 35,496 | | | 27,507 | | |
| Total average assets | \$ 656,086 | | | \$ 627,199 | | | \$ 554,725 | | |
| Liabilities and Shareholders' Equity: | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| NOW accounts | \$ 49,118 | \$ 241 | 0.49% | \$ 51,043 | \$ 244 | 0.48% | \$ 44,585 | \$ 171 | 0.38% |
| Money market accounts | 138,242 | 3,701 | 2.68% | 120,318 | 2,332 | 1.94% | 92,159 | 1,298 | 1.41% |
| Savings accounts | 35,135 | 198 | 0.56% | 35,500 | 175 | 0.49% | 29,548 | 136 | 0.46% |
| Time deposits | 195,922 | 8,457 | 4.32% | 196,642 | 5,772 | 2.94% | 203,839 | 3,983 | 1.95% |
| Other borrowings | 4,209 | 223 | 5.30% | 1,335 | 44 | 3.30% | 858 | 23 | 2.68% |
| Trust Preferred securities | 15,464 | 1,355 | 8.76% | 15,464 | 1,091 | 7.06% | 15,349 | 822 | 5.36% |

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| | | | | | | | | | |
|--|------------|-----------|-------|------------|----------|-------|------------|----------|-------|
| Total interest-bearing liabilities | 438,090 | \$ 14,175 | 3.24% | 420,302 | \$ 9,658 | 2.30% | 386,338 | \$ 6,433 | 1.67% |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Noninterest-bearing checking | 146,722 | | | 144,146 | | | 113,836 | | |
| Accrued interest payable | 2,021 | | | 1,421 | | | 773 | | |
| Other liabilities | 5,615 | | | 4,773 | | | 3,791 | | |
| Total average liabilities | 592,448 | | | 570,642 | | | 504,738 | | |
| Total average shareholders equity | 63,638 | | | 56,557 | | | 49,987 | | |
| Total average liabilities and Shareholders equity | \$ 656,086 | | | \$ 627,199 | | | \$ 554,725 | | |
| Interest income as a percentage of average earning assets | | | | | | | | | |
| | | | 8.09% | | | 7.00% | | | 6.19% |
| Interest expense as a percentage of average earning assets | | | | | | | | | |
| | | | 2.42% | | | 1.74% | | | 1.29% |
| Net interest margin | | | 5.67% | | | 5.26% | | | 4.90% |

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- (1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately \$3,480,000, \$3,480,000, and \$3,216,000 for the years ended December 31, 2006, 2005, and 2004, respectively.
- (2) Applicable nontaxable securities yields have not been calculated on a tax-equivalent basis because they are not material to the Company's results of operations.

As summarized in Table 2, the increase in net interest income between the two twelve-month periods ended December 31, 2006 and 2005 is comprised of an increase in total interest income of approximately \$8.5 million, which was only partially offset by an increase in total interest expense of approximately \$4.5 million. The Bank's net interest margin, as shown in Table 1, increased to 5.67% at December 31, 2006 from 5.26% at December 31, 2005, an increase of 41 basis points (100 basis points = 1%) between the two periods. The net margin of 5.26% reported during 2005 represents an increase of 36 basis points from the 4.90% net margin realized by the Company during 2004. While assets have grown over the past three years and the balance sheet mix has changed, interest rate movements over those three years have played a significant role in net interest income trends. Market rates of interest began to rise significantly during the second half of 2004, with the prime rate rising 125 basis points between June 30, 2004 and December 31, 2004, rising another 200 basis points during 2005, and then another 100 basis points during 2006. As a result, the prime rate averaged 7.96% for the year ended December 31, 2006 as compared to 6.19% and 4.34% for the years ended December 31, 2005 and 2004, respectively.

Both the Company's net interest income and net interest margin are affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as volume change. Both are also affected by changes in yields on interest-earning assets and rates paid on interest-bearing liabilities, referred to as rate change. The following table sets forth the changes in interest income and interest expense for each major category of interest-earning asset and interest-bearing liability, and the amount of change attributable to volume and rate changes for the years indicated. Changes in interest income and expense, which are not attributable specifically to either rate or volume, are allocated proportionately between the two variances based on the absolute dollar amounts of the change in each.

Table 2. Rate and Volume Analysis

| <i>(In thousands)</i> | 2006 compared to 2005 | | | 2005 compared to 2004 | | |
|--|-----------------------|----------------|-----------------|-----------------------|-----------------|-----------------|
| | Total | Rate | Volume | Total | Rate | Volume |
| Increase (decrease) in interest income: | | | | | | |
| Loans | \$ 9,824 | \$ 3,942 | \$ 5,882 | \$ 6,394 | \$ 4,295 | \$ 2,099 |
| Investment securities | (913) | (227) | (686) | 719 | 47 | 672 |
| Interest-bearing deposits in other banks | 16 | 6 | 10 | (2) | 11 | (13) |
| Federal funds sold and securities purchased under agreements to resell | (469) | 341 | (810) | 913 | 696 | 217 |
| Total interest income | 8,458 | 4,062 | 4,396 | 8,024 | 5,049 | 2,975 |
| Increase (decrease) in interest expense: | | | | | | |
| Interest-bearing demand accounts | 1,366 | 1,107 | 259 | 1,107 | 678 | 429 |
| Savings accounts | 23 | 25 | (2) | 39 | 10 | 29 |
| Time deposits | 2,685 | 2,706 | (21) | 1,789 | 1,934 | (145) |
| Other borrowings | 179 | 39 | 140 | 21 | 6 | 15 |
| Trust Preferred securities | 264 | 264 | 0 | 269 | 263 | 6 |
| Total interest expense | 4,517 | 4,141 | 376 | 3,225 | 2,891 | 334 |
| Increase (decrease) in net interest income | \$ 3,941 | \$ (79) | \$ 4,020 | \$ 4,799 | \$ 2,158 | \$ 2,641 |

Total interest income increased approximately \$8.5 million or 21.7% between the years ended December 31, 2005 and 2006, and is attributable to both an increase in earning asset volume, as well as the yields on those earning assets. As with the previous year, earning asset growth was mainly in loans, with minor volume declines experienced in investments and federal funds sold during 2006. On average, loans grew by approximately \$67.12 million between 2005 and 2006. The Company continues to maintain a high percentage of loans in its earning asset mix with loans averaging 80.3% of total earning assets for the year ended December 31, 2006, as compared to 72.5% and 75.1% for the years ended December 31, 2005 and 2004, respectively.

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Total interest expense increased approximately \$4.5 million between the years ended December 31, 2005 and 2006, primarily as a result of increased rates paid on deposit accounts as market rates of interest continued to rise throughout the first half of 2006. Rates paid on interest-bearing liabilities increase in all categories, with the greatest increases experienced in time deposits and money market deposit accounts. The Company's deposit mix continues to change with declines in average NOW and time deposit volume, which was more than offset by increases in the average volume of money market accounts. On average, NOW accounts and time deposits decreased \$1.9 million and \$720,000, respectively, while money market accounts increased on average by \$17.9 million between the years ended December 31, 2005 and December 31, 2006.

Total interest income increased approximately \$8.0 million or 26.0% between the years ended December 31, 2004 and 2005, and was attributable to both an increase in earning asset volume, as well as the yields on those earning assets. Earning asset growth was mainly in loans, with minor growth in investments and federal funds sold. On average, loans grew by approximately \$28.2 million between 2004 and 2005. The Company continues to maintain a high percentage of loans in its earning asset mix with loans averaging 72.5% of total earning assets for the year ended December 31, 2005, as compared to 75.1% for the year ended December 31, 2004.

Total interest expense increased approximately \$3.2 million between the years ended December 31, 2004 and 2005, primarily as a result of increased rates paid on deposit accounts as market rates of interest continued to rise throughout 2005. Rates paid on interest-bearing liabilities increased in all categories in 2005, with the greatest increases experienced in time deposits and money market deposit accounts. The Company's deposit mix changed in 2005 with continued declines in time deposit volume, which was more than offset by increases in the average volume of interest-bearing demand and savings accounts. On average, time deposits decreased \$7.2 million, while interest-bearing demand and savings accounts increased on average by \$34.6 million and \$6.0 million, respectively, between the years ended December 31, 2004 and December 31, 2005.

Provision for Credit Losses

Provisions for credit losses and the amount added to the allowance for credit losses is determined on the basis of management's continuous credit review of the loan portfolio, consideration of past loan loss experience, current and future economic conditions, and other pertinent factors. Such factors consider the allowance for credit losses to be adequate when it covers estimated losses inherent in the loan portfolio. Based on the condition of the loan portfolio, management believes the allowance is sufficient to cover risk elements in the loan portfolio. For the year ended December 31, 2006 the provision to the allowance for credit losses amounted to \$880,000 as compared to \$1.1 million for both the years ended December 31, 2005 and 2004. Reductions in the provision to the allowance for credit losses during 2006 were the result of lower levels of nonperforming loans during the year. The amount provided to the allowance for credit losses during 2006 brought the allowance to 1.67% of net outstanding loan balances at December 31, 2006, as compared to 1.86% of net outstanding loan balances at December 31, 2005, and 1.82% at December 31, 2004.

Noninterest Income

The following table summarizes significant components of noninterest income for the years indicated and the net changes between those years:

| <i>(In thousands)</i> | Years Ended December 31, | | | Increase (decrease) during Year | |
|-------------------------------------|--------------------------|-----------------|-----------------|------------------------------------|-----------------|
| | 2006 | 2005 | 2004 | 2006 | 2005 |
| Customer service fees | \$ 3,779 | \$ 4,399 | \$ 4,311 | \$ (620) | \$ 88 |
| Gain on sale of securities | 27 | 163 | 35 | (136) | 128 |
| Gain (loss) on sale of OREO | 50 | 325 | (98) | (275) | 423 |
| Proceeds from life insurance | 482 | 0 | 0 | 482 | 0 |
| Loss on swap ineffectiveness | (75) | 0 | 0 | (75) | 0 |
| Gain on sale of investment | 1,877 | 0 | 0 | 1,877 | 0 |
| Gain (loss) on sale of fixed assets | 1,018 | (5) | 7 | 1,023 | (12) |
| Shared appreciation income | 567 | 393 | 8 | 174 | 385 |
| Other | 1,306 | 1,005 | 479 | 301 | 526 |
| Total | \$ 9,031 | \$ 6,280 | \$ 4,742 | \$ 2,751 | \$ 1,538 |

Noninterest income consists primarily of fees and commissions earned on services that are provided to the Company's banking customers and, to a lesser extent, gains on sales of Company assets and other miscellaneous income. Noninterest income for the year ended December 31, 2006 increased \$2.8 million when compared to the previous year, and increased \$4.3 million when compared to the year ended December 31, 2004.

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Increases in noninterest income experienced during 2006 were the result of several large nonrecurring or unusual items, which were partially offset by modest declines in customer service fees.

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Customer service fees continue to provide the majority of noninterest income over the three years presented. Customer service fees decreased \$620,000 between the years ended December 2005 and December 31, 2006, which is attributable, in part, to declines in ATM fee income, as well as overdraft charges and business analysis fees. Increases in customer service fees realized between 2004 and 2005 were comprised of increases in ATM and overdraft charges, as well as additional fee revenue generated by the two Kern County branches acquired during April 2004.

Nonrecurring items included in noninterest income during 2006 included a \$1.8 million gain on the sale of an investment during the first quarter of 2006, as well as \$1.0 million gain from the sale of the Company's administration building during the third quarter of 2006. Noninterest income was further enhanced during the second quarter of 2006 by \$477,000 in death-benefit proceeds realized from the Company's bank owned life insurance.

Shared appreciation income has fluctuated over the three years presented, with increases of \$174,000 between 2005 and 2006, as compared to increases of \$385,000 between 2004 and 2005. Shared appreciation income results from agreements between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. The profit is determined by the appraised value of the completed project and subsequent refinancing or sale of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of shared appreciation projects, and as a result, does not anticipate large amounts of shared appreciation income on an ongoing basis. Gains on sales of investment securities decreased \$136,000 between 2005 and 2006, but increased \$128,000 between 2004 and 2005 as the result of securities sold during the fourth quarter of 2005 when the Company restructured the investment portfolio to reduce the risk profile of the Company.

Noninterest income increased \$1.5 million between the years ended December 31, 2005 and December 31, 2004. Customer service fees continued to provide the majority of noninterest income with a modest increase of \$88,000 between 2004 and 2005, and included increases in ATM and overdraft charges, as well as additional fee revenue generated by the two Kern County branches acquired during April 2004. Shared appreciation income increased \$385 between 2004 and 2005. Gains on sales of investment securities increased \$128,000 between 2004 and 2005 and are the result of securities sold during the fourth quarter of 2005 as the Company restructured the investment portfolio to reduce the risk profile of the Company.

Noninterest Expense

The following table sets forth the components of total noninterest expense in dollars and as a percentage of average earning assets for the years ended December 31, 2006, 2005 and 2004:

| <i>(Dollars in thousands)</i> | 2006 | | 2005 | | 2004 | |
|------------------------------------|------------------|--------------------------------------|------------------|--------------------------------------|------------------|--------------------------------------|
| | Amount | % of Average Earning Assets | Amount | % of Average Earning Assets | Amount | % of Average Earning Assets |
| Salaries and employee benefits | \$ 9,915 | 1.69% | \$ 8,046 | 1.45% | \$ 6,663 | 1.34% |
| Occupancy expense | 2,556 | 0.44% | 2,327 | 0.42% | 2,197 | 0.44% |
| Data processing | 470 | 0.08% | 624 | 0.11% | 659 | 0.13% |
| Professional fees | 998 | 0.17% | 1,234 | 0.22% | 1,236 | 0.25% |
| Directors fees | 222 | 0.04% | 210 | 0.04% | 192 | 0.04% |
| Amortization of intangibles | 537 | 0.09% | 537 | 0.10% | 470 | 0.09% |
| Correspondent bank service charges | 204 | 0.03% | 359 | 0.06% | 318 | 0.06% |
| Writedown on investment | 0 | 0.00% | 702 | 0.13% | 0 | 0.00% |
| Writedowns on OREO | 0 | 0.00% | 0 | 0.00% | 35 | 0.01% |
| Loss on CA Tax Credit Partnership | 440 | 0.08% | 458 | 0.08% | 395 | 0.08% |
| OREO expense | 2,193 | 0.37% | 38 | 0.01% | 85 | 0.02% |
| Other | 2,402 | 0.41% | 2,447 | 0.44% | 2,417 | 0.48% |
| Total | \$ 19,937 | 3.41% | \$ 16,982 | 3.06% | \$ 14,667 | 2.94% |

Noninterest expense, excluding provision for credit losses and income tax expense, totaled \$19.9 million for the year ended December 31, 2006 as compared to \$17.0 million and \$14.7 million for the years ended December 31, 2005 and 2004, respectively. These figures represent an increase of \$3.0 million or 17.4% between the years ended December 31, 2005 and 2006 and an increase of \$2.3 million or 15.8% between the years ended December 31, 2004 and 2005.

Noninterest expense increases between the three years presented are associated primarily with normal, anticipated growth of the Company, as well as additional costs incurred during both 2006 and 2005. Increases in OREO expense experienced during 2006 were primarily the result of additional expenses, including disposal and clean-up costs, incurred on a single OREO property, which is in the process of liquidation. Expenses on OREO increased approximately \$2.2 million between the years ended December 31, 2005 and December 31, 2006. Professional fees decreased \$236,000 between the year ended December 31, 2005 and December 31, 2006 primarily as the result of reductions in legal expenses associated with impaired loans. Noninterest expense incurred during 2005 included a write-down of \$702,000 on the Company's investment in a title company, Diversified Holding Corporation. As a percentage of average earning assets, total noninterest expense has experienced moderate increases over the past three years as the Company has controlled overhead expenses while experiencing profitable growth. Noninterest expense amounted to 3.41% of average earning assets for the year ended December 31, 2006 as compared to 3.06% at December 31, 2005 and 2.94% at December 31, 2004.

Pursuant to the adoption of SFAS No. 123R during the first quarter of 2006, the Company recognized stock-based compensation expense of \$248,000 (\$0.02 per share basic and diluted) for year ended December 31, 2006. This expense is included in noninterest expense under salaries and employee benefits. Under the current pool of stock options, the Company expects stock-based compensation expense to be about \$47,000 per quarter during 2007, then to \$28,000 per quarter for 2008, and decline after that through 2010. If new stock options are issued, or existing options fail to vest due, for example, to forfeiture, actual stock-based compensation expense in future periods will change.

Income Taxes

On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and has taken no related tax benefits since that time. The Company continues to review the information available from the FTB and its financial advisors and believes that the Company's position has merit. The Company will pursue its tax claims and defend its use of these entities and transactions. At this time, the Company cannot predict the ultimate outcome.

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit, and counsel has provided the FTB with documentation supporting the Company's position. The FTB concluded its audit during January 2006. At that time the FTB submitted a closing letter to the Company, which included proposed assessments related to the tax benefits taken for the REIT during 2002. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income resulting from the reversal of tax benefits taken during 2002 would be approximately \$755,000, excluding any possible penalties and interest. The Company cannot reasonably determine at this time what the ultimate outcome of the audit will be, although the FTB appears unwilling to accept the Company's position. The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (*City National v. Franchise Tax Board*). Based upon discussions with legal counsel, it is management's understanding that the FTB is unwilling to resolve or concede any issues in the audit pending the final outcome of the *City National* case which contains all of the issues related to the Company's audit with the FTB. The case is ongoing and may take several years to complete. As a result, the Company has not recognized any liability with respect to the FTB's assessment as of December 31, 2006.

Financial Condition

Total assets increased by \$49.5 million or 7.9% during the year to \$678.3 million at December 31, 2006, and increased \$66.6 million or 10.9% from the balance of \$611.7 million at December 31, 2004. During the year ended December 31, 2006, significant increases were experienced in loans, while federal funds sold and investment securities declined as loan growth outpaced deposit growth during the year. During 2006, net loans increased \$81.8 million, while federal funds sold decreased \$20.8 million, and investment securities declined \$11.9 million between the two period-ends.

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Total deposits of \$587.1 million at December 31, 2006 increased \$40.7 million or 7.4% from the balance reported at December 31, 2005, and increased \$50.5 million or 9.4% from the balance of \$536.7 million reported at December 31, 2004. During 2006, growth was experienced in time deposits of \$100,000 or more, money market accounts and noninterest bearing deposits.

Earning assets averaged approximately \$585.5 million during the year ended December 31, 2006, as compared to \$555.5 million and \$498.9 million for the years ended December 31 2005 and 2004, respectively. Average interest-bearing liabilities increased to \$438.1 million for the year ended December 31, 2006, as compared to \$420.3 million for the year ended December 31, 2005, and increased from the balance of \$386.3 million for the year ended December 31, 2004.

Loans

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of its earning assets. Loans totaled \$500.6 million at December 31, 2006, representing an increase of \$82.7 million or 19.8% when compared to the balance of \$417.9 million at December 31, 2005, and an increase of \$101.9 million or 25.6% when compared to the balance of \$398.7 million reported at December 31, 2004. Average loans totaled \$470.0 million, \$402.8 million, and \$374.7 million for the years ended December 31, 2006, 2005 and 2004, respectively. During 2006 average loans increased 16.7% when compared to the year ended December 31, 2005 and increased 25.4% compared to the year ended December 31, 2004.

The following table sets forth the amounts of loans outstanding by category and the category percentages as of the year-end dates indicated:

| <i>(In thousands)</i> | 2006 | | 2005 | | 2004 | | 2003 | | 2002 | |
|---------------------------|-------------------|---------------|-------------------|---------------|-------------------|---------------|-------------------|---------------|-------------------|---------------|
| | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans |
| Commercial and industrial | \$ 155,811 | 31.1% | \$ 113,263 | 27.1% | \$ 123,720 | 31.0% | \$ 116,991 | 33.9% | \$ 117,293 | 33.6% |
| Real estate mortgage | 113,613 | 22.7 | 89,503 | 21.4 | 88,187 | 22.1 | 96,381 | 27.9 | 100,417 | 28.9 |
| Real estate construction | 168,378 | 33.7 | 162,873 | 38.9 | 137,523 | 34.5 | 97,930 | 28.3 | 95,024 | 27.2 |
| Agricultural | 35,102 | 7.0 | 24,935 | 6.0 | 23,416 | 5.9 | 15,162 | 4.4 | 16,877 | 4.8 |
| Installment/other | 16,712 | 3.3 | 15,002 | 3.6 | 13,257 | 3.3 | 6,617 | 1.9 | 7,811 | 2.2 |
| Lease financing | 10,952 | 2.2 | 12,334 | 3.0 | 12,581 | 3.2 | 12,581 | 3.6 | 11,632 | 3.3 |
| Total Loans | \$ 500,568 | 100.0% | \$ 417,910 | 100.0% | \$ 398,684 | 100.0% | \$ 345,662 | 100.0% | \$ 349,054 | 100.0% |

Loan volume continues to be greatest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. During 2006, loan growth occurred in all categories except lease financing. The most significant loan increases during 2006 occurred in commercial and industrial loans, real estate mortgage loans, and agricultural loans, with increases of \$42.5 million, \$24.1 million, and \$10.2 million experienced in those three categories, respectively. Real estate construction loans increased a modest \$5.5 million or 3.4% during 2006 as the real estate construction market continues to remain stable within the San Joaquin Valley.

During 2005, loan growth occurred in all categories except commercial and industrial loans, and lease financing, with total loans growing by \$19.2 million or 4.8% between December 31, 2004 and December 31, 2005. The majority of that increase during 2005 was experienced in real estate construction loans. Real estate construction lending continues to be a substantial business line for the Company, as housing demand and business development remain strong throughout the Central San Joaquin Valley. Modest increases were experienced in real estate mortgage, agricultural, and installment consumer loans, while commercial and industrial loans declined by nearly \$10.5 million as several large commercial relationships matured during the later part of 2005.

At December 31, 2006, approximately 72% of commercial and industrial loans have floating rates and, although some may be secured by real estate, many are secured by accounts receivable, inventory, and other business assets. Construction loans continue to be a significant focus for the Company and increased \$5.5 million or 3.4% during 2006, increased \$25.4 million or 18.4% during 2005, and increased \$39.6 million or 40.0% during 2004. Construction loans are generally short-term, floating-rate obligations, which consist of both residential and commercial projects. Agricultural loans consisting of mostly short-term, floating rate loans for crop financing, increased \$10.2 million or 40.8% between December 31, 2005 and December 31, 2006, while installment loans increased \$1.7 million or 11.4% during that same period.

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The real estate mortgage loan portfolio totaling \$113.6 million at December 31, 2006 consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the core of this segment of the portfolio, with balances of \$71.7 million, \$43.6 million, and \$62.5 million at December 31, 2006, 2005, and 2004, respectively. Commercial real estate loans are generally a mix of short to medium-term, fixed and floating rate instruments and, are mainly tied to commercial income and multi-family residential properties. The Company does not currently offer traditional residential mortgage loans, but may purchase mortgage portfolios. As a result of real estate mortgage purchases over the past several years, that portion of the portfolio has grown with balances of \$39.2 million, \$43.3 million, and \$21.6 million at December 31, 2006, 2005 and 2004, respectively. The Company purchased a portfolio of 15-year fixed-rate jumbo mortgages totaling \$14.0 during the fourth quarter of 2004. Then, the Company purchased an additional mortgage portfolio, similar to the one purchased during 2004, totaling \$15.7 million during October 2005, bring the total purchased mortgage loans to \$26.5 million, or 68% of the \$39.2 held in residential mortgages held by the Company at December 31, 2006. The Company does offer mortgage loans provided by a third-party service provider through the Company's website. The Company also offers short to medium-term, fixed-rate, home equity loans, which totaled \$2.7 million at December 31, 2006, \$2.6 million at December 31, 2005, and \$4.1 million at December 31, 2004.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2006. Amounts presented are shown by maturity dates rather than repricing periods:

| <i>(In thousands)</i> | Due in one year or less | Due after one Year through Five years | Due after Five years | Total |
|-----------------------------|----------------------------|---|-------------------------|-------------------|
| Commercial and agricultural | \$ 125,925 | \$ 43,853 | \$ 21,135 | \$ 190,913 |
| Real estate construction | 144,350 | 24,028 | 0 | 168,378 |
| | 270,275 | 67,881 | 21,135 | 359,291 |
| Real estate mortgage | 7,663 | 51,094 | 54,856 | 113,613 |
| All other loans | 9,149 | 15,951 | 2,564 | 27,664 |
| Total Loans | \$ 287,087 | \$ 134,926 | \$ 78,555 | \$ 500,568 |

The average yield on loans was 9.13% for the year ended December 31, 2006, representing an increase of 92 basis points when compared to the year ended December 31, 2005 and was a result of a significant increase in average market rates of interest throughout 2005 and 2006. For the year ended December 31, 2005, the overall average yield on the loan portfolio was 8.21%, representing an increase of 109 basis points when compared to 7.12% for the same twelve-month period of 2004 and was a result of an increase in average market rates of interest beginning during the second half of 2004, and continuing throughout 2005. The Bank's loan portfolio is generally comprised of short-term or floating rate loans and is therefore susceptible to fluctuations in market rates of interest. At December 31, 2006, 2005 and 2004, approximately 59.5%, 58.1% and 67.4% of the Bank's loan portfolio consisted of floating rate instruments, with the majority of those tied to the prime rate.

The following table sets forth the contractual maturities of the Bank's fixed and floating rate loans at December 31, 2006. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:

| <i>(In thousands)</i> | Due in one year or less | Due after one Year through Five years | Due after Five years | Total |
|-------------------------------|----------------------------|---|-------------------------|----------------|
| Accruing loans: | | | | |
| Fixed rate loans | \$ 46,357 | \$ 76,606 | \$ 66,212 | \$ 189,175 |
| Floating rate loans | 233,974 | 57,318 | 11,964 | 303,256 |
| Total accruing loans | 280,331 | 133,924 | 78,176 | 492,431 |
| Nonaccrual loans: | | | | |
| Fixed rate loans | 5,425 | 739 | 116 | 6,280 |
| Floating rate loans | 1,331 | 263 | 263 | 1,857 |
| Total nonaccrual loans | 6,756 | 1,002 | 379 | 8,137 |

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| | | | | | | | | |
|-------------|----|---------|----|---------|----|--------|----|---------|
| Total Loans | \$ | 287,087 | \$ | 134,926 | \$ | 78,555 | \$ | 500,568 |
|-------------|----|---------|----|---------|----|--------|----|---------|

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Securities

Following is a comparison of the amortized cost and approximate fair value of available-for-sale and held-to-maturity securities for the three years indicated:

| (In thousands) | December 31, 2006 | | | | December 31, 2005 | | | |
|--|-------------------|------------------------|-------------------------|------------------------------|-------------------|------------------------|-------------------------|------------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) |
| Available-for-sale: | | | | | | | | |
| U.S. Government agencies | \$ 69,746 | \$ 51 | \$ (1,293) | \$ 68,504 | \$ 82,215 | \$ 110 | \$ (2,002) | \$ 80,323 |
| U.S. Government agency collateralized mortgage obligations | 17 | 0 | (1) | 16 | 22 | 0 | (1) | 21 |
| Obligations of state and political subdivisions | 2,226 | 65 | (1) | 2,290 | 2,226 | 94 | 0 | 2,320 |
| Other investment securities | 13,000 | 0 | (444) | 12,556 | 13,000 | 0 | (428) | 12,572 |
| Total available-for-sale | \$ 84,989 | \$ 116 | \$ (1,739) | \$ 83,366 | \$ 97,463 | \$ 204 | \$ (2,431) | \$ 95,236 |

| (In thousands) | December 31, 2004 | | | |
|--|-------------------|------------------------|-------------------------|-------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available-for-sale: | | | | |
| U.S. Treasuries | \$ 399 | \$ 0 | \$ (2) | \$ 397 |
| U.S. Government agencies | 89,329 | 312 | (764) | 88,877 |
| U.S. Government agency collateralized mortgage obligations | 31 | 0 | 0 | 31 |
| Obligations of state and political subdivisions | 2,242 | 155 | 0 | 2,397 |
| Other investment securities | 20,703 | 70 | (225) | 20,548 |
| Total available-for-sale | \$ 112,704 | \$ 537 | \$ (991) | \$ 112,250 |

Included in other investment securities at December 31, 2006, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.8 million. Included in other investment securities at December 31, 2005, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.9 million. Included in other investment securities at December 31, 2004, is a short-term government securities mutual fund totaling \$7.8 million, a commercial asset-backed trust totaling \$4.6 million, a CRA-qualified mortgage fund totaling \$5.0 million, and Trust Preferred securities pools totaling \$3.2 million. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

Realized gains on securities available-for-sale totaled \$27,000 during 2006, \$163,000 during 2005, and \$152,000 during 2004. There were no realized losses on securities available-for-sale during 2006 or 2005. Realized losses on securities available-for-sale totaled \$117,000 during 2004.

Investment securities decreased \$11.9 million between December 2005 and December 2006, as U.S. government agencies were paid down or matured. Proceeds from maturing securities were utilized to fund loan growth which exceeded deposit growth during 2006. Investment securities decreased \$17.0 million between December 31, 2004 and December 31, 2005, due in part to sales of approximately \$6.8 million in other investment securities during the fourth quarter of 2005 as the Company restructured the investment portfolio to improve the risk profile of the Company. Investment sales during the fourth quarter of 2005 included Trust Preferred Securities pools totaling \$3.3 million, and a commercial asset-backed trust totaling \$3.5 million.

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Securities that have been temporarily impaired less than 12 months at December 31, 2006 are comprised of one U.S. government agency security a weighted average life of 13.2 years. As of December 31, 2006, there were nineteen U.S. government agency securities, one collateralized mortgage obligation, one municipal security, and two other investment securities with a total weighted average life of 2.29 years that have been temporarily impaired for twelve months or more. Because the decline in market value is attributable to changes in market rates of interest rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2006.

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The following summarizes temporarily impaired investment securities at December 31, 2006

| <i>(In thousands)</i> | Less than 12 Months | | 12 Months or More | | Total | |
|--|------------------------------------|----------------------|------------------------------------|----------------------|------------------------------------|----------------------|
| | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses |
| Securities available for sale: | | | | | | |
| U.S. Government agencies | \$ 506 | \$ (6) | \$ 65,626 | \$ (1,287) | \$ 66,132 | \$ (1,293) |
| U.S. Government agency collateralized mortgage Obligations | 0 | 0 | 12 | (1) | 12 | (1) |
| Obligations of state and political subdivisions | 0 | 0 | 34 | (1) | 34 | (1) |
| Other investment securities | 0 | 0 | 12,556 | (444) | 12,556 | (444) |
| Total impaired securities | \$ 506 | \$ (6) | \$ 78,228 | \$ (1,733) | \$ 78,734 | \$ (1,739) |

The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2006 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

| <i>(Dollars in thousands)</i> | One year or less | | After one year to five years | | After five years to ten years | | After ten years | | Total | |
|--|------------------|--------------|------------------------------|--------------|-------------------------------|--------------|------------------|--------------|------------------|--------------|
| | Amount | Yield (1) | Amount | Yield (1) | Amount | Yield (1) | Amount | Yield (1) | Amount | Yield (1) |
| Available-for-sale: | | | | | | | | | | |
| U.S. Government agencies | \$ 27,756 | 3.34% | \$ 24,834 | 3.27% | \$ 472 | 5.48% | \$ 15,442 | 3.33% | \$ 68,504 | 3.34% |
| U.S. Government agency collateralized mortgage obligations | | | | | | | 16 | 5.15% | 16 | 5.15% |
| Obligations of state and political subdivisions | | | 255 | 4.85% | 1,772 | 5.14% | 263 | 5.37% | 2,290 | 5.10% |
| Other investment securities | 12,556 | 2.90% | | | | | | | 12,556 | 2.90% |
| Total estimated fair value | \$ 40,312 | 3.32% | \$ 25,089 | 3.29% | \$ 2,244 | 5.21% | \$ 15,721 | 3.37% | \$ 83,366 | 3.37% |

(1) Weighted average yields are not computed on a tax equivalent basis

At December 31, 2006 and 2005, available-for-sale securities with an amortized cost of approximately \$70.9 million and \$69.3 million, respectively (fair value of \$69.7 million and \$67.8 million, respectively) were pledged as collateral for public funds, FHLB borrowings, and treasury tax and loan balances.

Deposits

The Bank attracts commercial deposits primarily from local businesses and professionals, as well as retail checking accounts, savings accounts and time deposits. Total deposits increased \$40.7 million or 7.4% during the year to a balance of \$587.1 million at December 31, 2006 and increased \$9.8 million or 1.8% between December 31, 2004 and December 31, 2005. Core deposits, consisting of all deposits other than time deposits of \$100,000 or more and brokered deposits, continue to provide the foundation for the Bank's principal sources of funding and liquidity. These core deposits amounted to 71.1%, 75.7% and 73.4% of the total deposit portfolio at December 31, 2006, 2005 and 2004, respectively.

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The following table sets forth the year-end amounts of deposits by category for the years indicated, and the dollar change in each category during the year:

| <i>(In thousands)</i> | December 31, | | | Change during Year | |
|--|-------------------|-------------------|-------------------|--------------------|-----------------|
| | 2006 | 2005 | 2004 | 2006 | 2005 |
| Noninterest-bearing deposits | \$ 159,002 | \$ 153,113 | \$ 129,970 | \$ 5,889 | \$ 23,143 |
| Interest-bearing deposits: | | | | | |
| NOW and money market accounts | 184,384 | 175,852 | 173,943 | 8,532 | 1,909 |
| Savings accounts | 31,933 | 33,590 | 32,775 | (1,657) | 815 |
| Time deposits: | | | | | |
| Under \$100,000 | 42,428 | 53,254 | 61,626 | (10,826) | (8,372) |
| \$100,000 and over | 169,380 | 130,651 | 138,358 | 38,729 | (7,707) |
| Total interest-bearing deposits | 428,125 | 393,347 | 406,702 | 34,778 | (13,355) |
| Total deposits | \$ 587,127 | \$ 546,460 | \$ 536,672 | \$ 40,667 | \$ 9,788 |

During the year ended December 31, 2006 increases were experienced in noninterest-bearing checking accounts, money market accounts, and time deposits of \$100,000 and over. Increases in money market accounts and time deposits in excess of \$100,000 are primarily the result of depositors seeking higher yields over the past year as competitors such as brokerage firms and credit unions have driven up rates to attract deposits. Increases in time deposits of \$100,000 and over experienced during 2006 were largely the result of brokered time deposits obtained by the Company as part of its liquidity strategy to fund loan growth during the year. The Company continues to emphasize core deposits as part of its relationship banking strategy. As a result, core deposits, including NOW and money market accounts, and savings accounts, as well as noninterest-bearing checking accounts, continue to provide the Company's primary funding source.

During the years ended December 31, 2005 increases were experienced in all deposit categories, except in time deposits, which continue to decline as the Company reduces its dependency on brokered and other out-of-market time deposits.

The overall level of time deposits declined during 2004 and 2005, as the Company was able to control the level of these deposits to some degree with pricing strategies. Time deposits, including brokered and other out-of-market deposits were allowed to run-off as they matured as the need for such deposits diminished. Then, as loan growth exceeded deposit growth during 2006, the Company sought to increase time deposits, including brokered deposits, to fund that asset growth. The Company has utilized brokered deposits over the past several years to enhance its funding needs, with brokered deposits totaling \$67.7 million, \$32.8 million, and \$37.8 million at December 31, 2006, 2005 and 2004, respectively. In addition, the Company has been able to obtain time deposits from the State of California, which totaled \$45.0 million at December 31, 2006, and \$40.0 million at both December 31, 2005 and 2004. The time deposits of the State of California are collateralized by pledged securities in the Company's investment portfolio. The Company will continue to use pricing strategies to control the overall level of time deposits as part of its growth and liquidity planning process.

The Company's deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits. Interest-bearing deposits consist of time certificates, NOW and money market accounts and savings deposits. Total interest-bearing deposits increased \$34.8 million or 8.8% between December 31, 2005 and December 31, 2006, and noninterest-bearing deposits increased \$5.9 million or 3.9% between the same two periods presented. Between December 31, 2004 and December 31, 2005, total interest-bearing deposits decreased \$13.4 million or 3.3%, while noninterest-bearing deposits increased \$23.1 million or 17.8%.

On a year-to-date average, the Company experienced an increase of \$17.5 million or 3.2% in total deposits between the years ended December 31, 2005 and December 31, 2006. Between these two periods, average interest-bearing deposits increased \$14.9 million or 3.7%, while total noninterest-bearing checking increased \$2.6 million or 1.8% on a year-to-date average basis. On average, the Company experienced increases in money market accounts and noninterest-bearing checking accounts between the years ended December 31, 2005 and December 31, 2006, while other deposit categories experienced only minor declines on average during 2006. On a year-to-date average basis, total deposits increased \$63.7 million or 13.2% between the years ended December 31, 2004 and December 31, 2005. Of that total, interest-bearing deposits increased by \$33.4 million or 9.0%, while noninterest-bearing deposits increased \$30.3 million or 26.6% during 2005.

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The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2006, 2005 and 2004:

| (Dollars in thousands) | 2006 | | 2005 | | 2004 | |
|------------------------------|-----------------|--------|-----------------|--------|-----------------|--------|
| | Average Balance | Rate % | Average Balance | Rate % | Average Balance | Rate % |
| Interest-bearing deposits: | | | | | | |
| Checking accounts | \$ 187,360 | 2.10% | \$ 171,361 | 1.50% | \$ 136,744 | 1.07% |
| Savings | 35,135 | 0.56% | 35,500 | 0.49% | 29,548 | 0.46% |
| Time deposits (1) | 195,922 | 4.32% | 196,642 | 2.94% | 203,839 | 1.95% |
| Noninterest-bearing deposits | 146,722 | | 144,146 | | 113,836 | |

(1) Included at December 31, 2006, are \$169.4 million in time certificates of deposit of \$100,000 or more, of which \$108.4 million matures in three months or less, \$32.6 million matures in 3 to 6 months, \$15.2 million matures in 6 to 12 months, and \$13.2 million matures in more than 12 months.

Short-term Borrowings

The Company has the ability to obtain borrowed funds consisting of federal funds purchased, securities sold under agreements to repurchase (repurchase agreements) and Federal Home Loan Bank (FHLB) advances as alternatives to retail deposit funds. The Company has established collateralized and uncollateralized lines of credit with several correspondent banks, as well as a securities dealer, for the purpose of obtaining borrowed funds as needed. The Company may continue to borrow funds in the future as part of its asset/liability strategy, and may use these funds to acquire certain other assets as deemed appropriate by management for investment purposes and to better utilize the capital resources of the Bank. Federal funds purchased represent temporary overnight borrowings from correspondent banks and are generally unsecured. Repurchase agreements are collateralized by mortgage backed securities and securities of U.S. Government agencies, and generally have maturities of one to six months, but may have longer maturities if deemed appropriate as part of the Company's asset/liability management strategy. FHLB advances are collateralized by the Company's investment in FHLB stock, securities, and certain qualifying mortgage loans. In addition, the Company has the ability to obtain borrowings from the Federal Reserve Bank of San Francisco, which would be collateralized by certain pledged loans in the Company's loan portfolio. The lines of credit are subject to periodic review of the Company's financial statements by the grantors of the credit lines. Lines of credit may be modified or revoked at any time if the grantors feel there are adverse trends in the Company's financial position.

The Company had collateralized and uncollateralized lines of credit aggregating \$308.3 million and \$248.7 million, as well as FHLB lines of credit totaling \$28.0 million and \$10.7 million at December 31, 2006 and 2005, respectively. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR.

The table below provides further detail of the Company's federal funds purchased, repurchase agreements and FHLB advances for the years ended December 31, 2006, 2005 and 2004:

| (Dollars in thousands) | December 31, | | |
|------------------------------------|--------------|----------|--------|
| | 2006 | 2005 | 2004 |
| At period end: | | | |
| Federal funds purchased | \$ 0 | \$ 0 | \$ 0 |
| Repurchase agreements | 0 | 0 | 0 |
| FHLB advances | 0 | 0 | 0 |
| Total at period end | \$ 0 | \$ 0 | \$ 0 |
| Average ending interest rate total | 0.00% | 0.00% | 0.00% |
| Average for the year: | | | |
| Federal funds purchased | \$ 4,209 | \$ 1,331 | \$ 658 |
| Repurchase agreements | 0 | 0 | 0 |
| FHLB advances | 0 | 0 | 0 |

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| | | | |
|--|-----------|----------|----------|
| Total average for the year | \$ 4,209 | \$ 1,331 | \$ 658 |
| Average interest rate total | 5.30% | 3.32% | 1.92% |
| Maximum total borrowings outstanding at any month-end during the year: | | | |
| Federal funds purchased | \$ 17,100 | \$ 8,255 | \$ 6,480 |
| Repurchase agreements/FHLB advances | 0 | 0 | 0 |
| Total | \$ 17,100 | \$ 8,255 | \$ 6,480 |

Asset Quality and Allowance for Credit Losses

Lending money is the Company's principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Implicit in lending activities is the fact that losses will be experienced and that the amount of such losses will vary from time to time, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

The allowance for credit losses is maintained at a level deemed appropriate by management to provide for known and inherent risks in existing loans and commitments to extend credit. The adequacy of the allowance for credit losses is based upon management's continuing assessment of various factors affecting the collectibility of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The collectibility of a loan is subjective to some degree, but must relate to the borrower's financial condition, cash flow, quality of the borrower's management expertise, collateral and guarantees, and the state of the local economy. When determining the adequacy of the allowance for credit losses, the Company follows, in accordance with GAAP, the guidelines set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses (Statement) issued jointly by banking regulators during 2003, and updated and revised in 2006. The Statement outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was also released at this time which represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators.

The Company segments the loan and lease portfolio into eleven (11) segments, primarily by loan class and type, that have homogeneity and commonality of purpose and terms for analysis under SFAS No. 5. Those loans which are determined to be impaired under SFAS No. 114 are not subject to the general reserve analysis under SFAS No. 5, and evaluated individually for specific impairment. The eleven segments of the Company's loan portfolio are as follows (subtotals are provided as needed to allow the reader to reconcile the amounts to the Company's loan classification reported elsewhere in these financial statements):

| Loan Segments for Loan Loss Reserve Analysis (dollars in 000's) | | Loan Balance at December 31, | | | | |
|--|--|------------------------------|-------------------|-------------------|-------------------|-------------------|
| | | 2006 | 2005 | 2004 | 2003 | 2002 |
| 1 | Commercial and Business Loans | \$ 152,070 | \$ 109,783 | \$ 115,831 | \$ 107,068 | \$ 105,513 |
| 2 | Government Program Loans | 3,741 | 3,480 | 7,889 | 9,923 | 11,780 |
| | Total Commercial and Industrial | 155,811 | 113,263 | 123,720 | 116,991 | 117,293 |
| 3 | Commercial Real Estate Term Loans | 71,697 | 43,644 | 62,501 | 86,142 | 82,600 |
| 4 | Single Family Residential Loans | 39,184 | 43,308 | 21,567 | 5,240 | 7,827 |
| 5 | Home Improvement/Home Equity Loans | 2,732 | 2,551 | 4,119 | 4,999 | 9,990 |
| | Total Real Estate Mortgage | 113,613 | 89,503 | 88,187 | 96,381 | 100,417 |
| 6 | Total Real Estate Construction Loans | 168,378 | 162,873 | 137,523 | 97,930 | 95,024 |
| 7 | Total Agricultural Loans | 35,102 | 24,935 | 23,416 | 15,162 | 16,877 |
| 8 | Consumer Loans | 16,327 | 14,373 | 12,476 | 6,134 | 7,423 |
| 9 | Overdraft protection Lines | 82 | 102 | 117 | 142 | 167 |
| 10 | Overdrafts | 303 | 527 | 664 | 341 | 221 |
| | Total Installment/other | 16,712 | 15,002 | 13,257 | 6,617 | 7,811 |
| 11 | Total Lease Financing | 10,952 | 12,334 | 12,581 | 12,581 | 11,632 |
| | Total Loans | \$ 500,568 | \$ 417,910 | \$ 398,684 | \$ 345,662 | \$ 349,054 |

The Company's methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include:

- the formula allowance,
- specific allowances for problem graded loans (classified loans)

- and the unallocated allowance

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In addition, the allowance analysis also incorporates the results of measuring impaired loans as provided in:

- Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan and
- SFAS 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on the Company's historical loss experience and on the internal risk grade of those loans and, may be adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. Factors that may affect collectibility of the loan portfolio include:

Levels of, and trends in delinquencies and nonaccrual loans;

Trends in volumes and term of loans;

Effects of any changes in lending policies and procedures including those for underwriting, collection, charge-off, and recovery;

Experience, ability, and depth of lending management and staff;

National and local economic trends and conditions and;

Concentrations of credit that might affect loss experience across one or more components of the portfolio, including high-balance loan concentrations and participations.

Management determines the loss factors for problem-graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the past twelve quarters (three years) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the Company's loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications, which are pass, special mention, substandard, doubtful, and loss. Certain loans are homogenous in nature and are therefore pooled by risk grade. These homogenous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends, which if not corrected, could jeopardize repayment of the loan and result in further downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard, doubtful, and loss.

Loan participations are reviewed for allowance adequacy under the same guidelines as other loans in the Company's portfolio, with an additional participation factor added, if required, for specific risks associated with participations. In general, participations are subject to certain thresholds set by the Company, and are reviewed for geographic location as well as the well-being of the underlying agent bank.

The formula allowance includes reserves for certain off-balance sheet risks including letters of credit, unfunded loan commitments, and lines of credit. Reserves for undisbursed commitments are generally formula allocations based on the Company's historical loss experience and other loss factors, rather than specific loss contingencies. During 2006, 2005, and 2004, the Company classified reserves for off-balance sheet commitments totaling \$526,000, \$542,000, and \$507,000, respectively, as other liabilities pursuant to current accounting guidance. Prior to 2004, the reserves for these off-balance sheet commitments are included in the Company's allowance for credit losses, rather than a separate liability on the balance sheet because the reserve amounts are considered to be immaterial in relation to total liabilities. At December 31, 2006, 2005 and 2004 the formula reserve allocated to undisbursed commitments totaled \$526,000, \$542,000 and \$507,000, respectively.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in classified loans, impaired loans, and other loans in which management believes there is a probability that a loss has been incurred in excess of the amount determined by the application of the formula allowance. Specific allowance amounts include those calculated under SFAS No. 114. Under SFAS No. 114, for impaired loans, specific allowances are determined based on the collateralized value of the underlying properties, the net present value of the anticipated cash flows, or the market value of the underlying assets. Under SFAS No. 5, for classified loans excluding impaired loans, specific allowances, where required, are determined on the basis of additional risks involved with individual loans that may be in excess of risk factors associated with the loan portfolio as a whole. The specific allowance is different from the formula allowance in that the specific allowance is determined on a loan-by-loan basis based on risk factors directly related to a particular loan, as opposed to the formula allowance which is determined for a pool of loans with similar characteristics, based on past historical trends and other risk factors which may be relevant on an ongoing basis.

The unallocated portion of the allowance is the result of both expected and unanticipated changes in various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations,

and other business conditions.

The Company's methodology includes features that are intended to reduce the difference between estimated and actual losses. The specific allowance portion of the analysis is designed to be self-correcting by taking into account the current loan loss experience based on that portion of the portfolio. By analyzing the probable estimated losses inherent in the loan portfolio on a quarterly basis, management is able to adjust specific and inherent loss estimates using the most recent information available. In performing the periodic migration analysis, management believes that historical loss factors used in the computation of the formula allowance need to be adjusted to reflect current changes in market conditions and trends in the Company's loan portfolio. There are a number of other factors, which are reviewed when determining adjustments in the historical loss factors. They include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentration, and 10) other business conditions. There were no changes in estimation methods or assumptions during 2006 that affected the methodology for assessing the overall adequacy of the allowance for credit losses.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly and monthly basis, and through discussions and officer meetings as conditions change. The Company's Loan Committee meets weekly and serves as a forum to discuss specific problem assets that pose significant concerns to the Company, and to keep the Board of Directors informed through committee minutes. All special mention and classified loans are reported quarterly on Criticized Asset Reports, which are reviewed by senior management. With this information, the migration analysis and the impaired loan analysis are performed on a quarterly basis and adjustments are made to the allowance as deemed necessary.

The Company considers a loan to be impaired when, based upon current information and events, it believes it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include nonaccrual loans, restructured debt, and currently performing loans in which full payment of principal or interest is not expected. Management bases the measurement of these impaired loans on the fair value of the loan's collateral or the expected cash flows on the loans discounted at the loan's stated interest rates. Cash receipts on impaired loans not performing to contractual terms and that are on nonaccrual status are used to reduce principal balances. Impairment losses are included in the allowance for credit losses through a charge to the provision, if applicable. Impaired loans are measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary differences between impaired loans and nonperforming loans are: i) all loan categories are considered in determining nonperforming loans while impaired loan recognition is limited to commercial and industrial loans, commercial and residential real estate loans, construction loans, and agricultural loans, and ii) impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but also may include problem loans other than delinquent loans.

At December 31, 2006 and 2005, the Company's recorded investment in loans for which impairment has been recognized totaled \$8.9 million and \$12.9 million, respectively. Included in total impaired loans at December 31, 2006, are \$5.7 million of impaired loans for which the related specific allowance is \$4.1 million, as well as \$3.2 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. Total impaired loans at December 31, 2005 included \$10.6 million of impaired loans for which the related specific allowance is \$4.1 million, as well as \$2.3 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$10.1 million, \$15.9 million and \$16.6 million during the years ended December 31, 2006, 2005 and 2004, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method. For the years ended December 31, 2006 and 2005, the Company recognized income of \$65,000 and \$34,000, respectively, on such loans. For the year ended December 31, 2004, the Company recognized no income on such loans.

The Company focuses on competition and other economic conditions within its market area, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions creating pressure on loan pricing. With interest rates rising significantly since July 2004, the Federal Reserve perceived economic growth as strong, but with rates remaining level during the second half of 2006, indications are that rates may begin to decline sometime during the later part of 2007. Both business and consumer spending have improved during the past several years, with GDP currently ranging between 3.5% and 4.0%. It is difficult to determine how long the Federal Reserve will continue to adjust interest rates in an effort to influence the economy, however with the 125 basis point increase in the prime rate during the second half of 2004, an additional 200 basis point increase during 2005, and then four 25 basis point increases during 2006, it is predicted that we are near the end of an interest rate cycle. It is likely that the business environment in California will continue to be influenced by these domestic as well as global events. The local market has improved economically during the past several years while the rest of the state and the nation has experienced slowed economic growth. The local area residential housing markets continue to perform, which should bode well for sustained growth in the Company's market areas of Fresno and Madera, and Kern Counties, although there is some indication of slowing commercial and residential real estate markets in the area. Local unemployment rates remain high primarily as a result of the areas' agricultural dynamics, however unemployment rates have improved during the past several years. It is difficult to predict what impact this will have on the local economy. The Company believes that the Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain reasonable relative to other areas of the state, although this growth may begin to slow as higher interest rates dampen economic expansion. Management recognizes increased risk of loss due to the

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Company's exposure from local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

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The following table provides a summary of the Company's allowance for credit losses, provisions made to that allowance, and charge-off and recovery activity affecting the allowance for the years indicated.

| (Dollars in thousands) | December 31, | | | | |
|--|--------------|------------|------------|------------|------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Total loans outstanding at end of period before deducting allowances for credit losses | \$ 499,570 | \$ 417,156 | \$ 397,584 | \$ 344,797 | \$ 348,598 |
| Average net loans outstanding during period | \$ 469,959 | \$ 402,820 | \$ 374,748 | \$ 353,562 | \$ 347,192 |
| Balance of allowance at beginning of period | \$ 7,748 | \$ 7,251 | \$ 6,081 | \$ 5,556 | \$ 4,457 |
| Loans charged off: | | | | | |
| Real estate | 0 | 0 | 0 | 0 | 0 |
| Commercial and industrial | (290) | (323) | (14) | (1,080) | (659) |
| Lease financing | (164) | (364) | (496) | (161) | (238) |
| Installment and other | (48) | (86) | (80) | (33) | (36) |
| Total loans charged off | (502) | (773) | (590) | (1,274) | (933) |
| Recoveries of loans previously charged off: | | | | | |
| Real estate | 0 | 0 | 0 | 0 | 0 |
| Commercial and industrial | 195 | 108 | 82 | 61 | 37 |
| Lease financing | 1 | 3 | 29 | 25 | 31 |
| Installment and other | 43 | 54 | 25 | 0 | 1 |
| Total loan recoveries | 239 | 165 | 136 | 86 | 69 |
| Net loans charged off | (263) | (608) | (454) | (1,188) | (864) |
| Reclassification of off-balance sheet reserve | 0 | (35) | (507) | 0 | 0 |
| Reserve acquired in business acquisition | 0 | 0 | 986 | 0 | 0 |
| Provision charged to operating expense | 880 | 1,140 | 1,145 | 1,713 | 1,963 |
| Balance of allowance for credit losses at end of period | \$ 8,365 | \$ 7,748 | \$ 7,251 | \$ 6,081 | \$ 5,556 |
| Net loan charge-offs to total average loans | 0.06% | 0.15% | 0.12% | 0.34% | 0.25% |
| Net loan charge-offs to loans at end of period | 0.05% | 0.15% | 0.11% | 0.34% | 0.25% |
| Allowance for credit losses to total loans at end of period | 1.67% | 1.86% | 1.82% | 1.76% | 1.59% |
| Net loan charge-offs to allowance for credit losses | 3.14% | 7.85% | 6.26% | 19.54% | 15.55% |
| Net loan charge-offs to provision for credit losses | 29.89% | 53.33% | 39.65% | 69.35% | 44.01% |

Management believes that the 1.67% credit loss allowance to total loans at December 31, 2006 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that the economic conditions which may adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio. Management is not currently aware of any conditions that may adversely affect the levels of losses incurred in the Company's loan portfolio.

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Although the Company does not normally allocate the allowance for credit losses to specific loan categories, an allocation to the major categories has been made for the purposes of this report as set forth in the following table. The allocations are estimates based on the same factors as considered by management in determining the amount of additional provisions to the credit loss allowance and the overall adequacy of the allowance for credit losses.

| (Dollars in thousands) | 2006 | | 2005 | | 2004 | | 2003 | | 2002 | |
|---------------------------|---------------------------------|---------------|---------------------------------|---------------|---------------------------------|---------------|---------------------------------|---------------|---------------------------------|---------------|
| | Allowance for Loan Losses | % of Loans | Allowance for Loan Losses | % of Loans | Allowance for Loan Losses | % of Loans | Allowance for Loan Losses | % of Loans | Allowance for Loan Losses | % of Loans |
| Commercial and industrial | \$ 1,905 | 31.1% | \$ 1,397 | 27.1% | \$ 2,497 | 31.0% | \$ 1,755 | 33.9% | \$ 3,080 | 33.6% |
| Real estate mortgage | 619 | 22.7% | 330 | 21.4% | 386 | 22.1% | 508 | 27.9% | 803 | 28.9% |
| Real estate construction | 1,039 | 33.7% | 1,598 | 38.9% | 1,753 | 34.5% | 1,067 | 28.3% | 1,046 | 27.2% |
| Agricultural | 310 | 7.0% | 316 | 6.0% | 197 | 5.9% | 188 | 4.4% | 229 | 4.8% |
| Installment/other | 187 | 3.3% | 112 | 3.6% | 103 | 3.3% | 97 | 1.9% | 99 | 2.2% |
| Lease financing | 4,165 | 2.2% | 3,619 | 3.0% | 2,312 | 3.2% | 2,466 | 3.6% | 298 | 3.3% |
| Not allocated | 140 | | 376 | | 3 | | 0 | | 1 | |
| | \$ 8,365 | 100.0% | \$ 7,748 | 100.0% | \$ 7,251 | 100.0% | \$ 6,081 | 100.0% | \$ 5,556 | 100.0% |

During 2006, reserve allocations increased for commercial and industrial loans, leasing financing, real estate mortgage loans, and installment loans. As with prior years, the increase in reserve allocation for lease financing loans is the result of additional reserves allocated to a nonperforming lease portfolio (see discussion following). Increased reserve allocations for commercial and industrial loans are the result of increased loan volume, while increases in reserve allocations for real estate mortgage and installment loans are primarily the result of increases in substandard loans in those categories. Reserve allocations decreased for real estate construction loans as a result of significant decreases in the level of substandard loans in that category between December 31, 2005 and December 31, 2006.

Reserve allocations increased during 2005 for both leasing financing and agricultural loans. The increase in reserve allocation for lease financing loans is the result of additional reserves allocated to a nonperforming lease portfolio (see discussion following), while increases in reserve allocations for agricultural loans are the result of increases in substandard loans in that category. Reserve allocations decreased for commercial and industrial loans as a result of significant decreases in the level of substandard commercial and industrial loans between December 31, 2004 and December 31, 2005.

The increase in reserve allocations for lease financing loans since 2003 is the result of the nonperformance of a purchased lease portfolio. The Company purchased a schedule of payments collateralized by Surety Bonds and lease payments in September 2001 that have a current balance owing of \$5.4 million plus interest. The leases have been nonperforming since June of 2002. The impaired lease portfolio is on non-accrual status and has a specific allowance allocation of \$4.0 million and \$3.5 million allocated at December 31, 2006 and 2005, respectively, and a net carrying value of \$1.4 million at December 31, 2006. The specific allowance was determined based on an estimate of expected future cash flows.

The Company filed suit for recovery in September 2002 and shortly after, the Surety (guarantor) of the leases entered into court proceedings to discharge their guarantee based on the fact that many of the underlying leases were fraudulent. The Company, based upon advice from its counsel, does not believe it is probable the guarantors fraud defense will prevail and intends to vigorously pursue the guarantee.

Late in the third quarter of 2005 the Federal Judge in the proceeding issued an order on the Company s Motion for Judgment on the Pleadings. Under standard court procedural restraints for such motions, not all evidence can be considered. The conclusion of the order noted that the Company would prevail if certain evidence, not considered in the motion, can be introduced in a subsequent motion. The Company will submit documentation and evidence with the next motion that its legal counsel believes sufficient to prevail. The Judge ordered mediation and stayed further motions until mediation is completed. On January 5, 2006 the Company attended mediation. Although some progress was made, resolution of this matter was not concluded. The Company has filed a request with the court to submit a further motion and is awaiting a response from the court.

The guarantor is in a run-off program supervised by the Illinois Department of Insurance. Run-off programs allow companies to manage an orderly liquidation of assets and settlement of liabilities. A concern of the Company with the matters now before the court is the timing of the judicial process. At some point the Department of Insurance may take over management of the Surety and the Company believes this would

complicate and delay further the collection of amounts awarded by the court.

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The Company believes that under generally accepted accounting principles, a total loss of principal is not probable at this time and the specific allowance of \$4.0 million calculated for the impaired lease portfolio at December 31, 2006 under SFAS No. 114 is in accordance with GAAP.

During a regulatory examination in the fourth quarter of 2003, the lease portfolio in question was classified as doubtful by the Bank's regulators based upon state regulatory guidelines. California state statute No. 1951 requires that a credit, where interest is past due and unpaid for more than one year and is not well secured and not in the process of collection, be charged off. The regulators requested that the Bank charge-off the principal balance in the first or second quarter of 2004 for regulatory purposes if the judge had not made a ruling on the case by March 31, 2004 or, if a ruling had been made but no principal payments have been received by June 30, 2004. The court did not rule by March 31, 2004, and has not made a final ruling on the case at the time of this 10-K filing. As a result, effective March 31, 2004, the Company charged off the entire \$5.5 million principal balance for regulatory purposes. As a result of the regulatory charge-off, the Company carries a difference between its regulatory accounting principles (RAP) books and its generally accepted accounting principles (GAAP) books. The financial entries made for regulatory reporting purposes resulted in a \$5.5 million reduction in loan balances with a corresponding reduction in the reserve for credit losses. Additional provisions for credit losses of \$3.5 million were also required for regulatory accounting purposes, which resulted in a reduction of \$2.1 million in regulatory net income (net tax benefit of \$1.3 million) for the year ended December 31, 2004 as compared to the financial statements presented under GAAP in the Company's 2004 Annual Report on Form 10-K.

During 2003, the Company revised its methodology for allocating the total allowance for credit losses between the formula allowance and the specific allowance. Prior to 2003, the entire loan portfolio was reviewed under the guidelines set by SFAS No. 5 Accounting for Contingencies. In addition, those loans considered to be impaired were also reviewed under standards required by SFAS No. 114, and specific reserves were calculated under those guidelines. For purposes of allocating the formula allowance and the specific allowance, loans identified as impaired under SFAS No. 114 were allocated a formula reserve as calculated under SFAS No. 5, and an additional specific allowance if required under SFAS No. 114. As a result, a portion of the allowance for impaired loans might be included in the formula allowance as calculated under SFAS No. 5, and the remainder would be designated a specific allowance, so that the entire allowance for impaired loans would be adequate under SFAS No. 114. Effective June 2003, the Company segregated those loans considered impaired under SFAS No. 114 from the loan portfolio and analyzed the remainder of the loan portfolio under SFAS No. 5. Then loans considered impaired under SFAS No. 114 were reviewed separately for specific allowance allocation. As a result, all allowance reserves allocated to impaired loans are now considered specific reserves for purposes of the Company's evaluation of the adequacy of the allowance for credit losses, rather than a combination of formula allowance and specific allowance.

The following summarizes the Company's allowance for credit losses related to the specific, formula, and unallocated reserves for the year-ends shown (amounts shown prior to 2003 have been adjusted to reflect the revised methodology for allocating the total allowance between the formula allowance and the specific allowance as discussed above):

| | December 31, | | | | |
|----------------------------|--------------|----------|----------|----------|----------|
| <i>(Dollars in 000 \$)</i> | 2006 | 2005 | 2004 | 2003 | 2002 |
| Formula allowance | \$ 3,637 | \$ 2,976 | \$ 2,827 | \$ 3,737 | \$ 4,216 |
| Specific allowance | 4,588 | 4,396 | 4,421 | 2,344 | 1,339 |
| Unallocated allowance | 140 | 376 | 3 | 0 | 1 |
| Total allowance | \$ 8,365 | \$ 7,748 | \$ 7,251 | \$ 6,081 | \$ 5,556 |

The allowance for credit losses totaled \$8.4 million at December 31, 2006, and consisted of \$3.6 million in formula allowance, \$4.6 million in specific allowance, and \$140,000 in unallocated allowance. At December 31, 2006, \$4.0 million of the specific allowance was allocated to lease financing loans, and the remaining \$227,000, \$111,000, \$76,000, \$69,000 and \$58,000 were allocated to commercial real estate, agricultural, installment, commercial and industrial loans, and real estate construction loans, respectively. At December 31, 2005, the allowance for credit losses totaled \$7.7 million, and consisted of \$3.0 million in formula allowance, \$4.4 million in specific allowance, and \$376,000 in unallocated allowance. At December 31, 2005, \$3.5 million of the specific allowance was allocated to lease financing loans, and the remaining \$669,000, \$187,000 and \$83,000 were allocated to real estate construction loans, agricultural loans, and commercial and industrial loans, respectively. At December 31, 2004, the Company's allowance for credit losses was \$7.3 million, consisting of \$2.8 million in formula allowance, \$4.4 million in specific allowance, and \$3,000 in unallocated allowance. At December 31, 2004, \$1.3 million of the specific allowance was allocated to commercial and industrial loans, and the remaining \$2.1 million, \$955,000 and \$55,000 were allocated to lease financing loans, construction loans, and real estate mortgage loans, respectively.

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The total formula allowance increased approximately \$661,000 between 2005 and 2006, primarily as the result of increased volume in pass loans. There were only minor formula allowance allocation changes between loan categories occurring between December 31, 2005 and December 31, 2006, although the formula allowance for commercial and industrial loans increased nearly \$491,000 during 2006. Between December 31, 2005 and December 31, 2006, substandard loans decreased \$6.1 million, while special mention and doubtful loans increased \$5.3 million and \$5.5 million, respectively.

The total formula allowance increased approximately \$149,000 between 2004 and 2005, with only minor formula allowance allocation changes between loan categories occurring between December 31, 2004 and December 31, 2005. Although pass loans increased approximately \$28.4 million between December 31, 2004 and December 31, 2005, the overall formula allocation percentage dropped slightly as the result of adjustments to historical loss factors. Between December 31, 2004 and December 31, 2005, substandard loans and special mention loans decreased \$8.3 million and \$5.8 million, respectively.

Although in some instances, the downgrading of a loan resulting from the factors used by the Company in its allowance analysis has been reflected in the formula allowance, management believes that in some instances, the impact of material events and trends has not yet been reflected in the level of nonperforming loans or the internal risk grading process regarding these loans. Accordingly, the Company's evaluation of probable losses related to these factors may be reflected in the unallocated allowance. The evaluation of the inherent losses concerning these factors involve a higher degree of uncertainty because they are not identified with specific problem credits, and therefore the Company does not spread the unallocated allowance among segments of the portfolio. At December 31, 2006 the Company had an unallocated allowance of \$140,000, reflecting a decrease from the balance of \$376,000 at December 31, 2005, and an increase from the balance of \$3,000 at December 31, 2004. Management's estimates of the unallocated allowance are based upon a number of underlying factors including 1) the effect of deteriorating national and local economic trends, 2) the effects of export market conditions on certain agricultural and manufacturing borrowers, 3) the effects of abnormal weather patterns on agricultural borrowers, as well as other borrowers that may be impacted by such conditions, 4) the effect of increased competition in the Company's market area and the resultant potential impact of more relaxed underwriting standards to borrowers with multi-bank relationships, 5) the effect of soft real estate markets, and 6) the effects of having a larger number of borrowing relationships which are close to the Company's lending limit, any one of which were not to perform to contractual terms, would have a material impact on the allowance.

The Company's loan portfolio has concentrations in commercial real estate, commercial, and construction loans, however these portfolio percentages fall within the Company's loan policy guidelines.

It is the Company's policy to discontinue the accrual of interest income on loans for which reasonable doubt exists with respect to the timely collectibility of interest or principal due to the inability of the borrower to comply with the terms of the loan agreement. Such loans are placed on nonaccrual status whenever the payment of principal or interest is 90 days past due or earlier when the conditions warrant, and interest collected is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan. Management may grant exceptions to this policy if the loans are well secured and in the process of collection.

The following table sets forth the Company's nonperforming assets as of the dates indicated:

| <i>(Dollars in thousands, except footnote)</i> | December 31, | | | | |
|---|---------------------|-------------|-------------|-------------|-------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Nonaccrual loans (1) | \$ 8,138 | \$ 13,930 | \$ 16,682 | \$ 18,656 | \$ 15,432 |
| Restructured loans | 4,906 | 0 | 0 | 9 | 0 |
| Total nonperforming loans | 13,044 | 13,930 | 16,682 | 18,665 | 15,432 |
| Other real estate owned | 1,919 | 4,356 | 1,615 | 2,718 | 9,685 |
| Total nonperforming assets | \$ 14,963 | \$ 18,286 | \$ 18,297 | \$ 21,383 | \$ 25,117 |
| Loans, past due 90 days or more, still accruing | \$ 0 | \$ 0 | \$ 375 | \$ 0 | \$ 0 |
| Nonperforming loans to total gross loans | 2.61% | 3.33% | 4.18% | 5.40% | 4.42% |
| Nonperforming assets to total gross loans | 2.99% | 4.38% | 4.59% | 6.19% | 7.20% |

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- (1) There are no nonaccrual loans at December 31, 2006 and 2004, which are restructured. Included in nonaccrual loans at December 31, 2005 are restructured loans totaling \$5,114. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2006 in accordance with their original terms is approximately \$982,000.

The overall level of nonperforming assets declined between December 31, 2005 and December 31, 2006 primarily as the result of declines in other real estate owned. The decline in other real estate owned experienced during 2006 is the result of the partial sale of an OREO property during the third quarter of 2006. The Company incurred approximately \$2.2 million in disposal and cleanup costs related to this property during 2006. Nonaccrual loans declined between December 31, 2005 and December 31, 2006 as the result of a transfer of a single lending relationship from nonaccrual status to accrual status during the first quarter of 2006. The \$4.9 million loan, which was restructured during the first quarter of 2006 has been reclassified as such for reporting purposes.

The overall level of nonperforming assets remained level between December 31, 2004 and December 2005 totaling approximately \$18.3 million at both period-ends. While nonaccrual loans decreased \$2.8 million between the two periods, other real estate owned (OREO) increased \$2.7 million. Nonaccrual loans declined between the two periods as the result of nonperforming loans which were either sold, paid off, or charged off to the allowance for loan losses. A substantial portion of the nonaccrual loans at December 31, 2005 were collateralized by real estate. Although two significant OREO properties were sold during 2005, \$4.3 million of a \$6.1 million loan relationship which became nonperforming during 2005, was ultimately transferred to OREO during the third quarter of 2005 and included in the \$4.4 million balance at December 31, 2005. The remaining \$1.8 million of the nonperforming loan consisted of equipment and inventory, and was transferred to assets held for sale included in other assets on the Company's consolidated balance sheet.

The overall level of nonperforming assets has remained high since 2001, primarily as the result of a small number of large lending relationships, which have become nonperforming during that period. During 2001, three large relationships totaling approximately \$12.0 million were classified as nonaccrual, while approximately \$2.9 million in nonaccrual loans were transferred to other real estate owned through foreclosure. During 2002, \$5.0 million, representing one of the three large relationships that had become nonaccrual during the previous year, was foreclosed upon and transferred to other real estate owned through foreclosure. In addition during 2002, a nonperforming lease portfolio totaling \$5.5 million was taken to nonaccrual status. Nonperforming assets began to decline during 2004, remained stable through 2005, then again declined during 2006 as Management increased efforts to resolve nonperforming assets. Continued high levels of nonperforming assets have the potential to impact the future earnings growth of the Company, however Management believes that with stable nonperforming balances combined with prudent lending policies and adequate loan loss reserves, the Company will not experience any significant impact on earnings.

Loans past due more than 30 days are receiving increased management attention and are monitored for increased risk. The Company continues to move past due loans to nonaccrual status in its ongoing effort to recognize loan problems at an earlier point in time when they may be dealt with more effectively. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations and the allowance for credit losses is adjusted accordingly.

During February 2007, the Company determined that certain recent events had resulted in the deterioration of a land development loan with an outstanding principal balance of approximately \$6.0 million and accrued interest totaling \$865,000 at March 9, 2007. The loan is a shared appreciation credit, and as such, the Company has agreed to receive interest on the loan as lots are sold rather than monthly, and the borrower has agreed to share in the profits of the project. Interest is accrued and recognized in income on an ongoing basis. Shared appreciation profit is currently established at \$22,000 per lot. The amount can be changed by agreement of both parties. Due to the difficulty in calculating future values, shared appreciation income is recognized when received.

During October 2006, the Company approved the conversion of the existing loan made during January 2005 to an increased revolving line of credit to facilitate the completion of improvements on a 177-lot subdivision for which a final site map was in the process of approval, and to also provide for the building of 177 single-family residences. The existing loan was due to mature during February 2007. Funding for the project was to be provided in controlled stages based upon appropriate collateral values being created. The terms of the agreement, which included requirements for the modification and increases to the borrower, were minimum standards in the industry. Those requirements were presented to the borrower during October 2006.

The required information necessary to document and establish per lot/per unit cost controls was developed between the Company and the borrower during December 2006 and January 2007. During late January 2007, proposed revolving line of credit agreement was sent to the borrower for approval. Shortly thereafter, the borrower responded with a number of comments and requested changes to the agreement. During early February 2007, the Company reviewed the comments and requested changes to the agreement, acknowledging to the borrower that the Company would agree to certain changes, but would not comply with a number of the requested changes. During mid February 2007, the Company received notice that the borrower had filed a lawsuit for Breach of Contract, and Declaratory Relief and Accounting. The Company, through counsel, responded with notification to the borrower that the proposed revolving line of credit agreement was being terminated, and that the Company demanded payment in full on the matured loan by March 2, 2007. The Company did not receive payment in full on that date, and filed a notice of default on March 6, 2007.

The existing matured loan totaling \$6.0 million in principal and \$865,000 in accrued interest was moved to nonaccrual status during the second week of March 2007. Based upon the current appraised value of the property and the additional values estimated of the 177 completed lots, the Company has not reversed the accrued interest amount of \$865,000 from income. At this time, the Company believes that based upon such values, it will collect all principal and interest due on the loan.

Except for the loans included in the above table, and the land development loan discussed above, there were no loans at December 31, 2006 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

Liquidity and Asset/Liability Management

The primary function of asset/liability management is to provide adequate liquidity and maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities.

Liquidity

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2006 include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$336.4 million. The Company has maintained significant positive cash flows from operations over the past three years, which amounted to \$16.2 million, \$14.0 million, and \$9.6 million for the years ended December 31, 2006, 2005, and 2004, respectively.

Liquidity risk arises from the possibility the Company may not be able to satisfy current or future financial commitments, or the Company may become unduly reliant on alternative funding sources. The Company maintains a liquidity risk management policy to address and manage this risk. The policy identifies the primary sources of liquidity, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements, which comply with regulatory guidance. The liquidity position is continually monitored and reported on a monthly basis to the Board of Directors.

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to lines of credit from other banks totaling \$336.4 million, the contingency plan includes steps that may be taken in the event the total liquidity ratio falls or is projected to fall below 15% for any extended period of time. The Bank ALCO committee shall take steps to correct this condition using one or more of the following methods as needed:

- 1) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits.
- 2) Unsecured Fed Funds lines with correspondents may be used to fund short-term peaks in loan demand or deposit run-off. Other off-balance sheet funding sources such as credit lines at FHLB or the FRB may be used for longer periods.
- 3) The Bank will not rely on brokered money as a primary source of funds. However, it may be prudent to utilize brokered deposits particularly at times when the interest costs are lower than could be obtained in the local market. However, the sum of all brokered deposits will not exceed 15% of the total deposits of the Bank.
- 4) The Bank may elect to operate a Telemarketing Money Desk for the purpose of acquiring Certificates of Deposits from both the local market and national market. The Board of Directors and management recognize that deposits acquired through money desk operations may be considered a higher cost and more volatile type of deposit than traditional bank deposits.
- 5) Selling whole loans or participation in loans or by increasing the amounts sold in existing participation loans are additional means for increasing liquidity.

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- 6) The State of California Treasurer is a reliable source of deposits. The bank can typically accept CD s from this source up to 90% of equity as long as it has sufficient collateral pledged.
- 7) Marketing for CD s within our marketplace is another means for raising funds or through programs that post our rates on their Website, deposits from these sources should not exceed 15% of the banks total deposits for extended periods beyond 90 days without board approval.
- 8) Should the Bank become illiquid in spite of these steps, it will curtail its lending activities. The first step in this process will be to curtail credit marketing and tighten pricing guidelines. The second step will be to encourage loan payoffs on a selective basis where circumstances and loan documentation provide this opportunity. Only as a last resort will the Bank totally curtail lending activities to credit worthy customers.

The Company continues to utilize liability management, when needed, as part of its overall asset/liability management strategy. Through the discretionary acquisition of short term borrowings, the Company has been able to provide liquidity to fund asset growth while, at the same time, better utilizing its capital resources, and better controlling interest rate risk. The borrowings are generally short-term and more closely match the repricing characteristics of floating rate loans, which comprise approximately 59.5% of the Company s loan portfolio at December 31, 2006. This does not preclude the Company from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Company has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Company has the ability to utilize an asset management approach and, either control asset growth or, fund further growth with maturities or sales of investment securities.

The Company s liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell (reverse repos) and investment securities, is maintained at a level deemed sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company s highest yielding asset. At December 31, 2006, the Bank had 72.4% of total assets in the loan portfolio and a loan to deposit ratio of 85.1%. Liquid assets at December 31, 2006 include cash and cash equivalents totaling \$43.1 million as compared to \$63.0 million at December 31, 2005.

Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings. Core deposits, which comprise approximately 71.0% of total deposits at December 31, 2006, provide a significant and stable funding source for the Company. At December 31, 2006, unused lines of credit with the Federal Home Loan Bank and the Federal Reserve Bank totaling \$281.4 million are collateralized in part by certain qualifying loans in the Company s loan portfolio. The carrying value of loans pledged on these unused borrowing lines totaled \$381.5 million at December 31, 2006. For further discussion of the Company s borrowing lines, see Short Term Borrowings included in previously in the financial condition section of this financial review.

The liquidity of the parent company, United Security Bancshares, is primarily dependent on the payment of cash dividends by its subsidiary, United Security Bank, subject to limitations imposed by the Financial Code of the State of California. During 2006 and 2005, total dividends paid by the Bank to the parent company totaled \$7.3 million and \$5.0 million, respectively. As a bank holding company formed under the Bank Holding Act of 1956, United Security Bancshares is to provide a source of financial strength for its subsidiary bank(s). To help provide financial strength, United Security Bancshares trust subsidiary, United Security Bancshares Capital Trust I completed a \$15 million offering in Trust Preferred Securities during 2001, the proceeds of which were used to purchase Junior Subordinated Debentures of the Company. Of the \$14.5 million in net proceeds received by the Company, \$13.7 million in cash was contributed as capital to United Security Bank enhancing the liquidity and capital positions of the Bank, and the remainder provided liquidity to the holding company.

Contractual Obligations, Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements

The following table presents, as of December 31, 2006, the Company s significant fixed and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, or other similar carrying value adjustments. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

| <i>(In thousands)</i> | Payments Due In | | | | | Total |
|------------------------------------|-----------------|------------------|--------------------|---------------------|-----------------|------------|
| | Note Reference | One Year Or Less | One to Three Years | Three to Five Years | Over Five Years | |
| Deposits without a stated maturity | 6 | \$ 375,319 | \$ | \$ | \$ | \$ 375,319 |
| Time Deposits | 6 | 189,858 | 20,824 | 526 | 600 | 211,808 |
| Junior Subordinated Debt | 8 | | | | 15,464 | 15,464 |

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| | | | | | | |
|------------------|----|-----|-----|-----|-------|-------|
| Operating Leases | 12 | 209 | 418 | 434 | 1,502 | 2,563 |
| | | 47 | | | | |

A schedule of significant commitments at December 31, 2006 follows:

(In thousands)

| | |
|---|-----------|
| Commitments to extend credit: | |
| Commercial and industrial | \$ 57,298 |
| Real estate mortgage | 0 |
| Real estate construction | 110,536 |
| Agricultural | 14,845 |
| Installment | 5,233 |
| Revolving home equity and credit card lines | 254 |
| Standby letters of credit | 4,936 |

Further discussion of these commitments is included in Notes 3 and 12 to the consolidated financial statements.

Regulatory Matters

Capital Adequacy

Capital adequacy for bank holding companies and their subsidiary banks has become increasingly important in recent years. Continued deregulation of the banking industry since the 1980 s has resulted in, among other things, a broadening of business activities allowed beyond that of traditional banking products and services. Because of this volatility within the banking and financial services industry, regulatory agencies have increased their focus upon ensuring that banking institutions meet certain capital requirements as a means of protecting depositors and investors against such volatility.

During July 2001, the Company completed an offering of Trust Preferred Securities in an aggregate amount of \$15.0 million to enhance its regulatory base, while providing additional liquidity. Subsequent to the completion of the offering, the Company contributed \$13.7 million of that offering to the Bank to enhance its capital position. Under applicable regulatory guidelines, the Trust Preferred Securities qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital. Any additional portion will qualify as Tier 2 capital. As shareholders equity increases, the amount of Tier 1 capital that can be comprised of Trust Preferred Securities will increase.

The Board of Governors of the Federal Reserve System (Board of Governors) has adopted regulations requiring insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% Tier 1 capital to total assets. To be considered well capitalized, the institution must maintain a leverage capital ratio of 5%. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the minimum requirements.

The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and Tier 2 supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. The most highly rated insured institutions are required to maintain a minimum ratio of qualifying total capital to risk weighted assets of 8%, at least one-half (4%) of which must be in the form of Tier 1 capital. To be considered well capitalized, institutions must maintain a ratio of qualifying total capital to risk weighted assets of 10%, at least one-half (6%) of which must be in the form of Tier 1 capital.

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The following table sets forth the Company's and the Bank's actual capital positions at December 31, 2006 and the regulatory minimums for the Company and the Bank to be well capitalized under the guidelines discussed above:

| | <u>Company</u> | <u>Bank</u> | <u>Regulatory Minimums - Well Capitalized</u> |
|--|--------------------------------------|--------------------------------------|---|
| | <u>Actual Capital Ratios</u> | <u>Actual Capital Ratios</u> | |
| Total risk-based capital ratio | 13.85% | 13.52% | 10.00% |
| Tier 1 capital to risk-weighted assets | 12.72% | 12.39% | 6.00% |
| Leverage ratio | 11.55% | 11.23% | 5.00% |

Under Federal Reserve guidelines, the Company and the Bank are required to maintain a total risk-based capital ratio of 10%, tier 1 capital to risk-weighted assets of 8%, and a leverage ratio of 7%, to be considered well capitalized. As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at December 31, 2006. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

Dividends

Dividends paid to shareholders by the Company are subject to restrictions set forth in the California General Corporation Law. The California General Corporation Law provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal to the amount of the proposed distribution. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank. During the year ended December 31, 2006, the Company received \$7.3 million in cash dividends from the Bank, from which the Company declared \$5.2 million in dividends to shareholders.

The Bank as a state-chartered bank is subject to dividend restrictions set forth in California state banking law, and administered by the California Commissioner of Financial Institutions (the Commissioner). Under such restrictions, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the Commissioner, in an amount not exceeding the Bank's net income for its last fiscal year or the amount of its net income for the current fiscal year. Such restrictions do not apply to stock dividends, which generally require neither the satisfaction of any tests nor the approval of the Commissioner. Notwithstanding the foregoing, if the Commissioner finds that the shareholders' equity is not adequate or that the declarations of a dividend would be unsafe or unsound, the Commissioner may order the state bank not to pay any dividend. The FRB may also limit dividends paid by the Bank. This is not the case with the Bank. Year-to-date dividends of \$5.2 million and \$7.3 million paid to shareholders and the Company, respectively, through December 31, 2006 were well within the maximum allowed under those regulatory guidelines, and did not require prior approval of the Commissioner.

Stock Repurchase Plan (all figures have been restated to reflect effect of 2-for-1 stock split during May 2006)

| | For the Quarters Ended | | | | |
|---------------------------|-------------------------------|-----------------|----------------------|---------------------|------------|
| | <u>March 31,</u> | <u>June 30,</u> | <u>September 30,</u> | <u>December 31,</u> | <u>YTD</u> |
| Shares repurchased - 2006 | 84 | 13,121 | 84,215 | 10,585 | 108,005 |
| Average price paid - 2006 | \$ 16.57 | \$ 23.13 | \$ 22.21 | \$ 24.58 | \$ 22.55 |
| Shares repurchased - 2005 | 7,152 | 4,936 | 0 | 14,074 | 26,162 |
| Average price paid - 2005 | \$ 12.28 | \$ 12.78 | \$ | \$ 16.16 | \$ 14.46 |
| Shares repurchased - 2004 | 19,800 | 109,490 | 45,986 | 3,564 | 178,840 |
| Average price paid - 2004 | \$ 12.85 | \$ 11.41 | \$ 11.29 | \$ 12.11 | \$ 11.55 |
| Shares repurchased - 2003 | 33,226 | 14,696 | 22,000 | 0 | 69,922 |
| Average price paid - 2003 | \$ 8.54 | \$ 10.80 | \$ 11.32 | N/A | \$ 9.89 |
| Shares repurchased - 2002 | 45,552 | 24,600 | 4,000 | 55,200 | 129,352 |
| Average price paid - 2002 | \$ 8.37 | \$ 8.51 | \$ 8.62 | \$ 8.76 | \$ 8.57 |

During August 2001, the Company's Board of Directors approved a plan to repurchase, as conditions warrant, up to 280,000 shares (effectively 580,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. The duration of the program is open-ended and the timing of the purchases will depend on market conditions. During the years ended December 31, 2003 and 2002, the Company repurchased 34,961 (69,922 effected for 2006 stock split) and 64,676 (129,352 effected for 2006 stock split) for a total of \$691,000 and \$1.1 million, respectively. The repurchased shares were subsequently retired.

On February 25, 2004, the Company announced another stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares (effectively 553,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. As with the first plan, the duration of the new program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Board terminated the 2001 repurchase plan. During the year ended December 31, 2005, 13,081 shares (26,162 shares effected for 2006 2-for-1 stock split) were repurchased at a total cost of \$377,000 and an average price per share of \$28.92 (\$14.46 effected for 2006 2-for-1 stock split). During the year ended December 31, 2006, 108,005 shares were repurchased at a total cost of \$2.4 million and an average price per share of \$22.55.

Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2006 the Bank's qualifying balance with the Federal Reserve was approximately \$25,000.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity and Market Risk

An interest rate-sensitive asset or liability is one that, within a defined time period, either matures or is subject to interest rate adjustments as market rates of interest change. Interest rate sensitivity is the measure of the volatility of earnings from movements in market rates of interest, which is generally reflected in interest rate spread. As interest rates change in the market place, yields earned on assets do not necessarily move in tandem with interest rates paid on liabilities. Interest rate sensitivity is related to liquidity in that each is affected by maturing assets and sources of funds. Interest rate sensitivity is also affected by assets and liabilities with interest rates that are subject to change prior to maturity.

The object of interest rate sensitivity management is to minimize the impact on earnings from interest rate changes in the marketplace. In recent years, deregulation, causing liabilities to become more interest rate sensitive, combined with interest rate volatility in the capital markets, has placed additional emphasis on this principal. When management decides to maintain repricing imbalances, it usually does so on the basis of a well-conceived strategy designed to ensure that the risk is not excessive and that liquidity is properly maintained. The Company's interest rate risk management is the responsibility of the Asset/Liability Management Committee (ALCO), which reports to the Board of Directors on a periodic basis, pursuant to established operating policies and procedures.

As part of its overall risk management, the Company pursues various asset and liability management strategies, which may include obtaining derivative financial instruments to mitigate the impact of interest fluctuations on the Company's net interest margin. During the second quarter of 2003, the Company entered into an interest rate swap agreement with the purpose of minimizing interest rate fluctuations on its interest rate margin and equity.

Under the interest rate swap agreement, the Company receives a fixed rate and pays a variable rate based on the Prime Rate (Prime). The swap qualifies as a cash flow hedge under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, and is designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement is measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that is deemed effective in hedging the cash flows of the designated assets are recorded in accumulated other comprehensive income and reclassified into interest income when such cash flow occurs in the future. Any ineffectiveness resulting from the hedge is recorded as a gain or loss in the consolidated statement of income as part of noninterest income. The amortizing hedge has a remaining notional value of \$14.1 million and duration of approximately 12 months. As of December 31, 2006, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately 1.8 years. As of December 31, 2006, the loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$147,000 (net of tax benefit of \$138,000). During the year ended December 31, 2006, \$494,000 was reclassified from other accumulated comprehensive income as a reduction to interest income.

The Company has performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2006. As a result of a correlation analysis, the Company has determined that the swap remains highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continues to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. As a result, the notional value of the hedge instrument was approximately \$3.8 million greater than the underlying loans being hedged at June 30, 2006, \$3.3 million greater than the underlying loans being hedged at September 30, 2006, and \$3.3 million greater than the underlying loans being hedged at December 31, 2006. This difference between the notional value of the hedge and the underlying hedged assets is considered an overhedge pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than temporary. At June 30, 2006, the Company determined that the difference was other than temporary and, as a result, reclassified \$147,000 of the pretax hedge loss reported in other comprehensive income into earnings. During the third quarter of 2006, the Company adjusted the pretax loss reported in other comprehensive income by \$53,000 resulting in a year-to-date loss related to swap ineffectiveness of \$94,000 reported in earnings at September 30, 2006. Then, as a result of the fourth quarter analysis for ineffectiveness, the Company adjusted the pretax loss reported in other comprehensive income by \$19,000 resulting in a net year-to-date loss related to swap ineffectiveness of \$75,000 reported in earnings at December 31, 2006. The ineffective amount reclassified from other comprehensive income into earnings was based upon the difference between the net present value of the anticipated cash flows using the notional value of the hedge, and the net present value of anticipated cash flows using the remaining balances of the underlying loans being hedged. The \$75,000 in expense recognized as hedge ineffectiveness is reflected in noninterest income as of December 31, 2006.

Interest rate risk can be measured through various methods including gap, duration and market value analysis as well as income simulation models, which provides a dynamic view of interest rate sensitivity based on the assumptions of the Company's Management. The Company employs each of these methods and refines these processes to make the most accurate measurements possible. The information provided by these calculations is the basis for management decisions in managing interest rate risk.

From the Gap report below, the Company is apparently subject to interest rate risk to the extent that its assets have the potential to reprice more quickly than its liabilities within the next year. At December 31, 2006, the Company had a cumulative 12-month Gap of \$14.3 million or 2.4% of total earning assets. Management believes the Gap analysis shown below is not entirely indicative of the Company's actual interest rate sensitivity, because certain interest-sensitive liabilities would not reprice to the same degree as interest-sensitive assets. For example, if the prime rate were to change by 50 basis points, the floating rate loans included in the \$298.3 million immediately adjustable category would change by the full 50 basis points. Interest bearing checking and savings accounts which are also included in the immediately adjustable column probably would move only a portion of the 50 basis point rate change and, in fact, might not even move at all. The effects of market value risk have been mitigated to some degree by the makeup of the Bank's balance sheet. Loans are generally short-term or are floating-rate instruments. At December 31, 2006, \$385.5 million or 78.3% of the loan portfolio matures or reprices within one year, and only 2.6% of the portfolio matures or reprices in more than 5 years.

Total investment securities including call options and prepayment assumptions, have a combined duration of approximately 1.4 years. Nearly \$434.5 million or 98.0% of interest-bearing liabilities mature or can be repriced within the next 12 months, even though the rate elasticity of deposits with no defined maturities may not necessarily be the same as interest-earning assets.

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The following table sets forth the Company's gap, or estimated interest rate sensitivity profile based on ending balances as of December 31, 2006, representing the interval of time before earning assets and interest-bearing liabilities may respond to changes in market rates of interest. Assets and liabilities are categorized by remaining interest rate maturities rather than by principal maturities of obligations.

Maturities and Interest Rate Sensitivity

| December 31, 2006 | | | | | | |
|---|-------------------|--|--|---|------------------------|-------------------|
| (In thousands) | Immediately | Next Day But Within Three Months | After Three Months Within 12 Months | After One Year But Within Five Years | After Five Years | Total |
| Interest Rate Sensitivity Gap: | | | | | | |
| Loans (1) | \$ 298,269 | \$ 35,893 | \$ 51,372 | \$ 94,091 | \$ 12,805 | \$ 492,430 |
| Investment securities | | 26,760 | 22,029 | 32,638 | 1,939 | 83,366 |
| Interest bearing deposits in other banks | | | 198 | 5,836 | 1,859 | 7,893 |
| Federal funds sold and reverse repos | 14,297 | | | | | 14,297 |
| Total earning assets | \$ 312,566 | \$ 62,653 | \$ 73,599 | \$ 132,565 | \$ 16,603 | \$ 597,986 |
| Interest-bearing transaction accounts | 184,384 | | | | | 184,384 |
| Savings accounts | 31,933 | | | | | 31,933 |
| Time deposits (2) | 18,799 | 120,167 | 63,746 | 8,632 | 464 | 211,808 |
| Federal funds purchased/other borrowings | 0 | | | | | 0 |
| Trust Preferred securities | | 15,464 | | | | 15,464 |
| Total interest-bearing liabilities | \$ 235,116 | \$ 135,631 | \$ 63,746 | \$ 8,632 | \$ 464 | \$ 443,589 |
| Interest rate sensitivity gap | \$ 77,450 | \$ -72,978 | \$ 9,853 | \$ 123,933 | \$ 16,139 | \$ 154,397 |
| Cumulative gap | \$ 77,450 | \$ 4,472 | \$ 14,325 | \$ 138,258 | \$ 154,397 | |
| Cumulative gap percentage to Total earning assets | 13.0% | 0.7% | 2.4% | 23.1% | 25.8% | |

(1) Loan balance does not include nonaccrual loans of \$8.138 million.

(2) See above for discussion of the impact of floating rate CD's.

The Company utilizes a vendor-purchased simulation model to analyze net interest income sensitivity to movements in interest rates. The simulation model projects net interest income based on a 100, 200, and 300 basis point rise and a 100, 200, and 300 basis point fall in interest rates ramped over a twelve-month period, with net interest impacts projected out as far as twenty-four months. In addition, a most likely scenario is projected based upon expected rate changes over the 24-month period. The model is based on the actual maturity and repricing characteristics of the Company's interest-sensitive assets and liabilities. The model incorporates assumptions regarding the impact of changing interest rates on the prepayment of certain assets and liabilities. Projected net interest income is calculated assuming customers will reinvest maturing deposit accounts and the Company will originate new loans. The balance sheet growth assumptions utilized correspond closely to the Company's strategic growth plans and annual budget. Excess cash is invested in overnight funds or other short-term investments such as U.S. Treasuries. Cash shortfalls are covered through additional borrowing of overnight or short-term funds. The Board of Directors has adopted an interest rate risk policy which establishes maximum decreases in net interest income of 12% and 15% in the event of a 100 BP and 200 BP increase or decrease in market interest rates over a twelve month period. Based on the information and assumptions utilized in the simulation model at December 31, 2006, the resultant projected impact on net interest income falls within policy limits set by the Board of Directors for all rate scenarios simulated.

The Company also utilizes the same vendor-purchased simulation model to project the impact of changes in interest rates on the underlying market value of all the Company's assets, liabilities, and off-balance sheet accounts under alternative interest rate scenarios. The resultant net value, as impacted under each projected interest rate scenario, is referred to as the market value of equity (MV of Equity). This technique captures the interest rate risk of the Company's business mix across all maturities. The market analysis is performed using an immediate rate shock of 100, 200, and 300 basis points up and down calculating the present value of expected cash flows under each rate environment at applicable discount rates. The market value of loans is calculated by discounting the expected future cash flows over either the term to maturity

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for fixed rate loans or scheduled repricing for floating rate loans using the current rate at which similar loans would be made to borrowers with similar credit ratings. The market value of investment securities is based on quoted market prices obtained from reliable independent brokers. The market value of time deposits is calculated by discounting the expected cash flows using current rates for similar instruments of comparable maturities. The market value of deposits with no defined maturities, including interest-bearing checking, money market and savings accounts is calculated by discounting the expected cash flows at a rate equal to the difference between the cost of these deposits and the alternate use of the funds, federal funds in this case. Assumed maturities for these deposits are estimated using decay analysis and are generally assumed to have implied maturities of less than five years. For noninterest sensitive assets and liabilities, the market value is equal to their carrying value amounts at the reporting date. The Company's interest rate risk policy establishes maximum decreases in the Company's market value of equity of 12% and 15% in the event of an immediate and sustained 100 BP and 200 BP increase or decrease in market interest rates. As shown in the table below, the percentage changes in the net market value of the Company's equity are within policy limits for both rising and falling rate scenarios.

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The following sets forth the analysis of the Company's market value risk inherent in its interest-sensitive financial instruments as they relate to the entire balance sheet at December 31, 2006 and December 31, 2005 (\$ in thousands). Fair value estimates are subjective in nature and involve uncertainties and significant judgment and, therefore, cannot be determined with absolute precision. Assumptions have been made as to the appropriate discount rates, prepayment speeds, expected cash flows and other variables. Changes in these assumptions significantly affect the estimates and as such, the obtained fair value may not be indicative of the value negotiated in the actual sale or liquidation of such financial instruments, nor comparable to that reported by other financial institutions. In addition, fair value estimates are based on existing financial instruments without attempting to estimate future business.

| Change in Rates | December 31, 2006 | | | December 31, 2005 | | |
|-----------------|------------------------|---------------------------|--------------------------|------------------------|---------------------------|--------------------------|
| | Estimated MV of Equity | Change in MV of Equity \$ | Change in MV Of Equity % | Estimated MV of Equity | Change in MV of Equity \$ | Change in MV Of Equity % |
| + 200 BP | \$ 90,317 | \$ 912 | 1.02% | \$ 76,643 | \$ (519) | -0.67% |
| + 100 BP | 90,524 | 1,118 | 1.25% | 76,202 | (960) | -1.24% |
| 0 BP | 89,406 | 0 | 0.00% | 77,162 | 0 | 0.00% |
| - 100 BP | 87,291 | (2,115) | -2.37% | 72,918 | (4,244) | -5.50% |
| - 200 BP | 84,278 | (5,128) | -5.74% | 70,587 | (6,575) | -8.52% |

Item 8 - Financial Statements and Supplementary Data

Index to Consolidated Financial Statements:

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Moss Adams LLP
Certified Public Accountants

Report of Independent Registered Public Accounting Firm

To the Board of Directors
United Security Bancshares

We have audited the accompanying consolidated balance sheets of United Security Bancshares and Subsidiaries (Company) as of December 31, 2006 and 2005, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. We also have audited management's assessment included in the accompanying *Management's Report on Internal Control over Financial Reporting* that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in the Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with auditing 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 and whether effective internal control over financial reporting was maintained in all material respects. 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide 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, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of United Security Bancshares and Subsidiaries as of December 31, 2006 and 2005, and the results of their operations and cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that United Security Bancshares and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2006 is fairly stated, in all material respects, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, United Security Bancshares and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ Moss Adams LLP

Stockton, California
March 15, 2007

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets
December 31, 2006 and 2005

| | December 31, | |
|---|-------------------|-------------------|
| | 2006 | 2005 |
| <i>(in thousands except shares)</i> | | |
| Assets | | |
| Cash and due from banks | \$ 28,771 | \$ 27,915 |
| Federal funds sold | 14,297 | 35,115 |
| Cash and cash equivalents | 43,068 | 63,030 |
| Interest-bearing deposits in other banks | 7,893 | 7,656 |
| Investment securities available for sale at fair value | 83,366 | 95,236 |
| Loans and leases | 500,568 | 417,910 |
| Unearned fees | (999) | (753) |
| Allowance for credit losses | (8,365) | (7,748) |
| Net loans | 491,204 | 409,409 |
| Accrued interest receivable | 4,237 | 3,394 |
| Premises and equipment - net | 15,302 | 11,028 |
| Other real estate owned | 1,919 | 4,356 |
| Intangible assets | 2,264 | 2,801 |
| Goodwill | 750 | 750 |
| Cash surrender value of life insurance | 13,668 | 13,529 |
| Investment in limited partnership | 3,564 | 3,963 |
| Deferred income taxes | 5,307 | 5,194 |
| Other assets | 5,772 | 8,513 |
| Total assets | \$ 678,314 | \$ 628,859 |
| Liabilities & Shareholders Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing | \$ 159,002 | \$ 153,113 |
| Interest bearing | 428,125 | 393,347 |
| Total deposits | 587,127 | 546,460 |
| Other borrowings | 0 | 0 |
| Accrued interest payable | 2,477 | 1,875 |
| Accounts payable and other liabilities | 7,204 | 6,046 |
| Junior subordinated debt | 15,464 | 15,464 |
| Total liabilities | 612,272 | 569,845 |
| Commitments and Contingent Liabilities | | |
| Shareholders Equity | | |
| Common stock, no par value 20,000,000 shares authorized, 11,301,113 and 11,361,118 issued and outstanding, in 2006 and 2005, respectively | 20,448 | 22,084 |
| Retained earnings | 46,884 | 38,682 |
| Accumulated other comprehensive loss | (1,290) | (1,752) |
| Total shareholders equity | 66,042 | 59,014 |
| Total liabilities and shareholders equity | \$ 678,314 | \$ 628,859 |

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Income and Comprehensive Income
Years Ended December 31, 2006, 2005 and 2004

(in thousands except shares and EPS)

| | 2006 | 2005 | 2004 |
|--|------------------|------------------|-----------------|
| Interest Income | | | |
| Loans, including fees | \$ 42,902 | \$ 33,078 | \$ 26,684 |
| Investment securities - AFS taxable | 3,254 | 4,163 | 3,433 |
| Investment securities - AFS nontaxable | 108 | 112 | 123 |
| Federal funds sold and securities purchased under agreements to resell | 768 | 1,237 | 324 |
| Interest on deposits in other banks | 324 | 308 | 310 |
| Total interest income | 47,356 | 38,898 | 30,874 |
| Interest Expense | | | |
| Interest on deposits | 12,597 | 8,523 | 5,588 |
| Interest on other borrowed funds | 1,578 | 1,135 | 845 |
| Total interest expense | 14,175 | 9,658 | 6,433 |
| Net Interest Income Before Provision for Credit Losses | 33,181 | 29,240 | 24,441 |
| Provision for Credit Losses | 880 | 1,140 | 1,145 |
| Net Interest Income | 32,301 | 28,100 | 23,296 |
| Noninterest Income | | | |
| Customer service fees | 3,779 | 4,399 | 4,311 |
| Gain on sale of securities | 27 | 163 | 35 |
| Gain (loss) on sale of other real estate owned | 50 | 325 | (98) |
| Proceeds from life insurance | 482 | 0 | 0 |
| Loss on swap ineffectiveness | (75) | 0 | 0 |
| Gain on sale of investment | 1,877 | 0 | 0 |
| Gain (loss) on sale of fixed assets | 1,018 | (5) | 7 |
| Shared appreciation income | 567 | 393 | 8 |
| Other | 1,306 | 1,005 | 479 |
| Total noninterest income | 9,031 | 6,280 | 4,742 |
| Noninterest Expense | | | |
| Salaries and employee benefits | 9,915 | 8,046 | 6,663 |
| Occupancy expense | 2,556 | 2,327 | 2,197 |
| Data processing | 470 | 624 | 659 |
| Professional fees | 998 | 1,234 | 1,236 |
| Director fees | 222 | 210 | 192 |
| Amortization of intangibles | 537 | 537 | 470 |
| Correspondent bank service charges | 204 | 359 | 318 |
| Writedown on investment | 0 | 702 | 0 |
| Writedown on other real estate owned | 0 | 0 | 35 |
| Loss in equity of limited partnership | 440 | 458 | 395 |
| Expense on other real estate owned | 2,193 | 38 | 85 |
| Other | 2,402 | 2,447 | 2,417 |
| Total noninterest expense | 19,937 | 16,982 | 14,667 |
| Income Before Provision for Taxes on Income | 21,395 | 17,398 | 13,371 |
| Provision for Taxes on Income | 8,035 | 6,390 | 4,966 |
| Net Income | \$ 13,360 | \$ 11,008 | \$ 8,405 |
| Other comprehensive income, net of tax | | | |
| Unrealized income (loss) on available for sale securities, interest rate swaps, and unrecognized post-retirement costs - net income tax (benefit) of \$269, (\$733), and (\$535), respectively | 462 | (854) | (928) |
| Comprehensive Income | \$ 13,822 | \$ 10,154 | \$ 7,477 |

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| Net Income per common share | | | | |
|--|----|------------|------------|------------|
| Basic | \$ | 1.18 | \$ 0.97 | \$ 0.75 |
| Diluted | \$ | 1.17 | \$ 0.96 | \$ 0.74 |
| Weighted shares on which net income per common share were based | | | | |
| Basic | | 11,344,385 | 11,369,848 | 11,260,512 |
| Diluted | | 11,462,313 | 11,453,152 | 11,334,486 |

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2006

| <i>(in thousands except shares)</i> | Common stock Number of Shares | Amount | Retained Earnings | Unearned ESOP Shares | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-------------------------------------|-----------|----------------------|-------------------------|--|-----------|
| Balance January 1, 2004 | 11,025,076 | \$ 18,227 | \$ 27,093 | \$ (313) | \$ 29 | \$ 45,036 |
| Director/Employee stock options exercised | 10,000 | 86 | | | | 86 |
| Tax benefit of stock options exercised | | 11 | | | | 11 |
| Net changes in unrealized gain on available for sale securities (net of income tax benefit of \$484) | | | | | (726) | (726) |
| Net changes in unrealized loss on interest rate swaps (net of income tax benefit of \$51) | | | | | (201) | (201) |
| Dividends on common stock (\$0.32 per share) | | | (3,619) | | | (3,619) |
| Issuance of shares for business combination | 482,894 | 6,033 | | | | 6,033 |
| Repurchase and retirement of common shares | (178,840) | (2,058) | | | | (2,058) |
| Release of unearned ESOP shares | 28,458 | 23 | | 246 | | 269 |
| Net Income | | | 8,405 | | | 8,405 |
| Balance December 31, 2004 | 11,367,588 | 22,322 | 31,879 | (67) | (898) | 53,236 |
| Director/Employee stock options exercised | 12,000 | 118 | | | | 118 |
| Tax benefit of stock options exercised | | 13 | | | | 13 |
| Net changes in unrealized gain on available for sale securities (net of income tax benefit of \$709) | | | | | (1,064) | (1,064) |
| Net changes in unrealized loss on interest rate swaps (net of income tax benefit of \$24) | | | | | 210 | 210 |
| Dividends on common stock (\$0.37 per share) | | | (4,205) | | | (4,205) |
| Repurchase and retirement of common shares | (26,162) | (377) | | | | (377) |
| Release of unearned ESOP shares | 7,692 | 8 | | 67 | | 75 |
| Net Income | | | 11,008 | | | 11,008 |
| Balance December 31, 2005 | 11,361,118 | 22,084 | 38,682 | 0 | (1,752) | 59,014 |
| Director/Employee stock options exercised | 48,000 | 335 | | | | 335 |
| Tax benefit of stock options exercised | | 217 | | | | 218 |
| Net changes in unrealized loss on available for sale securities (net of income tax of \$242) | | | | | 363 | 363 |
| Net changes in unrealized loss on interest rate swaps (net of income tax of \$140) | | | | | 268 | 268 |
| Adjustment to initially apply SFAS No. 158 (net of income tax benefit of \$112) | | | | | (169) | (169) |
| Dividends on common stock (\$0.445 per share) | | | (5,158) | | | (5,158) |
| Repurchase and retirement of common shares | (108,005) | (2,436) | | | | (2,437) |
| Stock-based compensation expense | | 248 | | | | 248 |
| Net Income | | | 13,360 | | | 13,360 |
| Balance December 31, 2006 | 11,301,113 | \$ 20,448 | \$ 46,884 | \$ 0 | \$ (1,290) | \$ 66,042 |

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Cash Flows
Years December 31, 2006, 2005 and 2004

| <i>(in thousands)</i> | 2006 | 2005 | 2004 |
|--|-----------------|-----------------|-----------------|
| Cash Flows From Operating Activities: | | | |
| Net income | \$ 13,360 | \$ 11,008 | \$ 8,405 |
| Adjustments to reconcile net earnings to cash provided by operating activities: | | | |
| Provision for credit losses | 880 | 1,140 | 1,145 |
| Depreciation and amortization | 1,658 | 1,459 | 1,297 |
| (Accretion) amortization of investment securities | (70) | (74) | 37 |
| Gain on sale of securities | (27) | (163) | (35) |
| Gain on sale of stock | (1,877) | 0 | 0 |
| Increase in accrued interest receivable | (843) | (871) | (185) |
| Increase in accrued interest payable | 602 | 709 | 358 |
| Increase (decrease) in unearned fees | 246 | (346) | 327 |
| (Decrease) increase in income taxes payable | (245) | 575 | (1,647) |
| Excess tax benefits from stock-based payment arrangements | (1) | 0 | 0 |
| Stock-based compensation expense | 248 | 0 | 0 |
| Deferred income taxes | (382) | 86 | (877) |
| Decrease in accounts payable and accrued liabilities | 1,290 | 229 | 149 |
| Write-down of other investments | 0 | 702 | 0 |
| Write-down of other real estate owned | 0 | 0 | 35 |
| (Gain) loss on sale of other real estate owned | (50) | (325) | 98 |
| Loss on swap ineffectiveness | 75 | 0 | 0 |
| Income from life insurance proceeds | (482) | 0 | 0 |
| (Gain) loss on sale of assets | (1,018) | 5 | (7) |
| Decrease (increase) in surrender value of life insurance | 88 | (379) | (252) |
| Loss in limited partnership interest | 440 | 458 | 395 |
| Net decrease (increase) in other assets | 2,269 | (214) | 357 |
| Net cash provided by operating activities | 16,161 | 13,999 | 9,600 |
| Cash Flows From Investing Activities: | | | |
| Net (increase) decrease in interest-bearing deposits with banks | (237) | (227) | 975 |
| Purchases of available-for-sale securities | 0 | (4,804) | (55,552) |
| Net redemption (purchase) of FHLB/FRB and other bank stock | 51 | (267) | (1,038) |
| Maturities, calls, and principal payments on available-for-sale securities | 12,571 | 13,486 | 24,126 |
| Proceeds from sales of available-for-sale securities | 0 | 6,795 | 10,923 |
| Investment in limited partnership | 0 | (126) | 0 |
| Proceeds from sale of investment in title company | 149 | 527 | 0 |
| Premiums paid on life insurance | (227) | (579) | (9,000) |
| Net increase in loans | (84,795) | (25,971) | (28,238) |
| Cash and equivalents received in bank acquisitions, net of assets and liabilities acquired | 0 | 0 | 15,383 |
| Cash proceeds from sale of correspondent bank stock | 2,607 | 0 | 0 |
| Cash proceeds from sales of foreclosed leased assets | 1,946 | 258 | 192 |
| Cash proceeds from sales of other real estate owned | 2,487 | 1,895 | 970 |
| Capital expenditures for premises and equipment | (5,880) | (3,857) | (2,779) |
| Cash proceeds from sales of premises and equipment | 1,520 | 21 | 26 |
| Net cash used in investing activities | (69,808) | (12,849) | (44,012) |
| Cash Flows From Financing Activities: | | | |
| Net increase in demand deposit and savings accounts | 12,764 | 25,867 | 54,736 |
| Net increase (decrease) in certificates of deposit | 27,903 | (16,079) | (6,757) |
| Director/Employee stock options exercised | 335 | 118 | 86 |
| Excess tax benefits from stock-based payment arrangements | 1 | 0 | 0 |
| Repurchase and retirement of common stock | (2,436) | (377) | (2,058) |
| Repayment of ESOP borrowings | 0 | (75) | (269) |
| Payment of dividends on common stock | (4,881) | (3,980) | (3,510) |
| Net cash provided by financing activities | 33,686 | 5,474 | 42,228 |
| Net (decrease) increase in cash and cash equivalents | (19,962) | 6,624 | 7,816 |
| Cash and cash equivalents at beginning of year | 63,030 | 56,406 | 48,590 |

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| | | | |
|---|------------------|------------------|------------------|
| Cash and cash equivalents at end of year | <u>\$</u> 43,068 | <u>\$</u> 63,030 | <u>\$</u> 56,406 |
|---|------------------|------------------|------------------|

See notes to consolidated statements

Notes to Consolidated Financial Statements
Years Ended December 31, 2006, 2005, and 2004

I. Organization and Summary of Significant Accounting and Reporting Policies

Basis of Presentation The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary, United Security Bank and subsidiary (the Bank). United Security Bancshares Capital Trust I (the Trust) was deconsolidated in 2004 pursuant to FIN46. As a result, the Trust's Trust Preferred Securities are not presented on the Company's consolidated financial statements, but instead the Company's Subordinated Debentures are presented as a separate liability category. (see Note 8 to the Company's consolidated financial statements). Intercompany accounts and transactions have been eliminated in consolidation. In the following notes, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares, (including the Bank). United Security Bancshares operates as one business segment providing banking services to commercial establishments and individuals primarily in the San Joaquin Valley of California.

Nature of Operations United Security Bancshares is a bank holding company, incorporated in the state of California for the purpose of acquiring all the capital stock of the Bank through a holding company reorganization (the Reorganization) of the Bank. The Reorganization, which was accounted for in a manner similar to a pooling of interests, was completed on June 12, 2001. Management believes the Reorganization has provided the Company greater operating and financial flexibility and has permitted expansion into a broader range of financial services and other business activities.

United Security Bancshares Capital Trust I is a Delaware statutory business trust formed for the exclusive purpose of issuing and selling Trust Preferred Securities. The Trust was formed on June 28, 2001 and was deconsolidated in 2004 pursuant to FIN46 (See Note 8. Trust Preferred Securities and Junior Subordinated Debt).

USB Investment Trust Inc was incorporated effective December 31, 2001 as a special purpose real estate investment trust (REIT) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust (See Note 9. Income Taxes).

The Bank was founded in 1987 and currently operates ten branches and one construction lending office in an area from eastern Madera County to western Fresno County, as well as Taft and Bakersfield in Kern County. During February 2007, the Company acquired Legacy Bank with operations in Campbell California, which will expand the Company's operations into Santa Clara County, and add one branch. The Bank's primary source of revenue is providing loans to customers, who are predominantly small and middle-market businesses and individuals. The Bank engages in a full compliment of lending activities, including real estate mortgage, commercial and industrial, real estate construction, agricultural and consumer loans, with particular emphasis on short and medium term obligations.

The Bank offers a wide range of deposit instruments. These include personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal (NOW) accounts, money market accounts and time certificates of deposit. Most of the Bank's deposits are attracted from individuals and from small and medium-sized business-related sources.

The Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include cashiers checks, travelers checks, money orders, and foreign drafts. In addition, the Bank offers Internet banking services to its commercial and retail customers. The Bank does not operate a trust department, however it makes arrangements with its correspondent bank to offer trust services to its customers upon request.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change, relate to the determination of the allowance for loan losses, determination of fair market values, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for loan losses and the valuation of foreclosed assets held for sale, management obtains independent appraisals for significant properties.

Significant Accounting Policies - The accounting and reporting policies of the Company conform to generally accepted accounting principles and to prevailing practices within the banking industry. The following is a summary of significant policies:

- a. *Cash and cash equivalents* - Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. At times throughout the year, balances can exceed FDIC insurance limits. Generally, federal funds sold and repurchase agreements are sold for one-day periods. Repurchase agreements are with a registered broker-dealer affiliated with a correspondent bank and work much like federal funds sold, except that the transaction is collateralized by various investment securities. The securities collateralizing such transactions generally consist of U.S. Treasuries, U.S. Government and U.S. Government-sponsored agencies. The Bank did not have any repurchase agreements during 2006 or 2005, or at December 31, 2006 or 2005. All cash and cash equivalents have maturities when purchased of three months or less.
- b. *Securities* - Debt and equity securities classified as available for sale are reported at fair value, with unrealized gains and losses excluded from net income and reported, net of tax, as a separate component of comprehensive income and shareholders' equity. Debt securities classified as held to maturity are carried at amortized cost. Gains and losses on disposition are reported using the specific identification method for the adjusted basis of the securities sold.

The Company classifies its securities as available for sale or held to maturity, and periodically reviews its investment portfolio on an individual security basis. Securities that are to be held for indefinite periods of time (including, but not limited to, those that management intends to use as part of its asset/liability management strategy, those which may be sold in response to changes in interest rates, changes in prepayments or any such other factors) are classified as securities available for sale. Securities which the Company has the ability and intent to hold to maturity are classified as held to maturity.

Declines in fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary are recognized by write-downs of the individual securities to their fair value. Such write-downs would be included in earnings as realized losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other-than-temporary based upon the positive and negative evidence available. Evidence evaluated includes, but is not limited to, industry analyst reports, credit market conditions, and interest rate trends. If negative evidence outweighs positive evidence that the carrying amount is recoverable within a reasonable period of time, the impairment is deemed to be other-than-temporary and the security is written down in the period in which such determination is made.

- c. *Loans* - Interest income on loans is credited to income as earned and is calculated by using the simple interest method on the daily balance of the principal amounts outstanding. Loans are placed on non-accrual status when principal or interest is past due for 90 days and/or when management believes the collection of amounts due is doubtful. For loans placed on nonaccrual status, the accrued and unpaid interest receivable may be reversed at management's discretion based upon management's assessment of collectibility, and interest is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan.

Nonrefundable fees and related direct costs associated with the origination or purchase of loans are deferred and netted against outstanding loan balances. The net deferred fees and costs are generally amortized into interest income over the loan term using a method, which approximates the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient at the loan's observable market rate or the fair value of the collateral if the loan is collateral dependent.

- d. *Allowance for Credit Losses and Reserve for Unfunded Loan Commitments*- The allowance for credit losses is maintained to provide for losses that can reasonably be anticipated. The allowance is based on ongoing quarterly assessments of the probable losses inherent in the loan portfolio, and to a lesser extent, unfunded loan commitments. The reserve for unfunded loan commitments is a liability on the Company's consolidated financial statements. The reserve is computed using a methodology similar to that used to determine the allowance for loan losses, modified to take into account the probability of a drawdown on the commitment.

The allowance for credit losses is increased by provisions charged to operations during the current period and reduced by loan charge-offs net of recoveries. Loans are charged against the allowance when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, based on evaluations of the probability of collection. In evaluating the probability of collection, management is required to make estimates and assumptions that affect the reported amounts of loans, allowance for credit losses and the provision for credit losses charged to operations. Actual results could differ significantly from those estimates. These evaluations take into consideration such factors as the composition of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. The Company's methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include the formula allowance, specific allowances, and the unallocated allowance.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on the Company's historical loss experience and may be adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. The Company determines the loss factors for problem-graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates the Company's losses over the past twelve quarters (three years) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications, which are pass, special mention, substandard, doubtful, and loss. Certain loans are homogenous in nature and are therefore pooled by risk grade. These homogenous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends, which if not corrected, could jeopardize repayment of the loan and result in further downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard, doubtful, and loss.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in classified loans, impaired loans, and other loans in which management believes it is probable that a loss has been incurred in excess of the amount determined by the application of the formula allowance.

The unallocated portion of the allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentration, and other business conditions.

The allowance analysis also incorporates the results of measuring impaired loans as provided in Statement of Financial Accounting Standards (SFAS) No. 114, Accounting by Creditors for Impairment of a Loan and SFAS 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures. A loan is considered impaired when management determines that it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Impairment is measured by the difference between the original recorded investment in the loan and the estimated present value of the total expected cash flows, discounted at the loan's effective rate, or the fair value of the collateral, if the loan is collateral dependent. Any differences in the specific allowance amounts calculated in the impaired loan analysis and the migration analysis are reconciled by management and changes are made to the allowance as deemed necessary.

- e. *Loans held-for-sale* - Loans originated and designated as held-for-sale are carried at the lower of cost or estimated fair value, as determined by quoted market prices, in aggregate. Net unrealized losses are recognized in a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. The Company held no loans for sale at December 31, 2006 or 2005.
- f. *Premises and Equipment* - Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally on the straight-line method over the estimated useful lives of the assets. Estimated useful lives are as follows:

| | | | |
|-----------|----------|-------------------------|-----------|
| Buildings | 31 Years | Furniture and equipment | 3-7 Years |
|-----------|----------|-------------------------|-----------|

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- g. *Other Real Estate Owned* - Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of the book value of the loan, or fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense at foreclosure.
- h. *Intangible Assets and Goodwill* - Intangible assets are comprised of core deposit intangibles, other specific identifiable intangibles, and goodwill acquired in branch acquisitions in which the fair value of the liabilities assumed exceeded the fair value of the assets acquired. Core deposit intangibles of \$1,475,000 and \$1,875,000 (net of accumulated amortization of \$2,522,000 and \$2,121,000) at December 31, 2006 and 2005 are amortized over the estimated useful lives of the existing deposit bases (7 years) using a method which approximates the interest method. Other specific identifiable intangibles resulting from the purchase of certain bank branches, which were non self-sustaining businesses, in years prior to 2006, of \$790,000 and \$926,000 (net accumulated amortization of \$1.4 million and \$1.3 million) at December 31, 2006 and 2005 are being amortized using a method which approximates the interest method over a period of 15 years.

Goodwill resulting from the acquisition of Taft National Bank during April 2004 is considered to have an indefinite life and is not amortized. At December 31, 2006 goodwill related to Taft National Bank totaled \$750,000. Pursuant to SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is evaluated annually for impairment. Impairment testing of goodwill is performed during April of each year at a reporting unit level. The Company had no impairment adjustments during 2006, 2005, or 2004.

- i. *Income Taxes* - Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled.
- j. *Net Income per Share* - Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method. ESOP shares are only considered outstanding for earnings per share calculations when they are committed to be released (Note 16).
- k. *Cash Flow Reporting* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods.
- l. *Transfers of Financial Assets* - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.
- m. *Advertising Costs* - The Company expenses marketing costs as they are incurred. Advertising expense was \$105,000, \$98,000 and \$74,000 for the years ended December 31, 2006, 2005 and 2004, respectively.
- n. *Stock Based Compensation* - At December 31, 2006, the Company has a stock-based employee compensation plan, which is described more fully in Note 10. On January 1, 2006 the Company adopted the disclosure provisions of Financial Accounting Standards Board (FASB) Statement No. 123 R, *Accounting for Share-Based Payments*. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on the grant-date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the year ended December 31, 2006 is \$248,000 of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was insignificant.

Prior to January 1, 2006, the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. See Note 10 to the Company's consolidated financial statements for a table that illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 148, *Accounting for Stock-Based Compensation* Transition and Disclosure an amendment of FASB Statement No. 123 during 2004 and 2005.

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- o. *Long-Lived Assets* - The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other specific intangible assets, and core deposit intangible assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Based on such evaluation, the Bank determined that there is no impairment loss to be recognized in 2006, 2005 or 2004.
- p. *Employee Stock Ownership Plan (ESOP)* - The Bank accounts for shares acquired by its leveraged ESOP in accordance with the guidelines established by the American Institute of Certified Public Accountants Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans (SOP 93-6)*. Under SOP 93-6, the Bank recognizes compensation cost equal to the fair value of the ESOP shares during the periods in which they become committed to be released. To the extent that the fair value of the Bank's ESOP shares committed to be released differ from the cost of those shares, the differential is charged or credited to equity. The ESOP is externally leveraged and, as such, the ESOP debt is recorded as a liability and interest expense is recorded on that debt. The ESOP shares not yet committed to be released are accounted for as a reduction of shareholders' equity. The credit line related to the leveraged ESOP matured during 2005, and as result, all remaining balances were repaid during the first quarter of 2005. The Company had no leveraged ESOP transactions during 2006.
- q. *Derivative Financial Instruments* - All derivative instruments (including certain derivative instruments embedded in other contracts) are recognized in the consolidated balance sheet at fair value. The Company's accounting treatment for gains or losses from changes in the derivative instrument's fair value is contingent on whether the derivative instrument qualifies as a hedge. On the date the Company enters into a derivative contract, the Company designates the derivative instruments as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge) or (3), a hedge for trading, customer accommodation or not qualifying for hedge accounting (free-standing derivative instruments). For a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability or of an unrecognized firm commitment attributable to the hedged risk are recorded in current period net income. For a cash flow hedge, changes in the fair value of the derivative instrument to the extent that it is highly effective are recorded in other comprehensive income, net of tax, within shareholders' equity and subsequently reclassified to net income in the same period(s) that the hedged transaction impacts net income. For freestanding derivative instruments, changes in the fair values are reported in current period net income. The Company formally documents the relationship between hedging instruments and hedged items, as well as the risk management objective and strategy for undertaking any hedge transaction. This process includes relating all derivative instruments that are designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific forecasted transactions. The Company also formally assesses both at the inception of the hedge and on an ongoing basis, whether the derivative instruments used are highly effective in offsetting changes in fair values or cash flows of hedged items. If it is determined that the derivative instrument is not, and will not be, highly effective as a hedge, hedge accounting is discontinued.
- r. *Federal Home Loan Bank stock and Federal Reserve Stock* - As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB.
- s. *Comprehensive Income* - Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes items previously recorded directly to equity, such as unrealized gains and losses on securities available-for-sale, unrecognized costs of salary continuation defined benefit plans, and certain derivative instruments used as a cash flow hedge. Comprehensive income is presented in the consolidated statement of shareholders' equity.
- t. *Segment Reporting* - The Company's operations are solely in the financial services industry and include providing to its customers traditional banking and other financial services. The Company operates primarily in the San Joaquin Valley region of California. Management makes operating decisions and assesses performance based on an ongoing review of the Company's consolidated financial results. Therefore, the Company has a single operating segment for financial reporting purposes.

u. *New Accounting Standards:*

Statements of Financial Accounting Standards

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*. SFAS 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial position. Lastly, SFAS 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS 157. The Company has not yet determined if, or to what extent, it will elect to use the fair value option to value our financial assets and liabilities or the impact that the implementation of SFAS 159 will have on the Company's consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS No. 158). SFAS No. 158 amends SFAS No. 87 and SFAS No. 106. SFAS No. 158 amends previous applicable accounting statements and requires companies to better disclose, among other things, the funded status of benefit plans, and to recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, *Employers Accounting for Pensions*, or No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. SFAS No. 158 is effective for public companies with fiscal years ending after December 15, 2006. The Company adopted SFAS No. 158 effective December 31, 2006, and has made required disclosures as of December 31, 2006. As a result, the Company recorded \$169,000 in other comprehensive income (net tax of \$112,000) for the previously unrecognized cost of post-retirement benefits related to the Company's Salary Continuation Plan (see Note 11, *Employee Benefit Plans*).

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS No. 157 clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This statement applies whenever other accounting pronouncements require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 is not expected to have a material impact on the Bank's financial position or results of operations.

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* which amends FASB Statements Nos. 133 and 140 and specifies the accounting treatment of financial instruments with embedded derivatives. The statement allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host), if the holder elects to irrevocably account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. In January of 2007, the FASB approved the exemption of certain securities from SFAS No. 155 if the embedded derivative is tied only to the prepayment risk of the underlying financial asset and the investor does not control the right to accelerate the settlement. The adoption of SFAS No. 155 is not expected to have a material impact on the financial condition or results of operations of the Company.

Financial Accounting Standards Board Staff Positions and Interpretations

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109*. FIN 48 clarifies SFAS No. 109, *Accounting for Income Taxes*, to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of the Interpretation, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term *more likely than not* means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority. The scope of FIN 48 is broad and includes *all* tax positions accounted for in accordance with SFAS No. 109. Additionally, besides business enterprises, FIN 48 applies to pass-through entities, and entities whose tax liability is subject to 100 percent credit for dividends paid (such as real estate investment trusts). FIN 48 is effective for the Company beginning after January 1, 2007. Any cumulative effect of applying FIN 48 would be reported as an adjustment to retained earnings at the beginning of the period in which the Interpretation is adopted. Management is currently evaluating the impact of this

interpretation on the Company's financial position and results of operations.

SEC Staff Accounting Bulletins

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 was issued to provide interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The effects of prior year uncorrected errors include the potential accumulation of improper amounts that may result in a material misstatement on the balance sheet or the reversal of prior period errors in the current period that result in a material misstatement of the current period income statement amounts. Adjustments to current or prior period financial statements would be required in the event that after application of various approaches for assessing materiality of a misstatement in current period financial statements and consideration of all relevant quantitative and qualitative factors, a misstatement is determined to be material. The provisions of SAB 108 are effective for fiscal years ending on or after November 15, 2006. The adoption of SAB 108 did not have a material impact on the Company's financial position or results of operations.

- v. *New Entity* - During August 2005, the Bank formed a new subsidiary named United Security Emerging Capital Fund (the Fund) for the purpose of providing investment capital for Low-Income Communities (LICs). The new subsidiary was formed as a Community Development Entity (CDE) and as such, must be certified by the Community Development Financial Institutions Fund of the United States Department of the Treasury in order to apply for New Market Tax Credits (NMTC). The Fund submitted an application to the Department of the Treasury to become certified as a CDE in August 2005 and was approved in February 2006. Subsequent to that application, the Fund submitted an application to apply for an allocation of New Market Tax Credits in September 2005. The Fund was not awarded funding from the Treasury during the 2006 allocation process, but applied for the 2007 allocation of New Market Tax Credits in August 2006. If the Fund's NMTC application is approved, the Fund can attract investments and make loans and investments in LICs and thereby qualify its investors to receive Federal Income Tax Credits. The maximum that can be applied for under the New Markets Tax Credit program by any one CDE is \$150 million, and the Bank is subject to an investment limitation of 10% of its risk-based capital. Federal new market tax credits would be applied over a seven-year period, 5% for the first three years, and 6% for the next four years for a total of 39%.
- w. *Reclassifications* - Certain reclassifications have been made to the 2005 and 2004 financial statements to conform to the classifications used in 2006.

2. Investment Securities

Following is a comparison of the amortized cost and approximate fair value of investment securities for the years ended December 31, 2006 and December 31, 2005:

| <i>(In thousands)</i> | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) |
|--|-------------------|------------------------------|-------------------------------|------------------------------------|
| December 31, 2006: | | | | |
| <u>Securities available for sale:</u> | | | | |
| U.S. Government agencies | \$ 69,746 | \$ 51 | \$ (1,293) | \$ 68,504 |
| U.S. Government agency collateralized mortgage obligations | 17 | 0 | (1) | 16 |
| Obligations of state and political subdivisions | 2,226 | 65 | (1) | 2,290 |
| Other investment securities | 13,000 | 0 | (444) | 12,556 |
| Total securities available for sale | \$ 84,989 | \$ 116 | \$ (1,739) | \$ 83,366 |
| December 31, 2005: | | | | |
| <u>Securities available for sale:</u> | | | | |
| U.S. Government agencies | \$ 82,215 | \$ 110 | \$ (2,002) | \$ 80,323 |
| U.S. Government agency collateralized mortgage obligations | 22 | 0 | (1) | 21 |
| Obligations of state and political subdivisions | 2,226 | 95 | (1) | 2,320 |
| Other investment securities | 13,000 | 0 | (428) | 12,572 |
| Total securities available for sale | \$ 97,463 | \$ 205 | \$ (2,432) | \$ 95,236 |

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Included in other investment securities at December 31, 2006, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.8 million. Included in other investment securities at December 31, 2005, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.9 million. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other-than-temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due solely to interest rate changes and the Company has the ability and intent to hold all investment securities with identified impairments resulting from interest rate changes to the earlier of the forecasted recovery or the maturity of the underlying investment security.

The following summarizes temporarily impaired investment securities at December 31, 2006 and 2005:

| <i>(In thousands)</i> | Less than 12 Months | | 12 Months or More | | Total | |
|---|------------------------------------|----------------------|------------------------------------|----------------------|------------------------------------|----------------------|
| | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses |
| December 31, 2006: | | | | | | |
| <u>Securities available for sale:</u> | | | | | | |
| U.S. Government agencies | \$ 506 | \$ (6) | \$ 65,626 | \$ (1,287) | \$ 66,132 | \$ (1,293) |
| U.S. Govt. agency CMO s | 0 | 0 | 12 | (1) | 12 | (1) |
| Obligations of state and political subdivisions | 0 | 0 | 34 | (1) | 34 | (1) |
| Other investment securities | 0 | 0 | 12,556 | (444) | 12,556 | (444) |
| | 0 | 0 | 12,556 | (444) | 12,556 | (444) |
| Total impaired securities | \$ 506 | \$ (6) | \$ 78,228 | \$ (1,733) | \$ 78,734 | \$ (1,739) |
| December 31, 2005: | | | | | | |
| <u>Securities available for sale:</u> | | | | | | |
| U.S. Government agencies | \$ 18,071 | \$ (306) | \$ 58,074 | \$ (1,696) | \$ 76,145 | \$ (2,002) |
| U.S. Govt. agency CMO s | 0 | 0 | 16 | (1) | 16 | (1) |
| Obligations of state and political subdivisions | 35 | (1) | 0 | 0 | 35 | (1) |
| Other investment securities | 0 | 0 | 12,572 | (428) | 12,572 | (428) |
| | 0 | 0 | 12,572 | (428) | 12,572 | (428) |
| Total impaired securities | \$ 18,106 | \$ (307) | \$ 70,662 | \$ (2,125) | \$ 88,768 | \$ (2,432) |

Temporarily impaired securities at December 31, 2006 are comprised of nineteen (19) U.S. government agency securities, two other investment securities, one municipal bond, and one U.S. agency collateralized mortgage obligation with a total weighted average life of 2.4 years. Temporarily impaired securities at December 31, 2005 are comprised of twenty (20) U.S. government agency securities, two other investment securities, one municipal bond, and one U.S. agency collateralized mortgage obligation with a total weighted average life of 2.8 years.

There were gross realized gains on sales of available-for-sale securities totaling \$27,000, \$163,000, and \$152,000 during the years ended December 31, 2006, 2005, and 2004, respectively. There were no gross realized losses on available-for-sale securities during the year ended December 31, 2006 or 2005. There were gross realized losses on available-for-sale securities totaling \$117,000 during the year ended December 31, 2004.

The amortized cost and fair value of securities available for sale at December 31, 2006, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns.

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| <i>(In thousands)</i> | December 31, 2006 | |
|--|---------------------------|---|
| | Amortized Cost | Fair Value (Carrying Amount) |
| Due in one year or less | \$ 41,244 | \$ 40,590 |
| Due after one year through five years | 25,265 | 24,590 |
| Due after five years through ten years | 1,939 | 1,993 |
| Due after ten years | 16,524 | 16,177 |
| Collateralized mortgage obligations | 17 | 16 |
| | \$ 84,989 | \$ 83,366 |

At December 31, 2006 and 2005, available-for-sale securities with an amortized cost of approximately \$70.9 million and \$69.3 million (fair value of \$69.7 million and \$67.8 million) were pledged as collateral for public funds, treasury tax and loan balances, and repurchase agreements.

The Company had no held-to-maturity or trading securities at December 31, 2006 or 2005.

3. *Loans*

Loans are comprised of the following:

| <i>(In thousands)</i> | December 31, | |
|---------------------------|---------------------|-------------------|
| | 2006 | 2005 |
| Commercial and industrial | \$ 155,811 | \$ 113,263 |
| Real estate mortgage | 113,613 | 89,503 |
| Real estate construction | 168,378 | 162,873 |
| Agricultural | 35,102 | 24,935 |
| Installment | 16,712 | 15,002 |
| Lease financing | 10,952 | 12,334 |
| Total Loans | \$ 500,568 | \$ 417,910 |

The Company's loans are predominantly in the San Joaquin Valley, and the greater Oakhurst/East Madera County area, although the Company does participate in loans with other financial institutions, primarily in the state of California.

Commercial and industrial loans represent 31.1% of total loans at December 31, 2006 and have a high degree of industry diversification. A substantial portion of the commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 22.7% of total loans at December 31, 2006, are secured by trust deeds on primarily commercial property. Repayment of real estate mortgage loans is generally from the cash flow of the borrower.

Real estate construction loans, representing 33.7% of total loans at December 31, 2006, consist of loans to residential contractors, which are secured by single-family residential properties. All real estate loans have established equity requirements. Repayment on construction loans is generally from long-term mortgages with other lending institutions.

Agricultural loans represent 7.0% of total loans at December 31, 2006 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Lease financing loans, representing 2.2% of total loans at December 31, 2006, consist of loans to small businesses, which are secured by commercial equipment. Repayment of the lease obligation is from the cash flow of the borrower.

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Occasionally, shared appreciation agreements are made between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of shared appreciation projects. Shared appreciation income totaled \$567,000, \$393,000, and \$8,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

There were no loans over 90 days past due and still accruing at December 31, 2006 or 2005. Nonaccrual loans totaled \$8.1 million and \$13.9 million at December 31, 2006 and 2005, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at December 31, 2006. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2006 in accordance with their original terms is approximately \$982,000. The interest income recorded on such loans during 2006 and 2005 totaled \$65,000 and \$34,000, respectively. There was no interest income recorded on such loans during the year ended December 31, 2004.

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The Company has, and expects to have, lending transactions in the ordinary course of its business with directors, officers, principal shareholders and their affiliates. These loans are granted on substantially the same terms, including interest rates and collateral, as those prevailing on comparable transactions with unrelated parties, and do not involve more than the normal risk of collectibility or present unfavorable features.

Loans to directors, officers, principal shareholders and their affiliates are summarized below:

| <i>(In thousands)</i> | December 31, | |
|---|--------------|----------|
| | 2006 | 2005 |
| Aggregate amount outstanding, beginning of year | \$ 2,440 | \$ 1,244 |
| New loans or advances during year | 1,897 | 2,795 |
| Repayments during year | (2,732) | (3,209) |
| Other (1) | 0 | 1,610 |
| Aggregate amount outstanding, end of year | \$ 1,605 | \$ 2,440 |
| Loan commitments | \$ 2,241 | \$ 2,904 |

- (1) The balance reported at December 31, 2004 did not include \$1.6 million in outstanding balances for a Director elected during 2004. This amount has been added during 2005 for purposes of this schedule. During 2004, the Company added one director. This figure represents the addition of outstanding balances at the time of this Directors election.

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

| <i>(In thousands)</i> | Years Ended December 31, | | |
|--|--------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| Balance, beginning of year | \$ 7,748 | \$ 7,251 | \$ 6,081 |
| Provision charged to operations | 880 | 1,140 | 1,145 |
| Losses charged to allowance | (502) | (773) | (590) |
| Recoveries on loans previously charged off | 239 | 165 | 136 |
| Reserve acquired in merger | | | 986 |
| Reclass off-balance sheet reserve | | (35) | (507) |
| Balance at end-of-period | \$ 8,365 | \$ 7,748 | \$ 7,251 |

The allowance for credit losses represents management's estimate of the risk inherent in the loan portfolio based on the current economic conditions, collateral values and economic prospects of the borrowers. Significant changes in these estimates might be required in the event of a downturn in the economy and/or the real estate market in the San Joaquin Valley, and the greater Oakhurst and East Madera County area.

At December 31, 2006 and 2005, the Company's recorded investment in loans for which impairment has been recognized totaled \$8.9 million and \$12.9 million, respectively. Included in total impaired loans at December 31, 2006 are \$5.7 million of impaired loans for which the related specific allowance is \$4.1 million, as well as \$3.2 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. At December 31, 2005, total impaired loans included \$10.6 million for which the related specific allowance is \$4.1 million, as well as \$2.3 million of impaired loans that as a result of write-downs or the fair value of the collateral did not have a specific allowance. The average recorded investment in impaired loans was \$10.1 million, \$15.9 million, and \$16.6 million for the years ended December 31, 2006, 2005 and 2004, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method. For the year ended December 31, 2006 and 2005, the Company recognized income of \$65,000 and \$34,000, respectively, on such loans. For the year ended December 31, 2004, the Company recognized no income on impaired loans.

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In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2006 and 2005 these financial instruments include commitments to extend credit of \$188.2 million and \$192.3 million, respectively, and standby letters of credit of \$4.9 million and \$5.5 million, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

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. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are 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 loans to customers.

4. *Premises and Equipment*

The components of premises and equipment are as follows:

| <i>(In thousands)</i> | December 31, | |
|--|---------------------|------------------|
| | 2006 | 2005 |
| Land | \$ 968 | \$ 570 |
| Buildings and improvements | 13,017 | 9,710 |
| Furniture and equipment | 7,399 | 8,064 |
| | 21,384 | 18,344 |
| Less accumulated depreciation and amortization | (6,082) | (7,316) |
| Total premises and equipment | \$ 15,302 | \$ 11,028 |

During September 2006, the Company sold its administrative headquarters at 1525 E. Shaw Avenue in Fresno, California in preparation for a move to the Company's new administrative headquarters located in downtown Fresno during mid-November 2006. The Company rented the East Shaw premises during the two months for transition purposes pending its move to the new administrative location. Proceeds from the sale totaled \$1.5 million for the building and certain furniture and fixtures. The total carrying value of the building and furniture sold amounted to \$498,000, resulting in a realized gain of \$1.0 million during the third quarter of 2006.

During November 2006, the Company moved its administrative headquarters to its new location at 2126 Inyo Street, in downtown Fresno. The location was originally acquired in June 2003 as a real estate foreclosure (OREO). During 2005, the Company provided improvements to the building for a tenant that leases a portion of the building. Then during 2006, the Company completed the improvements to the building required to prepare it for occupancy as the Company's administrative headquarters. The Company owns the building with a total capitalized cost of \$7.8 million, including building and improvements of \$6.0 million, land and land improvements of \$1.1 million, and furniture and fixtures of \$710,000.

During 2005, the Company purchased the Taft branch premises for a total of \$1.0 million. The Company previously owned a 25% partnership interest in the building premises with a carrying cost of \$190,000, and rented space in the building for its Taft branch operations. The partnership interest was included in other assets on the Company's balance sheet prior to the purchase in 2005. As a result of the purchase, the Company eliminated its partnership investment and recorded a gain of \$61,000 on the transaction.

Total depreciation expense on Company premises and equipment totaled \$1.1 million, \$906,000, and \$823,000 for the years ended December 31, 2006, 2005 and 2004, respectively, and is included in occupancy expense in the accompanying consolidated statements of income.

5. *Investment in Limited Partnership*

The Bank owns limited interests in a private limited partnerships that acquire affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Bank's limited partnership investment is accounted for under the equity method. The Bank's noninterest expense associated with the utilization and expiration of these tax credits for the year ended December 31, 2006, 2005 and 2004 was \$440,000, \$458,000, and \$395,000, respectively. The limited partnership investments are expected to generate remaining tax credits of approximately \$3.1 million over the life of the investment. The tax credits expire between 2009 and 2014. Tax credits utilized for income tax purposes for the years ended December 31, 2006, 2005, and 2004 totaled \$547,000, \$547,000, and \$409,000, respectively.

6. *Deposits*

Deposits include the following:

| <i>(In thousands)</i> | December 31, | |
|--|-------------------|-------------------|
| | 2006 | 2005 |
| Noninterest-bearing deposits | \$ 159,002 | \$ 153,113 |
| Interest-bearing deposits: | | |
| NOW and money market accounts | 184,384 | 175,852 |
| Savings accounts | 31,933 | 33,590 |
| Time deposits: | | |
| Under \$100,000 | 42,428 | 53,254 |
| \$100,000 and over | 169,380 | 130,651 |
| Total interest-bearing deposits | 428,125 | 393,347 |
| Total deposits | \$ 587,127 | \$ 546,460 |

At December 31, 2006, the scheduled maturities of all certificates of deposit and other time deposits are as follows:

| <i>(In thousands)</i> | |
|---|-------------------|
| One year or less | \$ 189,858 |
| More than one year, but less than or equal to two years | 18,995 |
| More than two years, but less than or equal to three years | 1,829 |
| More than three years, but less than or equal to four years | 452 |
| More than four years, but less than or equal to five years | 74 |
| More than five years | 600 |
| | \$ 211,808 |

The Company may occasionally obtain brokered deposits as an additional source of funding. At December 31, 2006, the Company held brokered time deposits totaling \$67.7 million with an average rate of 5.06%. Of this balance, \$66.7 million is included in time deposits of \$100,000 or more, and the remaining \$1.0 million is included in time deposits of less than \$100,000. Included in brokered time deposits are balances totaling \$44.9 million maturing in three months or less, and \$22.8 million maturing in three to six months.

Deposits of directors, officers and other related parties to the Bank totaled \$6.2 million and \$6.4 million at December 31, 2006 and 2005, respectively. The rates paid on these deposits were those customarily paid to the Bank's customers in the normal course of business.

7. *Short-term Borrowings/Other Borrowings*

The Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$308.3 million, as well as Federal Home Loan Bank (FHLB) lines of credit totaling \$28.0 million at December 31, 2006. At December 31, 2006 and 2005, the Company had no advances on its lines of credit. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company's stock in the FHLB and certain qualifying mortgage loans. As of December 31, 2006, \$43.7 million

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in real estate-secured loans were pledged as collateral for FHLB advances. Additionally, \$337.8 million in real estate-secured loans were pledged at December 31, 2006 as collateral for unused borrowing lines with the Federal Reserve Bank totaling \$253.3 million. All lines of credit are on an as available basis and can be revoked by the grantor at any time.

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The Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$248.7 million, as well as Federal Home Loan Bank (FHLB) lines of credit totaling \$10.7 million at December 31, 2005.

8. *Junior Subordinated Debt*

On July 16, 2001, the Company's wholly owned special-purpose trust subsidiary, United Security Bancshares Capital Trust I (the Trust) issued \$15 million in Company obligated mandatorily redeemable cumulative trust preferred securities of subsidiary trust holding solely junior subordinated debentures (Trust Preferred Securities). Pursuant to FASB-issued Interpretation No. 46 (FIN46), the Company determined that USB Trust is a Variable Interest Entity (VIE) as defined, and deconsolidated the Trust effective March 31, 2004. The securities bear a floating rate of interest of 3.75% over the six month LIBOR rate, payable semi-annually. Concurrent with the issuance of the Trust Preferred Securities, the Trust used the proceeds from the Trust Preferred Securities offering to purchase a like amount of Junior Subordinated Debentures of the Company. The Company will pay interest on the Junior Subordinated Debentures to the Trust, which represents the sole revenues and sole source of dividend distributions to the holders of the Trust Preferred Securities. The Company has the right, assuming no default has occurred, to defer payments of interest on the Junior Subordinated Debentures at any time for a period not to exceed 20 consecutive quarters. The Trust Preferred Securities will mature on July 25, 2031, but can be redeemed after July 25, 2006 at a premium, and can be redeemed after July 25, 2011 at par. The obligations of the Trust are fully and unconditionally guaranteed, on a subordinated basis, by the Company.

The Company received \$14.5 million from the Trust upon issuance of the Junior Subordinated Debentures, of which \$13.7 million was contributed by the Company to the Bank to increase its capital. The remainder was utilized by the Company for general corporate purposes. Under applicable regulatory guidelines, a portion of the Trust Preferred Securities qualifies as Tier I Capital, and the remainder as Tier II Capital. Issuance costs of \$495,000 (\$405,000 remaining at December 31, 2006) related to the Trust Preferred Securities have been deferred and are being amortized over the 30-year life of the securities. Interest expense on the Trust Preferred Securities totaled \$1.3 million and \$1.1 million, and amortization expense totaled \$17,000 for both the years ended December 31, 2006 and 2005.

9. *Taxes on Income*

The tax effects of significant items comprising the Company's net deferred tax assets (liabilities) are as follows:

| <i>(In thousands)</i> | December 31, | |
|--|--------------|----------|
| | 2006 | 2005 |
| Deferred tax assets: | | |
| Credit losses not currently deductible | \$ 3,688 | \$ 3,177 |
| State franchise tax | 777 | 638 |
| Deferred compensation | 1,051 | 685 |
| Amortization of core deposit intangible | 353 | 290 |
| Write-down on other real estate owned | 15 | 14 |
| Deferred gain on sale of other real estate owned | 89 | 106 |
| Unrealized gain on interest rate swap | 136 | 275 |
| Unrealized loss on AFS securities | 649 | 891 |
| Unrecognized costs on post-retirement benefits | 112 | 0 |
| Amortization of premium on time deposits | 70 | 107 |
| Other | 96 | 172 |
| | 7,036 | 6,355 |
| Deferred tax liabilities: | | |
| Depreciation | (56) | (89) |
| FHLB dividend | (50) | (127) |
| Loss on limited partnership investment | (1,354) | (706) |
| Prepaid expenses | (269) | (239) |
| | (1,729) | (1,161) |
| Net deferred tax assets | \$ 5,307 | \$ 5,194 |

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. The Company has concluded that it is more likely than not that the deferred tax assets will be recognized in the normal course of business, therefore no valuation allowance is considered

necessary at December 31, 2006 and 2005.

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Taxes on income for the years ended December 31, consist of the following:

| <i>(In thousands)</i> | Federal | State | Total |
|-----------------------|-----------------|-----------------|-----------------|
| 2006: | | | |
| Current | \$ 6,284 | \$ 2,133 | \$ 8,417 |
| Deferred | (390) | 8 | (382) |
| | <u>\$ 5,894</u> | <u>\$ 2,141</u> | <u>\$ 8,035</u> |
| 2005: | | | |
| Current | \$ 4,686 | \$ 1,618 | \$ 6,304 |
| Deferred | (86) | 172 | 86 |
| | <u>\$ 4,600</u> | <u>\$ 1,790</u> | <u>\$ 6,390</u> |
| 2004: | | | |
| Current | \$ 4,169 | \$ 1,674 | \$ 5,843 |
| Deferred | (629) | (248) | (877) |
| | <u>\$ 3,540</u> | <u>\$ 1,426</u> | <u>\$ 4,966</u> |

A reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

| | Years Ended December 31, | | |
|--|---------------------------------|--------------|--------------|
| | 2006 | 2005 | 2004 |
| Statutory federal income tax rate | 35.0% | 34.3% | 34.0% |
| State franchise tax, net of federal income tax benefit | 7.0 | 7.2 | 7.2 |
| Tax exempt interest income | (0.2) | (0.6) | (0.9) |
| Low Income Housing federal credits | (2.6) | (3.1) | (3.1) |
| Other | (1.4) | (1.1) | (0.1) |
| | <u>37.8%</u> | <u>36.7%</u> | <u>37.1%</u> |

The Company's subsidiary Real Estate Investment Trust (REIT) subsidiary was formed effective December 31, 2001 and based on a tax opinion letter provided to the Company state tax benefits were recognized for the year ended December 31, 2002. On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and has taken no further tax benefits.

On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and has taken no related tax benefits since that time. The Company continues to review the information available from the FTB and its financial advisors and believes that the Company's position has merit. The Company will pursue its tax claims and defend its use of these entities and transactions. At this time, the Company cannot predict the ultimate outcome.

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit, and counsel has provided the FTB with documentation supporting the Company's position. The FTB concluded its audit during January 2006. At that time the FTB submitted a closing letter to the Company, which included proposed assessments related to the tax benefits taken for the REIT during 2002. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income resulting from the reversal of tax benefits taken during 2002 would be approximately

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\$755,000, excluding any possible penalties and interest. The Company cannot reasonably determine at this time what the ultimate outcome of the audit will be, although the FTB appears unwilling to accept the Company's position. The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (City National v. Franchise Tax Board). Based upon discussions with legal counsel, it is management's understanding that the FTB is unwilling to resolve or concede any issues in the audit pending the final outcome of the City National case which contains all of the issues related to the Company's audit with the FTB. The case is ongoing and may take several years to complete. As a result, the Company has not recognized any liability with respect to the FTB's assessment as of December 31, 2006.

10. Stock Options and Stock Based Compensation

On January 1, 2006 the Company adopted the disclosure provisions of Financial Accounting Standards Board (FASB) Statement No. 123 R, Accounting for Share-Based Payments. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on the grant-date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). The Company previously accounted for stock-based awards to employees under the intrinsic value provisions of APB 25 in which no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The Company has adopted SFAS No. 123 R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the year ended December 31, 2006 includes: a) compensation cost for all share-based awards granted prior to, but not yet vested as of January 1, 2006 and b) compensation cost for all share-based awards granted subsequent to January 1, 2006. Compensation cost was determined using proforma disclosure information previously calculated under SFAS No. 123. Pursuant to the modified-prospective-transition method, the results for prior periods have not been restated.

As of January 1, 2006, options have been granted to officers and key employees at an exercise price equal to estimated fair value at the date of grant as determined by the Board of Directors. All options granted are service awards, and as such are based solely upon fulfilling a requisite service period (the vesting period). In May 2005, the Company's shareholders approved the adoption of the United Security Bancshares 2005 Stock Option Plan (2005 Plan). At the same time, all previous plans, including the 1995 Plan, were terminated. The 2005 Plan provides for the granting of up to 500,000 shares (adjusted for the 2-for-1 stock split effective May 2006) of authorized and unissued shares of common stock at option prices per share which must not be less than 100% of the fair market value per share at the time each option is granted. The 2005 Plan further provides that the maximum aggregate number of shares that may be issued as incentive stock options under the 2005 Plan is 500,000 (as adjusted for stock split).

The options granted (incentive stock options for employees and non-qualified stock options for Directors) have an exercise price at the prevailing market price on the date of grant under the 1995 or 2005 Stock Option Plans. The options granted under both the 1995 and 2005 Stock Option Plans are exercisable 20% each year commencing one year after the date of grant and expire ten years after the date of grant. Pursuant to the adoption of the 2005 Stock Option Plan, there are no remaining shares reserved under the 1995 Stock Option Plan.

The number of shares granted remaining under the 1995 Plan was 126,000 shares (108,000 exercisable) as of December 31, 2006. Under the 2005 Plan, 171,500 shares granted remain (163,000 incentive stock options and 8,000 nonqualified stock options) as of December 31, 2006, of which 12,000 are vested.

Options outstanding, exercisable, exercised and forfeited are as follows:

| | 2005 Plan | Weighted Average Exercise Price | 1995 Plan | Weighted Average Exercise Price |
|---------------------------------------|----------------------|--|----------------------|--|
| Options outstanding January 1, 2004 | | | 166,000 | \$ 6.51 |
| Exercised during the year | | | 60,000 | 12.32 |
| Canceled or expired during the year | | | (10,000) | \$ 8.60 |
| <hr/> | | | | |
| Options outstanding December 31, 2004 | 0 | | 216,000 | \$ 8.02 |
| Granted during the year | 70,000 | \$ 14.18 | 30,000 | 12.16 |
| Exercised during the year | 0 | | (12,000) | \$ 9.86 |
| Canceled or expired | 0 | | (62,000) | \$ 12.20 |
| <hr/> | | | | |
| Options outstanding December 31, 2005 | 70,000 | \$ 14.18 | 172,000 | \$ 7.11 |
| Granted during the year | 103,500 | \$ 18.91 | | |
| Exercised during the year | (2,000) | \$ 12.65 | (46,000) | \$ 6.73 |
| <hr/> | | | | |
| Options outstanding December 31, 2006 | 171,500 | \$ 17.05 | 126,000 | \$ 7.25 |

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Included in total outstanding options at December 31, 2006, are 108,000 exercisable shares under the 1995 plan, at a weighted average price of \$6.43, and 12,000 exercisable shares under the 2005 plan, at a weighted average price of \$14.44. Included in total outstanding options at December 31, 2005, are 70,000 exercisable shares under the 1995 plan, at a weighted average price of \$12.31. There were no shares exercisable under the 2005 Plan at December 31, 2005.

Additional information regarding options as of December 31, 2006 is as follows:

| Options Outstanding | | | Options Exercisable | | |
|--------------------------|--------------------|--|-----------------------------|--------------------|-----------------------------|
| Range of Exercise Prices | Number Outstanding | Weighted Avg Remaining Contract Life (yrs) | Weighted Avg Exercise Price | Number Exercisable | Weighted Avg Exercise Price |
| \$5.67 | 90,000 | 0.6 | \$ 5.67 | 90,000 | \$ 5.67 |
| \$8.75 | 10,000 | 4.2 | \$ 8.75 | 10,000 | \$ 8.75 |
| \$12.08 to \$14.44 | 94,000 | 8.5 | \$ 13.65 | 20,000 | \$ 13.53 |
| \$16.88 to \$18.10 | 58,000 | 9.1 | \$ 17.04 | 0 | |
| \$19.38 to \$22.54 | 45,500 | 9.3 | \$ 21.28 | 0 | |
| Total | 297,500 | | | 120,000 | |

As of December 31, 2006, there was \$388,000 of total unrecognized compensation expense related to non-vested stock options. This cost is expected to be recognized over a weighted average period of approximately 1.5 years. The Company received \$335,000 in cash proceeds on options exercised during the year ended December 31, 2006. Tax benefits realized on those options exercised totaled \$218,000. Total share-based compensation expense for the year ending December 31, 2006 was \$248,000. The related tax benefit, recorded in the provision for income taxes was insignificant.

| | Year Ended December 31, 2006 | Year Ended December 31, 2005 |
|---|------------------------------------|------------------------------------|
| Weighted average grant-date fair value of stock options granted | \$ 4.30 | \$ 2.48 |
| Total fair value of stock options vested | \$ 61,030 | \$ 17,780 |
| Total intrinsic value of stock options exercised | \$ 661,840 | \$ 47,880 |
| Total intrinsic value of stock options exercisable | \$ 2,023,890 | |
| Total intrinsic value of stock options expected to vest | \$ 3,331,900 | |

The Bank determines fair value at grant date using the Black-Scholes-Merton pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividend yield and the risk-free interest rate over the expected life of the option.

The weighted average assumptions used in the pricing model are noted in the table below. The expected term of options granted is derived using the simplified method, which is based upon the average period between vesting term and expiration term of the options. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on the historical volatility of the Bank's stock over a period commensurate with the expected term of the options. The Company believes that historical volatility is indicative of expectations about its future volatility over the expected term of the options.

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For options granted after January 1, 2006, and valued in accordance with FAS 123R, the Bank expenses the fair value of the option on a straight-line basis over the vesting period for each separately vesting portion of the award. The Bank estimates forfeitures and only recognizes expense for those shares expected to vest. Based upon historical evidence, the Company has determined that because options are granted to a limited number of key employees rather than a broad segment of the employee base, expected forfeitures, if any, are not material.

| | Year Ended | |
|---------------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 |
| Risk Free Interest Rate | 4.60% | 4.54% |
| Expected Dividend Yield | 2.65% | 2.88% |
| Expected Life in Years | 6.50 Years | 6.43 Years |
| Expected Price Volatility | 18.38% | 16.78% |

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock based award and stock price volatility. The assumptions listed above represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, the Bank's recorded stock-based compensation expense could have been materially different from that previously reported in proforma disclosures. In addition, the Bank is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the Bank's actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different.

As stated previously, the Company has adopted SFAS No. 123 R using the modified-prospective-transition method, and as such, the results for prior periods have not been restated. The following table illustrates the effect on net income and earnings per share for the years ended December 31, 2005 and 2004, if the Company had applied the fair value recognition provisions of SFAS No. 148,

Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123 (earnings per share information has been restated to reflect 2-for-1 stock split effective May 1, 2006).

| <i>(In thousands except earnings per share)</i> | Year Ended December 31, | |
|---|-------------------------|-----------------|
| | 2005 | 2004 |
| Net income, as reported | \$ 11,008 | \$ 8,405 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (46) | (40) |
| Pro forma net income | \$ 10,962 | \$ 8,365 |
| Earnings per share: | | |
| Basic as reported | \$ 0.97 | \$ 0.75 |
| Basic pro forma | \$ 0.96 | \$ 0.74 |
| Diluted as reported | \$ 0.96 | \$ 0.74 |
| Diluted pro forma | \$ 0.96 | \$ 0.74 |

11. Employee Benefit Plans

Employee Stock Ownership Plan

The Company has an Employee Stock Ownership Plan and Trust, (the ESOP), designed to enable eligible employees to acquire shares of common stock. ESOP eligibility is based upon length of service requirements. The Bank contributes cash to the ESOP in an amount determined at the discretion of the Board of Directors. The trustee of the ESOP uses such contribution to purchase shares of common stock currently outstanding, or to repay debt on the leveraged portion of the ESOP, if applicable. The shares of stock purchased by the trustee are then allocated to the accounts of the employees participating in the ESOP on the basis of total relative compensation.

Employer contributions vest over a period of six years.

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During June of 2000, the Company's Employee Stock Ownership Plan (ESOP) established an unsecured five-year variable-rate line of credit (the loan) in the amount of \$1.0 million for the purpose of purchasing common stock of the Company. The loan was with a correspondent bank and was guaranteed by the plan's sponsor, United Security Bancshares. The loan matured and final payment was made during the first quarter of 2005. Concurrent with the loan payoff, the final 3,846 shares remaining unallocated leveraged ESOP shares, with an average cost of \$17.33 per share, were committed to be released. There are no further commitments on the line of credit.

The ESOP used the proceeds of the loan to acquire shares of the Company's common stock, which were held in a suspense account by the ESOP. At the end of each year, shares were released for allocation to the accounts of the individual ESOP participants in proportion to the principal and interest paid on the loan during the year. The ESOP loan was recorded as a liability of the Company and the unreleased shares purchased with the loan were reported as unearned ESOP shares in shareholders' equity. Unreleased shares were not recognized as outstanding for earnings per share and capital computations. Dividends on unallocated ESOP shares were used to pay debt service on the ESOP loan and, as such, were recorded as a reduction of debt and accrued interest. Dividends on unallocated ESOP shares used to pay debt service on the ESOP loan amounted to \$3,000 and \$14,000 for the years ended December 31, 2005 and 2004, respectively.

ESOP compensation expense totaled \$409,000, \$467,000, and \$328,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Interest expense incurred on the ESOP loan totaled \$408 and \$11,000 for the years ended December 31, 2005 and 2004.

Allocated, committed-to-be-released, and unallocated ESOP shares as of December 31, 2006, 2005 and 2004 were as follows (shares adjusted for 2-for-1 stock split of May 2006):

| | 2006 | 2005 | 2004 |
|---------------------------------|----------------|----------------|----------------|
| Allocated | 375,639 | 349,564 | 286,982 |
| Committed-to-be-released | 0 | 7,692 | 28,458 |
| Unallocated | 0 | 0 | 7,692 |
| | 375,639 | 357,256 | 323,132 |
| Total ESOP shares | 375,639 | 357,256 | 323,132 |
| Fair value of unreleased shares | N/A | N/A | \$ 98,035 |

401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the 401(k) Plan) organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 5% of the employees eligible annual compensation. Company contributions are subject to certain vesting requirements over a period of six years. Contributions made by the Company are invested in Company stock. During 2006, 2005 and 2004, the Company contributed a total of \$242,000, \$214,000, and \$191,000, respectively, to the Deferral Plan.

Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 15 years. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company's current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2006 and 2005, \$2.7 million and \$2.0 million, respectively, had been accrued to date, based on a discounted cash flow using a discount rate of 6.42% and 6.39%, respectively, and is included in other liabilities. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$3.6 million and \$3.4 million December 31, 2006 and 2005, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company's general creditors.

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Effective December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS No. 158). SFAS No. 158 amends SFAS No. 87 and SFAS No. 106, which the Bank previously has followed for accounting for its salary continuation plan.

SFAS No. 158 amends previous applicable accounting statements and requires companies to better disclose, among other things, the funded status of benefit plans, and to recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, *Employers Accounting for Pensions*, or No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

In addition to expanded disclosure requirements under the Statement, the Company is required to recognize in other comprehensive income, the amounts that have not yet been recognized as components of net periodic benefit costs. These unrecognized costs arise from of changes in estimated interest rates used in the calculation of net liabilities under the plan. Under SFAS No. 87 and SFAS No. 106, these differences were previously recognized over the remaining required service period of the salary continuation contracts. SFAS No. 158 requires the Company to record those unrecognized periodic benefit costs from previous period as a component of other comprehensive income.

As of December 31, 2006, the Company had approximately \$281,000 in unrecognized net periodic benefit costs arising from changes in interest rates used in calculating the current post-retirement liability required under the plan. This amount represents the difference between the plan liabilities calculated under net present value calculations, and the net plan liabilities actually recorded on the Company's books at December 31, 2006. Pursuant to SFAS No. 158, the Company recorded \$169,000 (net of tax of \$112,000), as a component of other comprehensive income. The following table summarizes the incremental effect of applying SFAS No. 158 on individual line items of the Company's statement of financial position at December 31, 2006 (\$in 000):

| | Before Application of Statement 158 | Adjustments | After Application of Statement 158 |
|--|--|--------------------|---|
| Deferred income taxes | \$ 5,195 | \$ 112 | \$ 5,307 |
| Total assets | 678,202 | 112 | 678,314 |
| Liability for accrued Salary Continuation Plan | 2,404 | 281 | 2,685 |
| Total liabilities | 611,991 | 281 | 612,272 |
| Accumulated other comprehensive income | (1,121) | (169) | (1,290) |
| Total shareholder's equity | 66,211 | (169) | 66,042 |

The average remaining life of the service terms of the Salary Continuation contracts to which the unrecognized service costs relate, is approximately two years. As a result, approximately \$140,000 of the unrecognized prior service cost is expected to be recognized in earnings during 2007, and reflected as an adjustment to other comprehensive income. Salary continuation expense is included in salaries and benefits expense, and totaled \$448,000, \$331,000, and \$271,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

Officer Supplemental Life Insurance Plan

During 2004, the Company purchased single premium Bank-owned life insurance policies (BOLI) on certain officers with a portion of the death benefits available to the officers' beneficiaries. The single premium paid at policy commencement of the BOLI in 2004 totaled \$9.0 million. Additional BOLI policies totaling \$227,000 and \$579,000 were purchased during 2006 and 2005, respectively. The BOLI's initial net cash surrender value is equivalent to the premium paid, and it adds income through non-taxable increases in its cash surrender value, net of the cost of insurance, plus any death benefits ultimately received by the Company. The cash surrender value of these insurance policies totaled \$10.1 million at both December 31, 2006 and December 31, 2005, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$400,000 and \$353,000 for the years ended December 31, 2006 and 2005, respectively.

12. Commitments and Contingent Liabilities

Lease Commitments: The Company leases land and premises for its branch banking offices and administration facilities. The initial terms of these leases expire at various dates through 2015. Under the provisions of most of these leases, the Company has the option to extend the leases beyond their original terms at rental rates adjusted for changes reported in certain economic indices or as reflected by market conditions. The total expense on land and premises leased under operating leases was \$407,000, \$455,000, and \$471,000 during 2006, 2005, and 2004, respectively.

Future minimum rental commitments under existing non-cancelable leases as of December 31, 2006 are as follows:

(In thousands):

| | | |
|------------|----|--------------|
| 2007 | \$ | 218 |
| 2008 | | 218 |
| 2009 | | 236 |
| 2010 | | 241 |
| 2011 | | 241 |
| Thereafter | | 1,236 |
| | \$ | <u>2,390</u> |

Financial Instruments with Off-Balance Sheet Risk: The Company is party to financial instruments with off-balance sheet risk which arise in the normal course of business. These instruments may contain elements of credit risk, interest rate risk and liquidity risk, and include commitments to extend credit and standby letters of credit. The credit risk associated with these instruments is essentially the same as that involved in extending credit to customers and is represented by the contractual amount indicated in the table below:

| <i>(in thousands)</i> | Contractual amount | | December 31, | |
|------------------------------|---------------------------|---------|---------------------|---------|
| | 2006 | | 2005 | |
| Commitments to extend credit | \$ | 188,166 | \$ | 192,269 |
| Standby letters of credit | | 4,936 | | 5,506 |

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. Substantially all of these commitments are at floating interest rates based on the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

Standby letters of credit are generally unsecured and are 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 loans to customers. The Company's letters of credit are short-term guarantees and have terms from less than one month to approximately 2.5 years. At December 31, 2006, the maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit totaled \$4.9 million.

13. Financial Instruments Fair Value Disclosure

The following summary disclosures are made in accordance with the provisions of Statement of Financial Accounting Standards No. 107,

Disclosures About Fair Value of Financial Instruments, which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate that value. Fair value is defined in SFAS No. 107 as the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. It is not the Company's intent to enter into such exchanges.

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In cases where quoted market prices were not available, fair values were estimated using present value or other valuation methods, as described below. The use of different assumptions (e.g., discount rates and cash flow estimates) and estimation methods could have a significant effect on fair value amounts. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. Because SFAS No. 107 excludes certain financial instruments and all non-financial instruments from its disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company.

| <i>(In thousands)</i> | December 31, 2006 | | December 31, 2005 | |
|-------------------------------|--------------------|----------------------------|--------------------|----------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial Assets: | | | | |
| Cash and cash equivalents | \$ 43,068 | \$ 43,068 | \$ 63,030 | \$ 63,030 |
| Interest-bearing deposits | 7,893 | 7,779 | 7,656 | 7,472 |
| Investment securities | 83,366 | 83,366 | 95,236 | 95,236 |
| Loans, net | 499,569 | 494,695 | 417,157 | 411,461 |
| Interest rate swap contracts | (320) | (320) | (937) | (937) |
| Financial Liabilities: | | | | |
| Deposits | 587,127 | 587,438 | 546,460 | 537,598 |
| Borrowings | 0 | 0 | 0 | 0 |
| Junior Subordinated Debt | 15,464 | 15,464 | 15,464 | 15,464 |
| Commitments to extend credit | | | | |

The following methods and assumptions were used in estimating the fair values of financial instruments:

Cash and Cash Equivalents - The carrying amounts reported in the balance sheets for cash and cash equivalents approximate their estimated fair values.

Interest-bearing Deposits - Interest bearing deposits in other banks consist of fixed-rate certificates of deposits. Accordingly, fair value has been estimated based upon interest rates currently being offered on deposits with similar characteristics and maturities.

Investments - Fair values for investment securities, including collateralized mortgage obligations, are based on quoted market prices.

Loans - Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values. Fair values for all other loans are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities.

Interest Rate Swaps - The Company records interest rate swap contracts at fair value on the balance sheet. The fair value of interest rate swap contracts is based on the discounted net present value of the swap using third party dealer quotes.

Deposits - In accordance with SFAS No. 107, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at December 31, 2006 and 2005 (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed by SFAS No. 107. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Borrowings - Borrowings consist of federal funds sold, securities sold under agreements to repurchase, and other short-term borrowings. Fair values of borrowings were estimated using the rates currently offered for borrowings with similar remaining maturities.

Junior Subordinated Debt - Junior subordinated debt re-prices semiannually. Consequently, fair values were estimated using the rates currently offered for borrowings with similar remaining repricing characteristics.

Off-balance sheet Instruments - Off-balance sheet instruments consist of commitments to extend credit, credit card arrangements, standby letters of credit and derivative contracts. The contract amounts of commitments to extend credit and standby letters of credit are disclosed in Note 12. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at December 31, 2006 and 2005.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. At December 31, 2002, these commitments were not reflected on the consolidated balance sheet. As discussed in Note 1 of the Company's consolidated financial statements, FIN 45 became effective for all guarantees issued or modified subsequent to December 31, 2002, and required the fair value of such commitments be recorded after that date. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are deferred and recognized over the term of the commitment, and are not material to the Company's consolidated balance sheet and results of operations.

14. Regulatory Matters

Capital Guidelines - The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements adopted by the Board of Governors of the Federal Reserve System (Board of Governors). Failure to meet minimum capital requirements can initiate certain mandates and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the consolidated Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders' equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% of Tier 1 capital to total assets. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the 3% minimum requirement.

| (In thousands) | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|--------|-------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2006 (Company): | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 84,826 | 13.85% | \$ 48,989 | 8.00% | N/A | N/A |
| Tier 1 Capital (to Risk Weighted Assets) | 77,891 | 12.72% | 24,494 | 4.00% | N/A | N/A |
| Tier 1 Capital (to Average Assets) | 77,891 | 11.55% | 20,228 | 3.00% | N/A | N/A |
| As of December 31, 2006 (Bank): | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 82,644 | 13.52% | \$ 48,884 | 8.00% | \$ 61,105 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 75,709 | 12.39% | 24,442 | 4.00% | 36,663 | 6.00% |
| Tier 1 Capital (to Average Assets) | 75,709 | 11.23% | 20,228 | 3.00% | 33,714 | 5.00% |
| As of December 31, 2005 - (Company): | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 75,966 | 14.07% | \$ 43,186 | 8.00% | N/A | N/A |
| Tier 1 Capital (to Risk Weighted Assets) | 69,652 | 12.90% | 21,593 | 4.00% | N/A | N/A |
| Tier 1 Capital (to Average Assets) | 69,652 | 10.91% | 19,152 | 3.00% | N/A | N/A |
| As of December 31, 2005 - (Bank): | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 74,014 | 13.74% | \$ 43,093 | 8.00% | \$ 53,867 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 67,700 | 12.57% | 21,547 | 4.00% | 32,320 | 6.00% |
| Tier 1 Capital (to Average Assets) | 67,700 | 10.61% | 19,135 | 3.00% | 31,892 | 5.00% |

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The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. Insured institutions are required to maintain a ratio of qualifying total capital to risk weighted assets of 8%, at least one-half of which must be in the form of Tier 1 capital. Management believes, as of December 31, 2006, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2006 and 2005, the most recent notifications from the Bank's regulators categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum total capital and Tier 1 capital (as defined) to risk-based assets (as defined), and a minimum leverage ratio of Tier 1 capital to average assets (as defined) as set forth in the proceeding discussion. There are no conditions or events since the notification that management believes have changed the institution's category.

Under regulatory guidelines, the \$15 million in Trust Preferred Securities issued in July of 2001 qualifies as Tier 1 capital up to 25% of Tier 1 capital. Any additional portion of Trust Preferred Securities qualifies as Tier 2 capital.

Dividends - Dividends paid to shareholders are paid by the bank holding company, subject to restrictions set forth in the California General Corporation Law. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank. Year-to-date as of December 31, 2006, the Company received \$7.3 million in cash dividends from the Bank, from which the Company has declared \$5.2 million in dividends to shareholders.

Under California state banking law, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the California State Department of Financial Institutions, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. As of December 31, 2006, approximately \$16.9 million was available to the Bank for cash dividend distributions without prior approval. Year-to-date, the Bank has paid dividends of \$7.3 million to the Company.

Cash Restrictions - The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At both December 31, 2006 and 2005, the Bank's qualifying balance with the Federal Reserve Bank was \$25,000 consisting of vault cash and balances.

15. Supplemental Cash Flow Disclosures

| <i>(In thousands)</i> | Years Ended December 31, | | |
|---|--------------------------|----------|------------------|
| | 2006 | 2005 | 2004 |
| Cash paid during the period for: | | | |
| Interest | \$ 13,574 | \$ 8,949 | \$ 6,075 |
| Income Taxes | 8,287 | 5,689 | 7,090 |
| Noncash investing activities: | | | |
| Loans transferred to foreclosed property | 0 | 4,311 | 0 |
| Dividends declared not paid | 1,413 | 1,135 | 910 |
| Supplemental disclosures related to acquisitions: | | | |
| Deposits | | | \$ 48,249 |
| Other liabilities | | | 454 |
| Interest-bearing deposits in other banks | | | (1,192) |
| Securities available for sale | | | (9,227) |
| Loans, net of allowance for loan loss | | | (23,250) |
| Premises and equipment | | | (1,588) |
| Intangibles | | | (2,611) |
| Accrued interest and other assets | | | (1,703) |
| Stock issued | | | 6,251 |
| Net cash and equivalents acquired | | | \$ 15,383 |

16. Net Income Per Share

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation. (Weighted average shares have been adjusted to give retroactive recognition for 2-for-1 stock split during May 2006):

| <i>(In thousands, except earnings per share data)</i> | Years Ended December 31, | | |
|---|--------------------------|-----------|----------|
| | 2006 | 2005 | 2004 |
| Net income available to common shareholders | \$ 13,360 | \$ 11,008 | \$ 8,405 |
| Weighted average shares issued | 11,344 | 11,370 | 11,282 |
| Less: unearned ESOP shares | 0 | 0 | (22) |
| Weighted average shares outstanding | 11,344 | 11,370 | 11,260 |
| Add: dilutive effect of stock options | 118 | 84 | 74 |
| Weighted average shares outstanding adjusted for potential dilution | 11,462 | 11,454 | 11,334 |
| Basic earnings per share | \$ 1.18 | \$ 0.97 | \$ 0.75 |
| Diluted earnings per share | \$ 1.17 | \$ 0.96 | \$ 0.74 |

17. Other Comprehensive Income

The following table provides a reconciliation of the amounts included in comprehensive income:

| <i>(In thousands)</i> | Years Ended December 31 | | |
|---|-------------------------|------------|----------|
| | 2006 | 2005 | 2004 |
| Unrealized (loss) gain on available-for-sale securities: | | | |
| Unrealized (loss) gain on sale securities net of income tax (benefit) of \$253, \$(644), and \$(470) | \$ 379 | \$ (966) | \$ (705) |
| Less: Reclassification adjustment for loss (gain) on sale of available-for-sale securities included in net income - net of income tax (benefit) of \$11, \$65, and \$14 | (16) | (98) | (21) |
| Net unrealized (loss) gain on available-for-sale securities - net income tax (benefit) of \$(242), \$(709), and \$(484) | \$ 363 | \$ (1,064) | \$ (726) |
| Unrealized loss on interest rate swaps: | | | |
| Unrealized losses arising during period net of income tax benefit of \$150, \$24 and \$201 | \$ (225) | \$ (36) | \$ (76) |
| Less: reclassification adjustments to interest income | 493 | 246 | (126) |
| Net change in unrealized loss on interest rate swaps - net of income tax benefit \$140, \$24 and \$201 | \$ 268 | \$ 210 | \$ (202) |
| Previously unrecognized past service costs of employee benefit plans (net tax benefit of \$112) | \$ (169) | | |
| Total other comprehensive income | \$ 462 | \$ (854) | \$ (928) |

18. Derivative Financial Instruments and Hedging Activities

As part of its overall risk management, the Company pursues various asset and liability management strategies, which may include obtaining derivative financial instruments to mitigate the impact of interest fluctuations on the Company's net interest margin. During the second quarter of 2003, the Company entered into an interest rate swap agreement with the purpose of minimizing interest rate fluctuations on its interest rate margin and equity.

Under the interest rate swap agreement, the Company receives a fixed rate and pays a variable rate based on the Prime Rate (Prime). The swap qualifies as a cash flow hedge under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, and is designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement is measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that is deemed effective in hedging the cash flows of the designated assets are recorded in accumulated other comprehensive income and reclassified into interest income when such cash flow occurs in the future. Any ineffectiveness resulting from the hedge is recorded as a gain or loss in the consolidated statement of income as part of noninterest income.

At December 31, 2006 and 2005, the information pertaining to the outstanding interest rate swap is as follows:

| (000 s in millions) | December 31, 2006 | December 31, 2005 |
|---|----------------------|----------------------|
| Notional amount | \$ 14,107 | \$ 17,113 |
| Weighted average pay rate | 7.86% | 6.19% |
| Weighted average receive rate | 4.88% | 4.88% |
| Weighted average maturity in years | 1.0 | 2.0 |
| Unrealized loss relating to interest rate swaps | \$ 320 | \$ 692 |

The amortizing hedge has a remaining notional value of \$14.1 million and a duration of approximately 12 months. As of December 31, 2006, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately 1.8 years. As of December 31, 2005, the loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$147,000 (net of tax benefit of \$98,000). During the year ended December 31, 2006, \$494,000 was reclassified from other accumulated comprehensive income as a reduction to interest income. As of December 31, 2006, the amounts in accumulated OCI associated with these cash flows that are expected to be reclassified into interest expense within the next 12 months total \$317,000.

The Company has performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2006. As a result of a correlation analysis, the Company has determined that the swap remains highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continues to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. As a result, the notional value of the hedge instrument was approximately \$3.8 million greater than the underlying loans being hedged at June 30, 2006, \$3.3 million greater than the underlying loans being hedged at September 30, 2006, and \$3.3 million greater than the underlying loans being hedged at December 31, 2006. This difference between the notional value of the hedge and the underlying hedged assets is considered an overhedge pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than temporary. At June 30, 2006, the Company determined that the difference was other than temporary and, as a result, reclassified \$147,000 of the pretax hedge loss reported in other comprehensive income into earnings. During the third quarter of 2006, the Company adjusted the pretax loss reported in other comprehensive income by \$53,000 resulting in a year-to-date loss related to swap ineffectiveness of \$94,000 reported in earnings at September 30, 2006. Then, as a result of the fourth quarter analysis for ineffectiveness, the Company adjusted the pretax loss reported in other comprehensive income by \$19,000 resulting in a net year-to-date loss related to swap ineffectiveness of \$75,000 reported in earnings at December 31, 2006. The ineffective amount reclassified from other comprehensive income into earnings was based upon the difference between the net present value of the anticipated cash flows using the notional value of the hedge, and the net present value of anticipated cash flows using the remaining balances of the underlying loans being hedged. The \$75,000 in expense recognized as hedge ineffectiveness is reflected in noninterest income as of December 31, 2006.

19. Investment in Title Company

During August 2001, the Company purchased an equity ownership interest of \$1.5 million in Diversified Holding Corporation (DHC). At December 31, 2004, the Company's ownership percentage of DHC was 13.8%. For financial reporting purposes, the equity investment is included in *other assets* in the consolidated balance sheets, and as *investment in nonbank entity* in the parent-only balance sheets.

During the early part of 2005, DHC sought restructuring options in an effort to remain a viable entity. DHC had experienced operating losses during 2004 primarily as the result of a significant decrease in mortgage loan refinancing business due to real estate price increases and rising interest rates. During February 2005, the Company provided DHC with a short-term working capital loan of \$600,000 to cover potential cash-flow shortfalls as DHC initiated plans to restructure and return to profitability. The \$600,000 loan to DHC was subsequently repaid during July 2005.

During April 2005 additional information was obtained on the status of DHC's operations. DHC continued to experience operating losses, and efforts to restructure, recapitalize, or sell the business had not been successful. The Company's management assessed the anticipated cash-flows of DHC and the ultimate ability to collect the Company's equity investment in DHC. At that time, management believed that it was reasonably possible that a loss would ultimately be incurred. Based upon management's estimate of the most likely amount of the potential loss at that time, the Company recorded a write-down of its equity investment in DHC of approximately \$662,000 during the second quarter of 2005, and an additional write-down of \$40,000 during the fourth quarter of 2005. The write-down is included in noninterest expense for the year ended December 31, 2005.

During July of 2005, DHC concluded a transaction with Transunion Corporation whereby Transunion would purchase DHC and DHC would cease to exist. A new shell corporation was formed to pay off the existing debts as monies are received from Transunion. During December 2005, the Company sold approximately 65% of its investment in Diversified Holdings Corp (1,183,593 of 1,825,443 total shares) leaving a net carrying value of \$271,000 at December 31, 2005. Then during August 2006, the Company sold another 335,250 shares, leaving 306,600 remaining total shares, and a net carrying value of \$122,000 at December 31, 2006. Based upon review of the investment at December 31, 2006, management believes the remaining carrying amount of the investment in DHC is fairly valued.

20. Stock Split

On March 28, 2006, the Company's Board of Directors approved a 2-for-1 stock split of the Company's no par common stock effected in the form of a 100% stock dividend. The stock dividend was payable May 1, 2006 to shareholders of record as of April 7, 2006. Effective May 1, 2006, each shareholder received one additional share for each common share held as of the record date. All periods presented in this 10-K have been restated to reflect the effect of the 2-for-1 stock split.

21. Common Stock Repurchase Plan

During August 2001, the Company's Board of Directors approved a plan to repurchase, as conditions warrant, up to 280,000 shares (effectively 580,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. The duration of the program is open-ended and the timing of the purchases will depend on market conditions.

On February 25, 2004, the Company announced another stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares (effectively 553,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. As with the first plan, the duration of the new program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Board terminated the 2001 repurchase plan. During the year ended December 31, 2005, 13,081 shares (26,162 shares effected for 2006 2-for-1 stock split) were repurchased at a total cost of \$377,000 and an average price per share of \$28.92 (\$14.46 effected for 2006 2-for-1 stock split). During the year ended December 31, 2006, 108,005 shares were repurchased at a total cost of \$2.4 million and an average price per share of \$22.55.

22. Subsequent Event - Business Combination

On October 6, 2006 the Company announced the signing of a definitive merger agreement providing for the merger of Legacy Bank, N.A. with and into United Security Bank, a wholly owned subsidiary of the Company. Legacy Bank currently operates one banking office in Campbell, California serving small business and retail banking clients. Upon completion of the merger on February 16, 2007, Legacy Bank's branch office began operating as a branch office of United Security Bank. As of the merger date of February 16, 2007, Legacy Bank had total assets of \$78.9 million and deposits of \$69.6 million.

In the merger, the Company issued shares of its stock in a tax-free exchange for all of the Legacy Bank common shares. The terms of the merger agreement provide for the shareholders of Legacy Bank to receive the Company's common shares with a market value of \$13.00 based upon the average closing price of the Company's shares during the 20 business day period prior to the merger, less the net costs of termination of Legacy's data processing/technology agreements divided by the outstanding number of shares of Legacy Bank common stock, provided that there are no stock options or warrants exercised for shares of Legacy Bank common stock. At the date of merger, Legacy Bank had 1,672,373 shares of common stock outstanding. Immediately prior to the merger, all outstanding options and warrants were cancelled by Legacy Bank and optionees and warrant holders received a cash payment equal to the difference between the option exercise price and the merger consideration for each share subject to an option or a warrant. In the event any options or warrants for shares of Legacy Bank common stock were exercised prior to merger, the market value of the Company's common shares Legacy Bank shareholders receive decreased based upon a set formula. Legacy employees exercised 2,000 stock options between the time the Definitive Agreement was signed and the consummation of the merger.

The total value of the merger transaction is approximately \$21.5 million. Shareholders of Legacy Bank are entitled to receive merger consideration consisting of approximately 976,594 shares of common stock of the Company. The shareholders of Legacy Bank who elected to receive cash, and were allocated cash, will receive cash for their shares based on a value of approximately \$12.86 per share and those who elected to receive stock, and were allocated common stock in United Security Bancshares, will receive approximately .58 shares of the Company's common stock for each Legacy Bank common share. The exchange ratio of .58 shares was based upon an average United Security Bancshares stock price of \$22.05 for the 20 business day period prior to the merger. As a result of the merger, former Legacy Bank shareholders own approximately 8% of Company's outstanding common shares. The merger transaction will be accounted for using the purchase accounting method, and will result in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The net of assets acquired and liabilities assumed totaled approximately \$8.8 million at the date of the merger. Fair value of Legacy assets and liabilities acquired, and resultant goodwill, has not yet been fully determined.

23. Parent Company Only Financial Statements

The following are the condensed financial statements of United Security Bancshares and should be read in conjunction with the consolidated financial statements:

United Security Bancshares (parent only)
Balance Sheets - December 31, 2006 and 2005

| <i>(In thousands)</i> | 2006 | 2005 |
|---|------------------|------------------|
| Assets | | |
| Cash and equivalents | \$ 2,417 | \$ 2,640 |
| Investment in bank subsidiary | 79,835 | 72,061 |
| Investment in nonbank entity | 122 | 271 |
| Other assets | 944 | 889 |
| Total assets | \$ 83,318 | \$ 75,861 |
| Liabilities & Shareholders' Equity | | |
| Liabilities: | | |
| Junior subordinated debt securities | \$ 15,464 | \$ 15,464 |
| Accrued interest payable | 613 | 508 |
| Other liabilities | 1,199 | 875 |
| Total liabilities | 17,276 | 16,847 |
| Shareholders' Equity: | | |
| Common stock, no par value 20,000,000 shares authorized, 11,301,113 and 11,361,118 issued and outstanding, in 2006 and 2005 | 20,448 | 22,084 |
| Retained earnings | 46,884 | 38,682 |
| Unearned ESOP shares | 0 | 0 |
| Accumulated other comprehensive income | (1,290) | (1,752) |

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| | | |
|--|-----------|-----------|
| Total shareholders' equity | 66,042 | 59,014 |
| Total liabilities and shareholders' equity | \$ 83,318 | \$ 75,861 |

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United Security Bancshares (parent only)
Income Statements

| <i>(In thousands)</i> | Years Ended December 31, | | |
|--|--------------------------|------------------|-----------------|
| | 2006 | 2005 | 2004 |
| Income | | | |
| Dividends from subsidiaries | \$ 7,300 | \$ 5,012 | \$ 6,500 |
| Other income | 0 | 20 | 0 |
| Total income | 7,300 | 5,032 | 6,500 |
| Expense | | | |
| Interest expense | 1,355 | 1,091 | 821 |
| Other expense | 378 | 1,033 | 288 |
| Total expense | 1,733 | 2,124 | 1,109 |
| Income before taxes and equity in undistributed income of subsidiary | 5,567 | 2,908 | 5,391 |
| Income tax benefit | (729) | (866) | (452) |
| Equity in undistributed income of subsidiary | 7,064 | 7,234 | 2,562 |
| Net Income | \$ 13,360 | \$ 11,008 | \$ 8,405 |

United Security Bancshares (parent only)
Statement of Cash Flows

| <i>(In thousands)</i> | Years Ended December 31, | | |
|---|--------------------------|-----------------|-----------------|
| | 2006 | 2005 | 2004 |
| Cash Flows From Operating Activities | | | |
| Net income | \$ 13,360 | \$ 11,008 | \$ 8,405 |
| Adjustments to reconcile net earnings to cash provided by operating activities: | | | |
| Equity in undistributed income of subsidiary | (7,064) | (7,234) | (2,562) |
| Write-down of other investments | 0 | 702 | 0 |
| Amortization of issuance costs | 17 | 17 | 17 |
| Net change in other liabilities | 297 | (92) | 60 |
| Net cash provided by operating activities | 6,610 | 4,401 | 5,920 |
| Cash Flows From Investing Activities | | | |
| Proceeds from sale of investment in title company | 149 | 527 | 0 |
| Net cash provided by investing activities | 149 | 527 | 0 |
| Cash Flows From Financing Activities | | | |
| Proceeds from stock options exercised | 335 | 118 | 86 |
| Repurchase and retirement of common stock | (2,436) | (377) | (2,058) |
| Payment of dividends on common stock | (4,881) | (3,980) | (3,510) |
| Net cash used in financing activities | (6,982) | (4,239) | (5,482) |
| Net (decrease) increase in cash and cash equivalents | (223) | 689 | 438 |
| Cash and cash equivalents at beginning of year | 2,640 | 1,951 | 1,513 |
| Cash and cash equivalents at end of year | \$ 2,417 | \$ 2,640 | \$ 1,951 |
| Supplemental cash flow disclosures | | | |
| Noncash financing activities: | | | |
| Dividends declared not paid | \$ 1,413 | \$ 1,135 | \$ 910 |

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24. Quarterly Financial Data (unaudited)

Selected quarterly financial data for the years ended December 31, 2006 and 2005 are presented below:

| (In thousands except per share data) | 2006 | | | | 2005 | | | |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|----------|----------|----------|
| | 4th | 3rd | 2nd | 1st | 4th | 3rd | 2nd | 1st |
| Interest income | \$ 12,847 | \$ 12,548 | \$ 11,409 | \$ 10,552 | \$ 10,376 | \$ 9,955 | \$ 9,430 | \$ 9,137 |
| Interest expense | 4,126 | 3,999 | 3,311 | 2,739 | 2,713 | 2,686 | 2,302 | 1,957 |
| Net interest income | 8,721 | 8,549 | 8,098 | 7,813 | 7,663 | 7,269 | 7,128 | 7,180 |
| Provision for credit losses | 241 | 276 | 123 | 240 | 250 | 392 | 247 | 251 |
| Gain (loss) on sale of securities | 27 | 0 | 0 | 0 | 163 | 0 | 0 | 0 |
| Other noninterest income | 1,872 | 2,331 | 1,594 | 3,207 | 1,578 | 1,531 | 1,712 | 1,296 |
| Noninterest expense | 5,293 | 5,060 | 5,036 | 4,548 | 4,388 | 4,064 | 4,514 | 4,016 |
| Income before income tax expense | 5,086 | 5,544 | 4,533 | 6,232 | 4,766 | 4,344 | 4,079 | 4,209 |
| Income tax expense | 2,113 | 2,083 | 1,471 | 2,368 | 1,737 | 1,618 | 1,490 | 1,545 |
| Net income | \$ 2,973 | \$ 3,461 | \$ 3,062 | \$ 3,864 | \$ 3,029 | \$ 2,726 | \$ 2,589 | \$ 2,664 |
| Net income per share: | | | | | | | | |
| Basic | \$ 0.26 | \$ 0.30 | \$ 0.27 | \$ 0.34 | \$ 0.27 | \$ 0.24 | \$ 0.23 | \$ 0.23 |
| Diluted | \$ 0.26 | \$ 0.30 | \$ 0.27 | \$ 0.34 | \$ 0.26 | \$ 0.24 | \$ 0.23 | \$ 0.23 |
| Dividends declared per share | \$ 0.125 | \$ 0.11 | \$ 0.11 | \$ 0.11 | \$ 0.10 | \$ 0.09 | \$ 0.09 | \$ 0.09 |
| Average shares outstanding | | | | | | | | |
| For net income per share: | | | | | | | | |
| Basic | 11,302 | 11,358 | 11,369 | 11,370 | 11,368 | 11,370 | 11,370 | 11,372 |
| Diluted | 11,430 | 11,476 | 11,496 | 11,490 | 11,466 | 11,456 | 11,444 | 11,444 |

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

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures:

a) As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in the Securities and Exchange Act Rule 13(a)-15(e). Based upon that evaluation, the CEO and CFO concluded that, as of the end of the period covered in this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that material information relating to our consolidated operations is made known to the Company's management, including the CEO and CFO, particularly during the period when the Company's periodic reports are being prepared.

(b) Changes in Internal Controls over Financial Reporting: There was no change in the Company's internal control over financial reporting that occurred during the fourth quarter of 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Management Report on Internal Control over Financial Reporting:

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of United Security Bancshares and Subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2006. The Company's internal control over financial reporting is a process designed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

The Company's system of internal control over financial reporting includes policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) 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.

Management recognizes that there are inherent limitations in the effectiveness of any system of internal control, and accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation and fair presentation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 based upon criteria in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, Management determined that the Company's internal control over financial reporting was effective as of December 31, 2006.

The Company's independent registered public accounting firm, Moss Adams LLP, who audits the Company's consolidated financial statements, have issued an attestation report on Management's assessment and on the effectiveness of the Company's internal control over financial reporting. This report is included in Item 8, financial statements and supplementary data to the Form 10-K.

Dated March 15, 2007

Item 9B. Other Information

None

PART III

Item 10 - Directors and Executive Officers of the Registrant

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled Information on Directors and Executive Officers set forth in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (Proxy Statement).

Item 11 - Executive Compensation

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled Compensation of Directors and Executive Officers set forth in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (Proxy Statement).

Item 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled Shareholdings of Certain Beneficial Owners and Management set forth in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (Proxy Statement).

Item 13 - Certain Relationships and Related Transactions

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled Certain Related Parties and Related Party Transactions set forth in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (Proxy Statement).

Item 14. Principal Accounting Fees and Services

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled Principal Accounting Fees and Services set forth in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders (Proxy Statement).

PART IV

Item 15 Exhibits and Financial Statement Schedules

(a)(1) Financial Statements

The Consolidated Financial Statements and related documents set forth in Item 8. Financial Statements and Supplementary Data of this report are filed as part of this report.

(a)(2) Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable or not required or because the information is included in the financial statements or notes thereto or is not material.

(a)(3) Exhibits

- 3.1 Articles of Incorporation of Registrant (1)
- 3.2 Bylaws of Registrant (1)
- 4.1 Specimen common stock certificate of United Security Bancshares (1)
- 10.1 Executive Salary Continuation Agreement for Dennis Woods (1)
- 10.2 Change in Control Agreement for Dennis Woods (1)
- 10.3 Executive Salary Continuation Agreement for Kenneth Donahue (1)
- 10.4 Change in Control Agreement for Kenneth Donahue (1)
- 10.5 Executive Salary Continuation Agreement for David Eytcheson (1)
- 10.6 Change in Control Agreement for David Eytcheson (1)
- 10.7 Executive Salary Continuation Agreement for Rhodlee Braa (1)
- 10.8 Change in Control Agreement for Rhodlee Braa (1)
- 10.9 Stock Option Agreement for Dennis Woods dated June 16, 1996 (1)
- 10.10 Stock Option Agreement for Dennis Woods dated July 21, 1997 (1)
- 10.11 Stock Option Agreement for Kenneth Donahue dated July 21, 1997 (1)
- 10.12 Stock Option Agreement for David Eytcheson dated July 21, 1997 (1)
- 10.13 Stock Option Agreement for Rhodlee Braa dated October 10, 1995 (1)
- 10.14 Stock Option Agreement for Rhodlee Braa dated July 21, 1997 (1)
- 10.15 USB 1995 Stock Option Plan. Filed as Exhibit 10.15 to the Company's Registration Statement on Form S-4 (file number 333-58256) filed April 4, 2001 and incorporated herein by reference.
- 10.16 Amendment to USB 1995 Stock Option Plan. Filed as Exhibit 99.2 to the Company's Registration Statement on Form S-8 (file number 333-89362) filed May 28, 2002 and incorporated herein by reference.

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- 10.17 Amended and Restated Declaration of Trust for USB Capital Trust I dated July 16, 2001. Filed as Exhibit 10.1 to the Company's Form 10-Q filed August 14, 2001.
- 10.18 Indenture Agreement between United Security Bancshares and Bank of New York for Junior Subordinated Securities dated July 16, 2001. Filed as Exhibit 10.2 to the Company's Form 10-Q filed August 14, 2001.
- 10.19 USB 2005 Stock Option Plan. Filed as Exhibit B to the Company's 2005 Schedule 14A Definitive Proxy filed April 18, 2005 and incorporated herein by reference.
- 10.20 Stock Option Agreement for William F. Scarborough dated August 1, 2005 (2)
- 10.21 Executive Salary Continuation Agreement for William F. Scarborough (2)
- 10.22 Stock Option Agreement for Dennis R. Woods dated February 6, 2006 (3)
- 10.20 Employment Agreement for Dennis R. Woods dated March 8, 2006 (4)
- 11.1 Computation of earnings per share.
- See Note 16 to Consolidated Financial Statements and related documents set forth in Item 8. Financial Statements and Supplementary Data of this report are filed as part of this report.
- 21 Subsidiaries of the Company
- 23.1 Consent of Moss Adams LLP, Independent Registered Public Accounting Firm
- 31.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Previously filed on April 4, 2001 as an exhibit to the Company's filing on Form S-4 (file number 333-58256).

(2) Previously filed on March 15, 2006 as an exhibit to the Company's filing on Form 10-K for the year ended December 31, 2006 (file number 000-32987).

(3) Previously filed on November 7, 2006 as an exhibit to the Company's filing on Form 10-Q/A for the period ended March 31, 2006 (file number 000-32987).

(4) Previously filed on November 8, 2006 as an exhibit to the Company's filing on Form 8-K (file number 000-32987).

(b) Exhibits filed:

See Exhibit Index under Item 15(a)(3) above for the list of exhibits required to be filed by Item 601 of regulation S-K with this report.

(c) Financial statement schedules filed:

See Item 15(a)(2) above.

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 on Form 10-K for the year ended December 31, 2005 to be signed on its behalf by the undersigned thereunto duly authorized, in Fresno, California, on the 15th day of March, 2007

United Security Bancshares

March 15, 2007

/S/ Dennis R. Woods

Dennis R. Woods
President and Chief Executive Officer

March 15, 2007

/S/ Kenneth L. Donahue

Kenneth L. Donahue
Senior Vice President and Chief Financial Officer

March 15, 2007

/S/ Richard B. Shupe

Richard B. Shupe
Vice President and Controller

Signatures

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 on the date indicated:

Date: 3/15/2007 /s/ Robert G. Bitter

Director

Date: 3/15/2007 /s/ Stanley J. Cavalla

Director

Date: 3/15/2007 /s/ Tom Ellithorpe

Director

Date: 3/15/2007 /s/ R. Todd Henry

Director

Date: 3/15/2007 /s/ Ronnie D. Miller

Director

Date: 3/15/2007 /s/ Robert M. Mochizuki

Director

Date: 3/15/2007 /s/ Walter Reinhard

Director

Date: 3/15/2007 /s/ John Terzian

Director

Date: 3/15/2007 /s/ Mike Woolf

Director