UNITED SECURITY BANCSHARES
Form 10-K
March 16, 2007

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

FORM 10-K

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

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT**
OF 1934 FOR THE TRANSITION PERIOD FROM__________ TO__________

Commission file number: 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 o No x

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 o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing for the past 90 days.

Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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. o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

Yes o No x

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 2001and 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.

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.

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.

	Rank	Share
Fresno County	8th	5.06%
Madera County	8th	4.49%
Kern County	13th	1.20%
Total of Fresno, Madera, Kern Counties	9th	3.65%
Santa Clara County	30th	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 (FHC s), 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

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).

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 depositary 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:

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.

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 Hoeffer & 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.

	Closing Prices		
Quarter	**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.

	Period Ending					
Index	**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

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).

	December 31,				
(in thousands except per share data and ratios)	**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 (LIC s). 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 LIC s 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%

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.

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.

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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

	2006			2005			2004		
(Dollars in thousands)	**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%

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

	2006 compared to 2005			**2005 compared to 2004**		
(In thousands)	**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.

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:

	Years Ended December 31,			Increase (decrease) during Year	
(In thousands)	**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.

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.

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:

	2006		2005		2004	
(Dollars in thousands)	**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.

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:

	2006		2005		2004		2003		2002	
(In thousands)	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.

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:

(In thousands)	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:

(In thousands)	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

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

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:

	December 31, 2006				December 31, 2005			
(In thousands)	**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

	December 31, 2004			
(In thousands)	**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.

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.

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

(In thousands)	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.

(Dollars in thousands)	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.

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:

	December 31,			Change during Year	
(In thousands)	**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.

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:

	2006		2005		2004	
(Dollars in thousands)	**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:

	December 31,		
(Dollars in thousands)	**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

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

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 lo
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

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.

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.

	December 31,				
(Dollars in thousands)	**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.

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.

	2006		2005		2004		2003		2002	
(Dollars in thousands)	**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.

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,				
(Dollars in 000 s)	**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.

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 if 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:

	December 31,				
(Dollars in thousands, except footnote)	**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