

UNITED SECURITY BANCSHARES  
Form 10-K  
March 17, 2008

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

**FORM 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007.

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  
(State or other jurisdiction of  
incorporation or organization)

91-2112732  
(I.R.S. Employer  
Identification No.)

2126 Inyo Street, Fresno, California  
(Address of principal executive offices)

93721  
(Zip Code)

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

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

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

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

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the  
Securities Act. Yes  No

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

Yes  No

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Small reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes [ ] 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, 2007: \$176,229,651

Shares outstanding as of February 29, 2008: 11,844,970

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Definitive Proxy Statement for the 2008 Meeting of Part III, Items 10, 11, 12, 13 and 14 Shareholders is incorporated by reference into Part III.

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## PART 1

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

### **Item 1 - Business**

#### ***General***

United Security Bancshares (the "Company") is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company's stock is listed on NASDAQ under the symbol "UBFO". United Security Bank (the "Bank") is a wholly-owned bank subsidiary of the Company and was formed in 1987. United Security Bancshares Capital Trust I (the "Trust") was formed during June of 2001 as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. The Trust was originally formed as a subsidiary of the Company, but was deconsolidated during 2004 pursuant to the adoption of FIN 46 (as revised), "Consolidation of Variable Interest Entities". During July 2007, the Trust Preferred Securities issued under USB Capital Trust I were redeemed, and upon retirement, the USB Capital Trust I was dissolved. During July the Company formed United Security Bancshares Capital Trust II and issued \$15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I, except at a lower interest rate. 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.

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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 February 16, 2007, the Company completed its merger with Legacy Bank, N.A., located in Campbell, California, with the acquisition of 100 percent of Legacy's outstanding common shares. At merger, Legacy Bank's one branch was merged with and into United Security Bank, a wholly owned subsidiary of the Company. The total value of the merger transaction was \$21.5 million, and the shareholders of Legacy Bank received merger consideration consisting of 976,411 shares of common stock of the Company. The merger transaction was accounted for as a purchase transaction, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The net of assets acquired and liabilities assumed totaled approximately \$8.6 million at the date of the merger. Fair value of Legacy assets and liabilities acquired, and resultant goodwill, has been determined and recorded as of the date of the merger and the resulting operations thereafter have been included in the financial statements as of and for the year ended December 31, 2007. (See Note 24 to the Company's consolidated financial statements contained herein for details of the merger).

During November 2007, the Company purchased the recurring contractual revenue stream and certain fixed assets from ICG Financial, LLC. Additionally, the Company hired all but one of the former employees of ICG Financial, LLC and its subsidiaries. The total purchase price was \$414,000 including \$378,000 for the recurring revenue stream and \$36,000 for the fixed assets. A newly formed department of the Bank, USB Financial Services provides wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients, utilizing employees hired from ICG Financial LLC. The Company believes the wealth management and related services provided by USB Financial Services will enhance the products and services offered by the Company, and increase noninterest income. The capitalized cost of \$378,000 for the recurring revenue stream will be amortized over a period of approximately three years.

At December 31, 2007, the Bank operates three branches (including its main office), one construction lending office, and one financial services 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 located at 2126 Inyo Street, Fresno, California, 93721.

At December 31, 2007, the consolidated Company had approximately \$771.7 million in total assets, \$585.6 million in net loans, \$634.6 million in deposits, and \$82.4 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, Kern, and Santa Clara Counties.

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 68% 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, 2007, the Bank had loans (net of unearned fees) outstanding of \$596.5 million, which represented approximately 94% of the Bank's total deposits and approximately 77% 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, 2007 and 2006, loan commitments and letters of credit of the Bank aggregated \$196.3 million and \$193.1 million, respectively. Of the \$196.3 million in loan commitments outstanding at December 31, 2007, \$159.7 million or 81.6% 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. The Company does however have collateralized and uncollateralized lines of credit which could be utilized if such loan commitments were to be exercised in excess of normal expectations.

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. In addition, the Bank offers a variety of specialized financial services, including wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients. 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, Kern, and Santa Clara 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, 2007 was located in Fresno, Madera, and Kern Counties, in which approximately 34 FDIC-insured financial institutions compete for business. Santa Clara County was added during February 2007 with the Legacy Bank acquisition, in which approximately 75 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, 2007, which is the most current information available.

|  | Rank             | Share |
|--|------------------|-------|
| Fresno County                          | 7 <sup>th</sup>  | 5.39% |
| Madera County                          | 8 <sup>th</sup>  | 4.84% |
| Kern County                            | 13 <sup>th</sup> | 1.19% |
| Total of Fresno, Madera, Kern Counties | 10 <sup>th</sup> | 3.80% |
| Santa Clara County                     | 17 <sup>th</sup> | 0.96% |

### ***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.

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.

In September 2007, the President signed into law the College Cost Reduction Act that increases the size of Pell grants by \$500 per year over the next 5 years and cut interest rates on federal student loans from 6.8 percent to 3.4 percent over the same period. To offset these costs, the law will reduce subsidies to private and nonprofit lenders by 55 and 40 basis points, respectively. The new law also cuts the special allowance payment subsidy and reduces lender insurance rates and increase loan origination fees.

The Private Student Loan Disclosure Enhancement Act (S. 1831) is being considered by Congress to prevent unfair and deceptive private educational lending practices and eliminating conflicts of interest by prohibiting gifts and revenue sharing. The proposed bill would prohibit private education lenders from directly or indirectly offering or providing any gift to a higher education institution or employee in exchange for loan volume or any other advantage. The proposed bill also prohibits institutions and employees from receiving any gifts in exchange for preferential treatment of private student loans. Institutions of higher education and lenders would also be prohibited from entering into revenue sharing agreements under the proposed bill. There would also be a co-branding prohibition in the proposed bill-that prohibits private education lenders from using the name, emblem, mascot, or logo of an institution when marketing private educational loans in a way that implies that an institution endorses the private loan offered by the lender. This provision also forbids lenders from using words, pictures, or symbols readily identified with an institution. Compensation in Connection with Advisory Boards would also be limited in that the proposed bill would prohibit employees of financial aid offices that serve on a private lenders advisory board, commission, or group of lenders from receiving anything of value from the lender. As to covered student loans, the bill would prohibit lenders from imposing fees for early repayment or prepayment of educational loans and required improved detailed disclosure of loan terms and rates before consummation of the loan transaction. In addition, the bill provides a 30 day period to review the loan before accepting the loan during which the terms may not be changed. The proposed bill would provide credit for lenders (used to meet the credit needs of its community under the Community Reinvestment Act) that make low-cost private loans to low-income borrowers.

Congress is also considering The Federal Housing Administration Modernization Act of 2007 (S. 2338): The FHA Modernization Act of 2007 seeks to help American families that have been hit hard by the current crisis in the mortgage markets by addressing problems in the mortgage market that have shut off funding for home loans and make FHA loans a more viable alternative to the subprime market by raising FHA loan limits, modifying downpayment requirements and expanding the access to FHA programs. The proposed bill also removes the current cap on the number of reverse mortgages made through the Home Equity Conversion Mortgage program and raises the current loan limit for this program to a single national loan limit. The proposed bill would also make the Home Equity Conversion Mortgage program permanent.

In December 2007, the FDIC issued a proposed rule to improve the process for determining uninsured depositors at larger institutions in the event of a failure. The measure is intended to allow the FDIC to make funds promptly available to insured deposit customers in the unlikely event that a large financial institution is closed. The proposal is broken into two parts. One section relates to so-called covered institutions, those that have at least \$2 billion in domestic deposits, have more than 250,000 deposit accounts, or have total assets of more than \$20 billion, regardless of the number of deposits or accounts. A covered institution would be required to adopt mechanisms that, in the event of a failure, would place provisional holds on large deposit accounts in a percentage specified by the FDIC; provide the FDIC with deposit account data in a standard format; and allow automatic removal of provisional holds once the FDIC makes an insurance determination. The second part applies to all FDIC-insured institutions, regardless of size, and governs the specific time and circumstance under which account balances will be determined in the event of a

failure. The FDIC is proposing to use the end-of-day ledger balance as normally calculated by the institution. By using the end-of-day ledger, the FDIC will be able to apply a single standard across all failed banks in order to treat every transaction equally. This is also the same deposit balance used for Call Report and assessment purposes. There would be no requirements placed on open institutions as a result of this provision. The FDIC places a high priority on providing access to insured deposits promptly and, in the past, has usually been able to allow most depositors access to their deposits on the next business day. If adopted, the proposed rule would better enable the FDIC to continue this practice, especially for the larger, more complex institutions it insures.

The Federal Reserve Board in November 2007 approved final rules to implement the Basel II framework for large bank capital requirements. The new risk-based capital requirements apply to large, internationally active banking organizations in the United States. The new capital adequacy requirements were designed to align regulatory capital requirements with actual risks and are expected to strengthen banking organizations' risk-management practices. Basel II would replace the current U.S. rules implementing the Basel Capital Accord of 1988 (Basel I) and be mandatory for large, internationally active banking organizations (so-called "core" banking organizations with at least \$250 billion in total assets or at least \$10 billion in foreign exposure) and optional for others. Under Basel II, core banking organizations would be required to enhance the measurement and management of their risks, including credit risk and operational risk. Core banking organizations will be required to have rigorous processes for assessing their overall capital adequacy in relation to their total risk profile and to publicly disclose information about their risk profile and capital adequacy.

The new U.S. Basel II rule is technically consistent in most respects with international approaches and includes a number of prudential safeguards as originally proposed in September 2006. These safeguards include a requirement that banking organizations satisfactorily complete a four-quarter parallel run period before operating under the Basel II framework, a requirement that an institution satisfactorily complete a series of transitional periods before operating under Basel II without floors, and a commitment by the agencies to conduct ongoing analysis of the framework to ensure Basel II is working as intended. Basel II in the United States will be implemented with retention of the leverage ratio and prompt corrective action (PCA) requirements, which will continue to bolster capital and complement risk-based measures. Following a successful parallel run period, a banking organization would have to progress through three transitional periods (each lasting at least one year), during which there would be floors on potential declines in risk-based capital requirements. Those transitional floors would limit maximum cumulative reductions of a banking organization's risk-based capital requirements to 5 percent during the first transitional floor period, 10 percent during the second transitional floor period, and 15 percent during the third transitional floor period. A banking organization would need approval from its primary federal regulator to move into each of the transitional floor periods, and at the end of the third transitional floor period to move to full Basel II.

In October 2007, the Federal Trade Commission following the federal financial institution regulatory agencies approved the final rules on identity theft "red flags" requiring each financial institution and creditor that holds any consumer account, or other account for which there is a reasonably foreseeable risk of identity theft, to develop and implement an Identity Theft Prevention Program (Program) for combating identity theft in connection with new and existing accounts. The Program must include reasonable policies and procedures for detecting, preventing, and mitigating identity theft and enable a financial institution or creditor to:

- Identify relevant patterns, practices, and specific forms of activity that are "red flags" signaling possible identity theft and incorporate those red flags into the Program;
- Detect red flags that have been incorporated into the Program;
- Respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and
- Ensure the Program is updated periodically to reflect changes in risks from identity theft.

The agencies also issued guidelines to assist financial institutions and creditors in developing and implementing a Program, including a supplement that provides examples of red flags. The final rules require credit and debit card issuers to develop policies and procedures to assess the validity of a request for a change of address that is followed closely by a request for an additional or replacement card. In addition, the final rules require users of consumer reports to develop reasonable policies and procedures to apply when they receive a notice of address discrepancy from a consumer reporting agency. The final rules are effective on January 1, 2008. Covered financial institutions and creditors must comply with the rules by November 1, 2008.

The federal financial regulatory agencies issued final rules in October 2007 that provide consumers with an opportunity to "opt out" before a financial institution uses information provided by an affiliated company to market its products and services to the consumer. The final rules on affiliate marketing implement section 214 of the Fair and Accurate Credit Transactions Act of 2003, which amends the Fair Credit Reporting Act (FCRA). The final rules generally prohibit a financial institution from using certain information received from an affiliate to make a solicitation to a consumer unless the consumer is given notice and a reasonable opportunity to opt out of such solicitations, and the consumer does not opt out. The final rules apply to information obtained from the consumer's transactions or account relationships with an affiliate, any application the consumer submitted to an affiliate, and third-party sources, such as credit reports, if the information is to be used to send marketing solicitations. Nothing in the final rules supersedes or amends a consumer's existing right to opt out of the sharing of non-transaction or experience information under section 603(d) of the FCRA. The final rules also implement the statutory exceptions to



the affiliate marketing notice and opt-out requirement. The final rules are effective on January 1, 2008, and all covered entities must comply with the rules no later than October 1, 2008.

In September 2007, the SEC and Federal Reserve Board of Governors adopted final rules to implement the bank “broker” provisions of the Gramm-Leach-Bliley Act. The rules define the scope of securities activities that banks may conduct without registering with the SEC as a securities broker and implement the most important “broker” exceptions for banks adopted by the GLB Act. Specifically, the rules implement the statutory exceptions that allow a bank, subject to certain conditions, to continue to conduct securities transactions for its customers as part of the bank’s trust and fiduciary, custodial and deposit “sweep” functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer. The rules are designed to accommodate the business practices of banks and to protect investors. The effective date for compliance is the first day of the bank’s fiscal year commencing after September 30, 2008.

Also in September 2007, the federal regulatory banking agencies issued final rules allowing well-managed insured depository institutions with less than \$500 million in total assets to qualify for an extended 18 month on-site examination cycle. The final rules implement a provision of the Financial Services Regulatory Relief Act of 2006.

In June 2007, the federal banking regulatory agencies issued a final statement on Subprime Mortgage Lending to address issues relating to certain adjustable-rate mortgage (ARM) products that can cause payment shock. The statement describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to repay. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity. Consumer protection standards include clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty.

In California, a new Section 691.1 was added to the Financial Code that exempts a bank from obtaining a securities permit for the following transactions:

- any offer (but not a sale) not involving a public offering by a bank organized under the laws of this state of its securities
- the execution and delivery of any agreement for the sale of the securities pursuant to the offer if no part of the consideration for the securities is paid to or received by the bank and none of the securities are issued until the sale of the securities is authorized by the commissioner or exempted from authorization.
- any stock split by a bank organized under the laws of this state that is effected pursuant to an amendment to its articles, an agreement of merger, or a certificate of ownership that has been approved by the commissioner, unless this exemption is withheld by order of the commissioner
- any offer or sale of securities by a bank organized under the laws of this state that is either (1) to a person actually approved by the commissioner pursuant to Section 702 of the Financial Code to acquire control of the bank if all of the material terms and conditions of the offer and sale of securities are disclosed in the application for approval specified in Section 702 and the offer and sale of securities is in accordance with the terms and subject to the conditions of the approval to acquire control or (2) in a transaction exempted from the approval requirement of Section 701 by a regulation or an order of the commissioner, unless this exemption is withheld by order of the commissioner.

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 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.

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, 2007, the Company employed 155 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, Kern, and Santa Clara 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. The significant economic downturn experienced in the sub-prime lending and credit markets beginning during the second half of 2007, has negatively impacted the Company's operations and financial condition to some degree, and may further worsen with further deterioration of local and state-wide economic conditions. 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, 2007, 17.1%, and 29.8% 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 increased volatility 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

non-bank 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, 2007, the Company's allowance for loan losses was approximately \$10.9 million representing 1.82% 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, 2007, noninterest-bearing checking accounts comprised 21.9% of the Company's deposit base, and interest-bearing checking and money market accounts comprised an additional 7.2% and 17.1%, 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 July 25, 2007 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 II. The junior subordinated debentures mature in July 2037.

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, 2007.

**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.

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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 7088 N. First location 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, Oakhurst, California. The branch facility consists of approximately 5,000 square feet with a lease term of 15 years ending April 2014, and has 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 Company owns the San Joaquin branch facilities located at 21574 Manning Avenue, San Joaquin, California. The bank branch is approximately 2,500 square feet.

The Company owns the Firebaugh bank branch located at 1067 O Street, Firebaugh, California. 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. 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 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 Company leases the Campbell branch located at 125 E. Campbell Ave, Campbell, California, which has approximately 6,995 square feet which it occupied after the merger completed in February 2007. The lease expires on December 31, 2010.

The Company subleases the space for its USB Financial Services offices at 855 "M" Street, Suite 1120, Fresno, California from Centex Homes, Inc. The subleased facility totals 3,656 square feet and the lease expires on March 31, 2008.

The Company owns its administrative headquarters at 2126 Inyo Street, Fresno, California. 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 2007.

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## PART II

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

#### *Trading History*

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

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

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

The Company has been included in the Russell 2000 Stock Index since June 2006. 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.

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, 2007 and 2006.

| Quarter          | Closing Prices |          | Volume    |
|------------------|----------------|----------|-----------|
|                  | High           | Low      |           |
| 4th Quarter 2007 | \$ 20.00       | \$ 14.34 | 1,505,900 |
| 3rd Quarter 2007 | \$ 21.00       | \$ 13.99 | 1,167,700 |
| 2nd Quarter 2007 | \$ 22.63       | \$ 17.14 | 2,083,400 |
| 1st Quarter 2007 | \$ 25.00       | \$ 19.07 | 1,649,400 |
| 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   |

At January 31, 2008, there were approximately 864 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 \$0.125 per share on January 25, 2007, April 18, 2007, July 18, 2007 and October 24, 2007. During the previous year, 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.

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, 2007.

| 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     | 212,500  | \$ 16.14  | 305,200   |
| Equity compensation plans not approved by security holders | N/A  | N/A   | N/A   |
| <b>Total</b>   | <b>212,500</b>   | <b>\$ 16.14</b>   | <b>305,200</b>  |

A complete description of the above plans is included in Note 12 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 |
|----------------------------------|----------------------------------|---------------------------------------|--|--|
| 10/01/07 to 10/31/07             | 9,009                            | \$ 18.50                              | 9,009  | 314,574  |
| 11/01/07 to 11/30/07             | 35,149                           | \$ 15.73                              | 35,149   | 279,425  |
| 12/01/07 to 12/31/07             | 15,097                           | \$ 15.08                              | 15,097   | 264,328  |
| <b>Total fourth quarter 2007</b> | <b>59,255</b>                    | <b>\$ 18.32</b>                       | <b>59,255</b>  |  |

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.

On February 25, 2004 the Company announced a second 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.

On May 16, 2007, the Company announced another stock repurchase plan to repurchase, as conditions warrant, up to 610,000 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Company canceled the remaining 75,733 shares available under the 2004 repurchase plan.

During the year ended December 31, 2007, 512,332 shares were repurchased at a total cost of \$10.1 million and an average per share price of \$19.71. Of the shares repurchased during 2007, 166,660 shares were repurchased under the 2004 plan at an average cost of \$20.46 per shares, and 345,672 shares were repurchased under the 2007 plan at an average cost of \$19.35 per share.

**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.

| <i>Index</i>               | <i>Period Ending</i> |                 |                 |                 |                 |                 |
|----------------------------|----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                            | <b>12/31/02</b>      | <b>12/31/03</b> | <b>12/31/04</b> | <b>12/31/05</b> | <b>12/31/06</b> | <b>12/31/07</b> |
| United Security Bancshares | 100.00               | 156.95          | 150.50          | 184.96          | 298.54          | 192.86          |
| Russell 2000               | 100.00               | 147.25          | 174.24          | 182.18          | 215.64          | 212.26          |
| Russell 3000               | 100.00               | 131.06          | 146.71          | 155.69          | 180.16          | 189.42          |
| SNL Bank \$500M-\$1B Index | 100.00               | 144.19          | 163.41          | 170.41          | 193.81          | 155.31          |

**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, 2007 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, |            |            |            |            |
|--|--------------|------------|------------|------------|------------|
| <i>(in thousands except per share data and ratios)</i>                   | 2007         | 2006       | 2005       | 2004       | 2003       |
| <b><u>Summary of Year-to-Date</u></b>                                    |              |            |            |            |            |
| <b><u>Earnings:</u></b>  |              |            |            |            |            |
| Interest income and loan fees  | \$ 57,156    | \$ 47,356  | \$ 38,898  | \$ 30,874  | \$ 27,050  |
| Interest expense   | 20,573       | 14,175     | 9,658      | 6,433      | 7,260      |
| Net interest income  | 36,583       | 33,181     | 29,240     | 24,441     | 19,790     |
| Provision for credit losses  | 5,697        | 880        | 1,140      | 1,145      | 1,713      |
| Net interest income after provision for credit losses                    | 30,886       | 32,301     | 28,100     | 23,296     | 18,077     |
| Noninterest income   | 9,664        | 9,031      | 6,280      | 4,742      | 6,148      |
| Noninterest expense  | 22,732       | 19,937     | 16,982     | 14,667     | 11,855     |
| Income before taxes on income  | 17,818       | 21,395     | 17,398     | 13,371     | 12,370     |
| Taxes on income  | 6,561        | 8,035      | 6,390      | 4,966      | 4,664      |
| Net Income   | \$ 11,257    | \$ 13,360  | \$ 11,008  | \$ 8,405   | \$ 7,706   |
| <b><u>Per Share Data:</u></b>  |              |            |            |            |            |
| Net Income - Basic   | \$ 0.94      | \$ 1.18    | \$ 0.97    | \$ 0.75    | \$ 0.71    |
| Net Income - Diluted   | \$ 0.94      | \$ 1.17    | \$ 0.96    | \$ 0.74    | \$ 0.70    |
| Average shares outstanding - Basic                                       | 11,925,767   | 11,344,385 | 11,369,848 | 11,260,512 | 10,919,852 |
| Average shares outstanding - Diluted                                     | 11,960,514   | 11,462,313 | 11,453,152 | 11,334,486 | 11,023,340 |
| Cash dividends paid  | \$ 0.50      | \$ 0.43    | \$ 0.35    | \$ 0.325   | \$ 0.285   |
| <b><u>Financial Position at</u></b>                                      |              |            |            |            |            |
| <b><u>Period-end:</u></b>  |              |            |            |            |            |
| Total assets   | \$ 771,715   | \$ 678,314 | \$ 628,859 | \$ 611,696 | \$ 506,588 |
| Total net loans and leases   | 585,580      | 491,204    | 409,409    | 390,334    | 338,716    |
| Total deposits   | 634,617      | 587,127    | 546,460    | 536,672    | 440,444    |
| Total shareholders' equity   | 82,431       | 66,042     | 59,014     | 53,236     | 45,036     |
| Book value per share   | \$ 6.95      | \$ 5.84    | \$ 5.19    | \$ 4.69    | \$ 4.09    |
| <b><u>Selected Financial Ratios:</u></b>                                 |              |            |            |            |            |
| Return on average assets   | 1.47%        | 2.04%      | 1.76%      | 1.52%      | 1.51%      |
| Return on average shareholders' equity                                   | 13.73%       | 20.99%     | 19.46%     | 16.81%     | 17.80%     |
| Average shareholders' equity to average assets                           | 10.73%       | 9.70%      | 9.02%      | 9.01%      | 8.48%      |
| Allowance for credit losses as a percentage of total nonperforming loans | 50.45%       | 64.13%     | 55.62%     | 42.51%     | 32.58%     |
|  | 0.76%        | 0.05%      | 0.15%      | 0.12%      | 0.34%      |

|   |        |        |        |        |        |
|---|--------|--------|--------|--------|--------|
| Net charge-offs to average loans                                |        |        |        |        |        |
| Allowance for credit losses as a percentage of period-end loans | 1.83%  | 1.67%  | 1.86%  | 1.82%  | 1.76%  |
| Dividend payout ratio   | 53.12% | 38.18% | 38.50% | 43.16% | 40.07% |

## 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, and vi) 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 January 1, 2007, the Company adopted the fair value provisions of SFAS No. 159 for its junior subordinated debt issued by the Trust. As a result of the adoption of SFAS No. 159, the Company recorded a fair value adjustment of \$1.3 million, reflected as an adjustment to beginning retained earnings. On July 25, 2007, the Company redeemed the \$15.0 million in subordinated debentures plus accrued interest of \$690,000 and a 6.15% prepayment penalty totaling \$922,500. Concurrently, the Trust Preferred securities issued by Capital Trust I were redeemed. The prepayment penalty of \$922,500 had previously been a component of the fair value adjustment for the junior subordinated debt at the initial adoption of SFAS No. 159.

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 completed its 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 \$6.0 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. The Fund was not awarded funding during the 2007 allocation process. The Fund did not apply for the 2008 allocation of New Market Credits during 2007. If the Fund's NMTC is ever approved for the allocation of New Market Credits, 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%.



On February 16, 2007, the Company completed its 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 operated 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, Legacy Bank's branch office began operating as a branch office of United Security Bank. As of February 16, 2007 Legacy Bank had net assets of approximately of \$8.6 million, including net loans of approximately \$62.4 million and deposits of approximately \$69.6 million.

In the merger with Legacy Bank, the Company issued 976,411 shares of its stock in a tax free exchange for all of the Legacy Bank common shares. The total value of the transaction was approximately \$21.7 million. The merger 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 Legacy based on the fair value of those assets and liabilities. Fair-market-value adjustments and intangible assets totaled approximately \$12.9 million, including \$8.8 million in goodwill. The allocations of purchase price based upon the fair market value of assets acquired and liabilities assumed were finalized in the fourth quarter of 2007.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. Like USB Capital Trust I formed in July 2001, USB Capital Trust II is a Variable Interest Entity (VIE) and a deconsolidated entity pursuant to FIN 46. On July 23, 2007 USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate (initial coupon rate of 6.65%). Interest will be paid quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company will pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company may redeem the junior subordinated debentures at anytime before October 2008 at a redemption price of 103.3, and thereafter each October as follows: 2008 at 102.64, 2009 at 101.98, 2010 at 101.32, 2011 at 100.66, and at par anytime after October 2012.

The Bank currently has eleven banking branches, one construction lending office, and one financial services office, which provide banking and financial services in Fresno, Madera, Kern, and Santa Clara counties. As a community-oriented bank holding company, 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.

### ***Current 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 | YTD Average | YTD Average |
|-------------|-------------|-------------|
|-------------|-------------|-------------|

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|  | 12/31/07 | 12/31/06 | 12/31/05 |
|--|----------|----------|----------|
| Loans                                    | 85.00%   | 80.26%   | 72.50%   |
| Investment securities                    | 13.46%   | 15.65%   | 19.81%   |
| Interest-bearing deposits in other banks | 1.02%    | 1.33%    | 1.36%    |
| Federal funds sold                       | 0.52%    | 2.76%    | 6.33%    |
| Total earning assets                     | 100.00%  | 100.00%  | 100.00%  |
| NOW accounts                             | 8.82%    | 11.21%   | 12.14%   |
| Money market accounts                    | 25.99%   | 31.56%   | 28.63%   |
| Savings accounts                         | 8.79%    | 8.02%    | 8.45%    |
| Time deposits                            | 50.05%   | 44.72%   | 46.78%   |
| Other borrowings                         | 3.40%    | 0.96%    | 0.32%    |
| Trust Preferred Securities               | 2.95%    | 3.53%    | 3.68%    |
| Total interest-bearing liabilities       | 100.00%  | 100.00%  | 100.00%  |

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The Company continues its business development and expansion efforts throughout a dynamic and growing market area, and as a result, realized substantial increases in both loan and deposit volumes during the year ended December 31, 2007. With approximately 65% of the increase resulting from the Legacy Bank merger completed during February 2007, the Company experienced increases of \$97.7 million in loans, while other interest earning assets, including federal funds sold and interest-bearing deposits in other banks, declined during 2007, 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, and commercial real estate loans. Deposit growth totaled \$47.5 million during the year ended December 31, 2007, with deposit increases being the result of the merger with Legacy Bank during February 2007. Deposit growth occurred almost exclusively in time deposits, with moderate increases experienced in savings deposits. NOW and money market accounts, as well as noninterest-bearing deposits, declined \$30.7 million and \$20.0 million, respectively, during the year ended December 31, 2007 as core deposits became increasingly competitive. Deposit pricing was a significant factor during 2007 as depositors were attracted to money market accounts and time deposits over \$100,000, as they sought higher yields.

With market rates of interest remaining level through much of 2007, then declining 100 basis points during the fourth quarter of 2007, and another 75 basis points during January 2008, the Company has begun to experience declines in its net interest margin. The Company's net interest margin was 5.35% for the year ended December 31, 2007, as compared to 5.67% and 5.26% for the years ended December 31, 2006 and 2005, respectively. With approximately 62% of the loan portfolio in floating rate instruments at December 31, 2007, the effects of market rates continue to be realized almost immediately on loan yields. Loans yielded 9.07% during the year ended December 31, 2007, as compared to 9.13% for the year ended December 31, 2006, and 8.21% for the year ended December 31, 2005. Loan yield was enhanced during 2007, as a nonperforming loan was paid off during the first quarter of 2007, providing an additional \$902,000 in previously unrecognized interest income that would not have otherwise been recognized during 2007, and an enhancement to loan yield of approximately 15 basis points. The Company continues to experience pricing pressures on deposits, especially money market accounts and time deposits, as increased competition for deposits continues throughout the Company's market area. The Company's average cost of funds was 3.91% for the year ended December 31, 2007 as compared to 3.24% and 2.30% for the years ended December 31, 2006 and 2005, respectively.

Noninterest income continues to be driven by customer service fees, which totaled \$4.8 million for the year ended December 31, 2007, representing an increase of \$1.0 million or 26.8% over the \$3.8 million in customer service fees reported for the year ended December 31, 2006. Total noninterest income increased by \$633,000 between the year-to-date periods ended December 31, 2006 and December 31, 2007, primarily as the result of a \$2.5 million gain recognized during the year ended December 31, 2007 resulting from favorable fair value adjustments to the Company's junior subordinated debt. The Company accounts for its junior subordinated debt at fair value and records fair value changes through earnings. Offsetting this were several reductions in noninterest income including, a nonrecurring \$1.9 million gain on the sale of an investment in correspondent bank stock recognized during the first quarter of 2006, and a \$1 million gain on the sale of the Company's administrative headquarters during the third quarter of 2006, both of which were not repeated during 2007. Other noninterest income increased approximately \$279,000 as the result of a number of items including increases in rental and OREO income experienced during 2007.

Noninterest expense increased approximately \$2.8 million or 14.0% between the years ended December 31, 2006 and December 31, 2007. The primary components of the increase experienced during 2007 were employee salary and benefit costs, including additional employee costs associated with the new financial services department, increased legal fees associated with the resolution of impaired loans, losses on lease assets held, and increased amortization costs for intangible assets. As part of noninterest expense, OREO expense actually declined by \$2.0 million or 90.5% between the years ended December 31, 2006 and December 31, 2007 as costs associated with an OREO property the Company was in the process of liquidating during 2006, were not again incurred during 2007.



The Company has maintained a strong balance sheet, with sustained loan growth and sound deposit growth. With the Legacy merger completed during February 2007, total assets have grown more than \$93.4 million between December 31, 2006 and December 31, 2007, while net loans have grown \$94.4 million, and deposits have grown \$47.5 million during the year ended December 31, 2007. With increased loan growth during 2007, average loans comprised approximately 85% of overall average earning assets during the year ended December 31, 2007. 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, 2007, although time deposits as a percentage of average deposits for the period have increased during 2007 as the Company has sought brokered deposits to fund continued loan demand. Effectively utilizing brokered deposits to help fund asset growth has allowed the Company to better control the cost of its core deposit base. To further fund loan demand, the Company has utilized its overnight borrowing lines, with overnight borrowings totaling \$22.3 million at December 31, 2007. In addition, the Company utilized its FHLB term credit line during the first quarter of 2007, borrowing \$10.0 million for a term of two years at a fixed rate of 4.92%.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred securities. At the same time, the Company redeemed the \$15 million in junior subordinated debt issued to USB Capital Trust I which in turn had issued Trust Preferred securities to investors. The Trust Preferred securities issued by USB Capital Trust I during 2001 carried a floating interest rate of six-month LIBOR plus 3.75% and had a maturity term of thirty years. During July, USB Capital Trust II issued \$15 million in Trust Preferred securities at a floating rate of three-month LIBOR plus 1.29% and had a maturity term of thirty years. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company with substantially like terms to the Trust Preferred securities issued by the Trust. The new subordinated debentures will reduce the cost of the Company's \$15 million debt by 246 basis points, and should result in pre-tax interest cost savings of approximately \$30,000 per month. Effective January 1, 2007, the Company elected the fair value option for the Company's junior subordinated debt pursuant to SFAS No. 159. The Company also elected the fair value option for the subordinated debentures issued to USB Capital Trust II during July 2007. As a result of favorable quarterly fair value adjustments at September 30, 2007 and December 31, 2007, the Company recorded a total gain \$2.4 million gain on its junior subordinated debt issued under USB Capital Trust II, primarily resulting from an overall deterioration of the credit markets during the third and fourth quarters of 2007 which increased pricing spreads from base rates on similar debt instruments.

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, as well as its new market area of Campbell, in Santa Clara County. 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 during 2007. Average loans have increased more than \$110.9 million between the year-to-date periods ended December 31, 2006 and December 31, 2007, and end-of-period loans have increased more than \$97.7 million between December 31, 2006 and December 31, 2007. Growth continues primarily in commercial and industrial loans, and commercial real estate loans, and to a lesser degree in construction loans and agricultural loans. 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 third and fourth quarters of 2007 presented challenges with credit tightening, weakening real estate markets, and loan losses affecting the loan portfolio. The charge-off of a \$1.6 million land development loan during the third quarter of 2007, combined with an increase in impaired loans, necessitated an additional \$1.7 million in loan loss provision for the quarter ended September 30, 2007. Further deteriorating real estate markets during the fourth quarter resulted in additional loan charge-offs totaling \$2.6 million, and additional loan loss provisions of \$3.3 million during the fourth quarter. Additionally, OREO increased \$4.7 million during the year ended December 31, 2007 resulting from the transfer of collateral for three loan relationships to foreclosed property, one of which was ultimately sold. As a result of these events, nonperforming assets as a

percentage of total assets increased from 2.19% at December 31, 2006 to 4.73% at December 31, 2007.

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 2008 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 banking industry is currently experiencing continued pressure on net margins as well as asset quality resulting from concerns in the sub-prime real estate market, and a general deterioration in credit markets. As a result, market rates of interest and asset quality will continue to be an important factor in the Company's ongoing strategic planning process.

### **Application of Critical Accounting Policies and Estimates**

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 using the Company's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

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 credit losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for credit 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 credit losses and a discussion of the factors driving changes in the amount of the allowance for credit 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, 2007, would be approximately \$652,000 pretax (\$378,000 net of tax, or \$0.03 per share basic and diluted). This estimate is comprised of an additional \$246,000 (\$143,000 net of tax, or \$0.01 per share basic and diluted) for criticized loans (those classified as special mention or worse and excluding those considered impaired under SFAS No. 114), and an additional \$406,000 (\$235,000 net of tax, or \$0.02 per share basic and diluted) 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 fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value of the collateral is charged to the allowance for credit losses. The determination of fair value is generally based upon pre-approved, external appraisals. 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 \$1.6 million, and the recent acquisition of Legacy Bank resulted in goodwill of approximately \$8.8 million. 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 using an internal cash flow model. 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 January 1, 2007 the Company adopted Financial Accounting Standards Board (FASB) Interpretation 48 (FIN 48), "Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109". FIN 48 clarifies SFAS No. 109, "Accounting for Income Taxes", to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of FIN48, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

The Company reviewed its various tax positions, including its ongoing REIT case with the California Franchise Tax Board (FTB), as of January 1, 2007 (adoption date), and then again each subsequent quarter during 2007 in light of the adoption of FIN48. The Bank, with guidance from advisors believes the case related to consent dividends taken by the Bank's REIT during 2002 has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is "more than likely" (as defined in FIN48) that the Bank will prevail in its case with the FTB. As a result of this determination, effective January 1, 2007 the Company recorded an adjustment of \$1,298,470 to beginning retained earnings upon adoption of FIN48 to recognize the potential tax liability under the guidelines of the interpretation. The adjustment includes amounts for assessed taxes, penalties, and interest. During the year ended December 31, 2007, the Company increased the unrecognized tax liability by an additional \$87,091 in interest for the period, bringing the total recorded tax liability under FIN48 to \$1,385,561 at December 31, 2007. It is the Company's policy to recognize interest and penalties under FIN48 as a component of income tax expense.

Pursuant to FIN 48, the Company will continue to re-evaluate existing tax positions, as well as new positions as they arise. If the Company determines in the future that its tax positions are not "more likely than not" to be sustained (as defined) by taxing authorities, the Company may need to recognize additional tax liabilities.

### *Stock-Based Compensation*

For all years presented in the Consolidated Financial Statements prior to 2006, the Company accounted for stock options, which were issued "at-the-money" 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 12 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 12 "Stock Options and Stock Based Compensation" in the Company's Notes to Consolidated Financial Statements.

On January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004) ("SFAS 123R"), "Share-Based Payment", which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R 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 board of directors of the Company beginning with the effective date (a) based on the requirements of Statement 123R 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 and directors prior to the effective date of Statement 123R that remain unvested on the effective date. The total compensation expense recognized pursuant to SFAS No. 123R during 2007 and 2006 totaled \$187,000 and \$248,000, respectively.

### *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, 2007, 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.

### *Fair Value*

Effective January 1, 2007, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157, *Fair Value Measurements*, choosing to apply the pronouncement to its junior subordinated debt. SFAS No 157 defines how applicable assets and liabilities are to be valued, and requires expanded disclosures about financial instruments carried at fair value. SFAS No. 157 establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments infrequently traded or not quoted in an active market will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Determining fair values under SFAS No. 157 may include judgments related to measurement factors that may vary from actual transactions executed in the marketplace. For the year ended December 31, 2007, the Company recorded fair value gains related to its junior subordinated debt totaling \$2.5 million. (See Note 15 of the *Notes to Consolidated Financial Statements* for additional information about financial instruments carried at fair value.)

### **Results of Operations**

For the year ended December 31, 2007, the Company reported net income of \$11.3 million or \$0.94 per share (\$0.94 diluted) as compared to \$13.4 million or \$1.18 per share (\$1.17 diluted) for the year ended December 31, 2006, and \$11.0 million or \$0.97 per share (\$0.96 diluted) for the year ended December 31, 2005. Net income decreased \$2.1 million between December 31, 2006 and December 31, 2007 primarily as the result of increased provisions for credit losses taken during the fourth quarter, which more than offset increased net interest income realized from increased volume in earning assets. 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.

The Company's return on average assets was 1.47 % for the year ended December 31, 2007 as compared to 2.04 % and 1.76 % for the same twelve-month periods of 2006 and 2005, respectively. The Company's return on average equity was 13.73% for the year ended December 31, 2007 as compared to 20.99 % and 19.46 % for the same twelve-month periods of 2006 and 2005, respectively. Declines in the return on average assets and average equity experienced by the Company during 2007 were primarily the result of decreasing net interest margins, and additional loan loss provisions taken during the year.

### ***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 \$36.6 million for the year ended December 31, 2007 as compared to \$33.2 million for the year ended December 31, 2006, and \$29.2 million for the year ended December 31, 2005. This represents an increase of \$3.4 million or 10.3 % between the years ended December 31, 2006 and 2007, as compared to an increase of \$3.9 million or 13.5% between 2005 and 2006. The increase in net interest income between 2006 and 2007 is the result of increased volume in earning assets which more than outweighed rate and volume increases experienced in interest-bearing liabilities. 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, 2007, 2006, and 2005

|   | 2007               |           |                | 2006               |           |                | 2005               |           |                |
|---|--------------------|-----------|----------------|--------------------|-----------|----------------|--------------------|-----------|----------------|
| <i>(Dollars in thousands)</i>             | Average<br>Balance | Interest  | Yield/<br>Rate | Average<br>Balance | Interest  | Yield/<br>Rate | Average<br>Balance | Interest  | Yield/<br>Rate |
| <b>Assets:</b>                            |                    |           |                |                    |           |                |                    |           |                |
| Interest-earning assets:                  |                    |           |                |                    |           |                |                    |           |                |
| Loans (1)                                 | \$ 580,873         | \$ 52,690 | 9.07%          | \$ 469,959         | \$ 42,902 | 9.13%          | \$ 402,820         | \$ 33,078 | 8.21%          |
| Investment Securities -<br>taxable        | 89,765             | 3,896     | 4.34%          | 89,378             | 3,254     | 3.64%          | 107,761            | 4,163     | 3.86%          |
| Investment Securities -<br>nontaxable (2) | 2,227              | 108       | 4.85%          | 2,226              | 108       | 4.85%          | 2,261              | 112       | 4.95%          |
| Interest on deposits in<br>other banks    | 7,001              | 271       | 3.87%          | 7,771              | 324       | 4.17%          | 7,539              | 308       | 4.09%          |
| Federal funds sold and<br>reverse repos   | 3,527              | 191       | 5.42%          | 16,166             | 768       | 4.75%          | 35,139             | 1,237     | 3.52%          |
| Total interest-earning<br>assets          | 683,393            | \$ 57,156 | 8.36%          | 585,500            | \$ 47,356 | 8.09%          | 555,520            | \$ 38,898 | 7.00%          |
| Allowance for possible<br>credit losses   | (9,787)            |           |                | (8,067)            |           |                | (7,608)            |           |                |
| Noninterest-bearing<br>assets:            |                    |           |                |                    |           |                |                    |           |                |
|   | 25,255             |           |                | 26,426             |           |                | 29,940             |           |                |

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|   |            |           |       |            |           |       |           |            |       |
|---|------------|-----------|-------|------------|-----------|-------|-----------|------------|-------|
| Cash and due from banks                                   |            |           |       |            |           |       |           |            |       |
| Premises and equipment, net                               | 15,899     |           |       | 12,706     |           |       |           | 9,551      |       |
| Accrued interest receivable                               | 4,061      |           |       | 3,597      |           |       |           | 2,661      |       |
| Other real estate owned                                   | 3,187      |           |       | 3,354      |           |       |           | 1,639      |       |
| Other assets  | 42,326     |           |       | 32,570     |           |       |           | 35,496     |       |
| Total average assets                                      | \$ 764,334 |           |       | \$ 656,086 |           |       |           | \$ 627,199 |       |
| <b>Liabilities and Shareholders' Equity:</b>              |            |           |       |            |           |       |           |            |       |
| Interest-bearing liabilities:                             |            |           |       |            |           |       |           |            |       |
| NOW accounts  | \$ 46,382  | \$ 292    | 0.63% | \$ 49,118  | \$ 286    | 0.58% | \$ 51,043 | \$ 244     | 0.48% |
| Money market accounts                                     | 136,720    | 4,246     | 3.11% | 138,242    | 3,701     | 2.68% | 120,318   | 2,332      | 1.94% |
| Savings accounts  | 46,225     | 883       | 1.91% | 35,135     | 198       | 0.56% | 35,500    | 175        | 0.49% |
| Time deposits   | 263,196    | 12,993    | 4.94% | 195,922    | 8,412     | 4.29% | 196,642   | 5,772      | 2.94% |
| Other borrowings  | 17,891     | 925       | 5.17% | 4,209      | 223       | 5.30% | 1,335     | 44         | 3.30% |
| Trust Preferred securities                                | 15,537     | 1,234     | 7.94% | 15,464     | 1,355     | 8.76% | 15,464    | 1,091      | 7.06% |
| Total interest-bearing liabilities                        | 525,951    | \$ 20,573 | 3.91% | 438,090    | \$ 14,175 | 3.24% | 420,302   | \$ 9,658   | 2.30% |
| Noninterest-bearing liabilities:                          |            |           |       |            |           |       |           |            |       |
| Noninterest-bearing checking                              | 146,954    |           |       | 146,722    |           |       |           | 144,146    |       |
| Accrued interest payable                                  | 2,207      |           |       | 2,021      |           |       |           | 1,421      |       |
| Other liabilities   | 7,221      |           |       | 5,615      |           |       |           | 4,773      |       |
| Total average liabilities                                 | 682,333    |           |       | 592,448    |           |       |           | 570,642    |       |
| Total average shareholders' equity                        | 82,001     |           |       | 63,638     |           |       |           | 56,557     |       |
| Total average liabilities and Shareholders' equity        | \$ 764,334 |           |       | \$ 656,086 |           |       |           | \$ 627,199 |       |
| Interest income as a percentage of average earning assets |            |           | 8.36% |            |           | 8.09% |           |            | 7.00% |
| Interest income as a percentage of average earning assets |            |           | 3.01% |            |           | 2.42% |           |            | 1.74% |
| Net interest margin                                       |            |           | 5.35% |            |           | 5.67% |           |            | 5.26% |

(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 \$3,076,000, \$3,536,000, and \$3,480,000 for the years ended December 31, 2007, 2006, and 2005,

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.

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As summarized in Table 2, the increase in net interest income between the two twelve-month periods ended December 31, 2007 and 2006 is comprised of an increase in total interest income of approximately \$9.8 million, which was only partially offset by an increase in total interest expense of approximately \$6.4 million. The Bank's net interest margin, as shown in Table 1, decreased to 5.35% at December 31, 2007 from 5.67% at December 31, 2006, a decrease of 32 basis points (100 basis points = 1%) between the two periods. The net margin of 5.67% reported during 2006 represents an increase of 41 basis points from the 5.26% net margin realized by the Company during 2005. 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. As a result of changes in market rates of interest, the prime rate averaged 8.05% for the year ended December 31, 2007 as compared to 7.96% and 6.19% for the years ended December 31, 2006 and 2005, respectively.

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

Table 2. Rate and Volume Analysis

| <i>(In thousands)</i>  | 2007 compared to 2006 |            |           | 2006 compared to 2005 |          |          |
|--|-----------------------|------------|-----------|-----------------------|----------|----------|
|  | Total                 | Rate       | Volume    | Total                 | Rate     | Volume   |
| Increase (decrease) in interest income:                                |                       |            |           |                       |          |          |
| Loans  | \$ 9,788              | \$ (275)   | \$ 10,063 | \$ 9,824              | \$ 3,942 | \$ 5,882 |
| Investment securities  | 642                   | 628        | 14        | (913)                 | (227)    | (686)    |
| Interest-bearing deposits in other banks                               | (53)                  | (25)       | (28)      | 16                    | 6        | 10       |
| Federal funds sold and securities purchased under agreements to resell | (577)                 | 95         | (672)     | (469)                 | 341      | (810)    |
| Total interest income  | 9,800                 | 423        | 9,377     | 8,458                 | 4,062    | 4,396    |
| Increase (decrease) in interest expense:                               |                       |            |           |                       |          |          |
| Interest-bearing demand accounts                                       | 551                   | 643        | (92)      | 1,366                 | 1,107    | 259      |
| Savings accounts   | 685                   | 605        | 80        | 23                    | 25       | (2)      |
| Time deposits  | 4,581                 | 1,391      | 3,190     | 2,685                 | 2,706    | (21)     |
| Other borrowings   | 702                   | (6)        | 708       | 179                   | 39       | 140      |
| Trust Preferred securities   | (121)                 | (127)      | 6         | 264                   | 264      | 0        |
| Total interest expense   | 6,398                 | 2,506      | 3,892     | 4,517                 | 4,141    | 376      |
| Increase (decrease) in net interest income                             | \$ 3,402              | \$ (2,083) | \$ 5,485  | \$ 3,941              | \$ (79)  | \$ 4,020 |



Total interest income increased approximately \$9.8 million or 20.7% between the years ended December 31, 2006 and 2007, and was attributable primarily to increase in earning asset volume, as well as the yields on those earning assets to a lesser degree. Earning asset growth was almost exclusively in loans, with minimal growth in investments. On average, loans grew by approximately \$111.0 million between 2006 and 2007. The Company continues to maintain a high percentage of loans in its earning asset mix with loans averaging 85.0% of total earning assets for the year ended December 31, 2007, as compared to 80.3% and 72.5% for the years ended December 31, 2006 and 2005, respectively.

Total interest expense increased approximately \$6.4 million between the years ended December 31, 2006 and 2007, both as a result of increased volumes in time deposits and other borrowings, as well as increased rates paid on deposit accounts as deposit rates continued to rise throughout much of 2007. Deposit rates began to decline during the fourth quarter of 2007 as market rates of interest declined as a result of the Federal Reserves' actions to protect a faltering economy. Between the years ended December 31, 2007 and December 31, 2006, rates paid on interest-bearing liabilities increased in all categories except other borrowing and junior subordinated debt, with the greatest increases experienced in time deposits, money market deposits, and savings accounts. The increases experienced in savings account rates during 2007 were largely the result of more than \$25.0 million in savings accounts purchased with Legacy Bank during February 2007, many of which carried high preferential interest rates. Some of those savings accounts have been closed, and the Company has been able to reduce the cost of the remaining accounts as the preferential rate terms of the savings accounts expired.

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.

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 changed during 2006 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. Between the years ended December 31, 2005 and December 31, 2006, rates paid on interest-bearing liabilities increased in all categories as a result of general increases in market rates of interest, with the greatest increases experienced in rates on time deposits and other borrowings

### ***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, 2007 the provision to the allowance for credit losses amounted to \$5.7 million as compared to \$880,000 and \$1.1 million for the years ended December 31, 2006 and 2005, respectively. Increases in the provision to the allowance for credit losses during 2007, including provisions of \$2.0 million and \$3.3 million in the third and fourth quarters of 2007, respectively, were the result of higher levels of nonperforming loans during the year, and general deterioration in the housing and credit markets during the later part of 2007. The amount provided to the allowance for credit losses during 2007 brought the allowance to 1.83% of net outstanding loan balances at December 31, 2007, as compared to 1.67% of net outstanding loan balances at December 31, 2006, and 1.86% at December 31, 2005.

**Noninterest Income**

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

| <i>(In thousands)</i>                         | Years Ended December 31, |                 |                 | Increase (decrease)<br>during Year |                 |
|---|--------------------------|-----------------|-----------------|------------------------------------|-----------------|
|   | 2007                     | 2006            | 2005            | 2007                               | 2006            |
| Customer service fees                         | \$ 4,790                 | \$ 3,779        | \$ 4,399        | \$ 1,011                           | \$ (620)        |
| Gain on sale of securities                    | 0                        | 27              | 163             | (27)                               | (136)           |
| Gain (loss) on sale of OREO                   | 209                      | 50              | 325             | 159                                | (275)           |
| Proceeds from life insurance                  | 483                      | 482             | 0               | 1                                  | 482             |
| Gain (loss) on swap ineffectiveness           | 66                       | (75)            | 0               | 141                                | (75)            |
| Gain on fair value option of financial assets | 2,504                    | 0               | 0               | 2,504                              | 0               |
| Gain on sale of investment                    | 0                        | 1,877           | 0               | (1,877)                            | 1,877           |
| Gain (loss) on sale of fixed assets           | 2                        | 1,018           | (5)             | (1,016)                            | 1,023           |
| Shared appreciation income                    | 42                       | 567             | 393             | (525)                              | 174             |
| Other   | 1,568                    | 1,306           | 1,005           | 262                                | 301             |
| <b>Total</b>                                  | <b>\$ 9,664</b>          | <b>\$ 9,031</b> | <b>\$ 6,280</b> | <b>\$ 633</b>                      | <b>\$ 2,751</b> |

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, 2007 increased \$633,000 when compared to the previous year, and increased \$3.4 million when compared to the year ended December 31, 2005. Increases in noninterest income experienced during 2007 were the result of increased customer services fees which were partially offset by changes in nonrecurring or unusual items between the two years.

Customer service fees continue to provide a substantial part of noninterest income over the three years presented. Increases of \$1.0 million in customer service fees between 2006 and 2007 were comprised of increases in ATM and overdraft charges, as well as additional fee revenue generated by the Campbell branch acquired during February 2007. 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.

Other than customer service fees, increases in noninterest income experienced during 2007 were primarily the result of a \$2.5 million gain recognized on the change in fair value to the Company's junior subordinated debt. With the deterioration in credit markets during the second half of 2007, the rate on the Company's junior subordinated debt was far below current market rates of interest on similar instruments, resulting in the significant gains recorded during the third and fourth quarters of 2007. This was offset during 2007 by a decline in gain on sale of investments, and gain on sale of fixed assets. Declines in gain on sale of investments resulted from a \$1.8 million gain on the sale of an investment in correspondent bank during the first quarter of 2006, which was not again experienced during 2007. Declines in gain on sale of fixed assets resulted from a \$1.0 million gain on the sale of the Company's administrative headquarters during the third quarter of 2006, which was not again experienced during 2007. Noninterest income was further enhanced during the years ended December 31, 2007 and December 31, 2006 from death-benefit proceeds realized from the Company's bank owned life insurance totaling \$483,000 and \$482,000 during those two years, respectively.

Shared appreciation income has fluctuated over the three years presented, with decreases of \$525,000 between 2006 and 2007, as compared to increases of \$174,000 between 2005 and 2006. 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, as the result of securities sales during the fourth quarter of 2005 when 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, 2007, 2006 and 2005:*

| <i>(Dollars in thousands)</i>  | 2007      |                             | 2006     |                             | 2005     |                             |
|--------------------------------|-----------|-----------------------------|----------|-----------------------------|----------|-----------------------------|
|                                | Amount    | % of Average Earning Assets | Amount   | % of Average Earning Assets | Amount   | % of Average Earning Assets |
| Salaries and employee benefits | \$ 10,830 | 1.58%                       | \$ 9,915 | 1.69%                       | \$ 8,046 | 1.45%                       |
| Occupancy expense              | 3,787     | 0.55%                       | 2,556    | 0.44%                       | 2,327    | 0.42%                       |

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|                                    |           |       |           |       |           |       |
|------------------------------------|-----------|-------|-----------|-------|-----------|-------|
| Data processing                    | 420       | 0.06% | 470       | 0.08% | 624       | 0.11% |
| Professional fees                  | 1,811     | 0.27% | 998       | 0.17% | 1,234     | 0.22% |
| Directors fees                     | 268       | 0.04% | 222       | 0.04% | 210       | 0.04% |
| Amortization of intangibles        | 1,021     | 0.15% | 537       | 0.09% | 537       | 0.10% |
| Correspondent bank service charges | 476       | 0.07% | 204       | 0.03% | 359       | 0.06% |
| Writedown on investment            | 17        | 0.00% | 0         | 0.00% | 702       | 0.13% |
| Loss on lease assets held for sale | 820       | 0.12% | 0         | 0.00% | 0         | 0.00% |
| Loss on CA Tax Credit Partnership  | 430       | 0.06% | 440       | 0.08% | 458       | 0.08% |
| OREO expense                       | 209       | 0.03% | 2,193     | 0.37% | 38        | 0.01% |
| Other                              | 2,643     | 0.39% | 2,402     | 0.41% | 2,447     | 0.44% |
| Total                              | \$ 22,732 | 3.33% | \$ 19,937 | 3.41% | \$ 16,982 | 3.06% |

Noninterest expense, excluding provision for credit losses and income tax expense, totaled \$22.7 million for the year ended December 31, 2007 as compared to \$19.9 million and \$17.0 million for the years ended December 31, 2006 and 2005, respectively. These figures represent an increase of \$2.8 million or 14.0% between the years ended December 31, 2006 and 2007 and an increase of \$3.0 million or 17.4% between the years ended December 31, 2005 and 2006.

Increases in noninterest expense between the three years presented are associated primarily with normal continued growth of the Company including additional staffing costs, as well as additional costs incurred in each of those three years. As a percentage of average earning assets, total noninterest expense has remained relatively stable over the past three years as the Company has successfully controlled overhead expenses while experiencing profitable growth. Noninterest expense amounted to 3.33% of average earning assets for the year ended December 31, 2007 as compared to 3.41% at December 31, 2006 and 3.06% at December 31, 2005.

Increases in noninterest expense during 2007 included costs associated with the new branch operations in Campbell, California, resulting from the merger with Legacy Bank, additional employee costs associated with the new financial services department acquired during November 2007, increased professional fees associated with the resolution of impaired loans, losses on lease assets held for sale, and increased amortization costs for intangible assets. Losses on lease assets held for sale totaled \$820,000 for the year ended December 31, 2007 and are the result of charge-offs of foreclosed lease assets, mainly equipment and furniture, which the Company has determined have no value or cannot be located. Decreases in OREO expense during 2007 were the primarily result of additional disposal and clean-up costs, incurred during 2006 on a single OREO property, which was in the process of liquidation. These additional OREO costs were not incurred again during 2007.

Expenses on OREO increased approximately \$2.2 million between the years ended December 31, 2005 and December 31, 2006. As previously discussed, increases in OREO expense experienced during 2006 were primarily the result of additional expenses related to the clean-up and disposal of a single OREO property during 2006 of liquidation. 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.

Pursuant to the adoption of SFAS No. 123R during the first quarter of 2006, the Company recognized stock-based compensation expense of \$187,000 (\$0.02 per share basic and diluted) during the year ended December 31, 2007, and \$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 \$29,000 per quarter during 2008, then to \$17,000 per quarter for 2009, and decline after that through 2011. 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. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company, which included proposed tax and penalty assessments related to the tax benefits taken for the REIT during 2002. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. 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.

On January 1, 2007 the Company adopted Financial Accounting Standards Board (FASB) Interpretation 48 (FIN 48), "Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109". FIN 48 clarifies SFAS No. 109, "Accounting for Income Taxes", to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of FIN48, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

The Company has reviewed its REIT tax position as of January 1, 2007 (adoption date), and then again each subsequent quarter during 2007 in light of the adoption of FIN48. The Bank, with guidance from advisors believes that the case has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is "more than likely" (as defined in FIN48) that the Bank will prevail in its case with the FTB. As a result of this determination, effective January 1, 2007 the Company recorded an adjustment of \$1.3 million to beginning retained earnings upon adoption of FIN48 to recognize the potential tax liability under the guidelines of the interpretation. The adjustment includes amounts for assessed taxes, penalties, and interest. During the year ended December 31, 2007, the Company increased the unrecognized tax liability by an additional \$87,000 in interest for the period, bringing the total recorded tax liability under FIN48 to \$1.4 million at December 31, 2007. It is the Company's policy to recognize interest and penalties under FIN48 as a component of income tax expense. The Company has reviewed all of its tax positions as of December 31, 2007, and has determined that, other than the REIT, there are no other material amounts that should be recorded under the guidelines of FIN48.

### **Financial Condition**

Total assets increased by \$93.4 million or 13.8% during the year to \$771.7 million at December 31, 2007, and increased \$142.9 million or 22.7% from the balance of \$628.9 million at December 31, 2005. The Legacy Bank acquisition completed during February 2007 added \$62.4 million in net loans, \$7.4 in investments, and \$69.6 in deposits to the Company's balance sheet. During the year ended December 31, 2007, significant increases were experienced in loans, while federal funds sold and investment securities declined as loan growth outpaced deposit growth during the year. During 2007, net loans increased \$94.4 million, while federal funds sold decreased \$14.3 million, and investment securities increased \$6.0 million between the two period-ends.

Total deposits of \$634.6 million at December 31, 2007 increased \$47.5 million or 8.1% from the balance reported at December 31, 2006, and increased \$88.2 million or 16.1% from the balance of \$546.5 million reported at December 31, 2005. During 2007, growth was experienced in time deposits, and savings accounts, with declines experienced in other deposit categories.

Earning assets averaged approximately \$683.4 million during the year ended December 31, 2007, as compared to \$585.5 million and \$555.5 million for the years ended December 31, 2006 and 2005, respectively. Average interest-bearing liabilities increased to \$526.0 million for the year ended December 31, 2007, as compared to \$438.1 million for the year ended December 31, 2006, and increased from the balance of \$420.3 million for the year ended December 31, 2005.

***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 \$598.2 million at December 31, 2007, representing an increase of \$97.7 million or 19.5% when compared to the balance of \$500.6 million at December 31, 2006, and an increase of \$180.3 million or 43.2% when compared to the balance of \$417.9 million reported at December 31, 2005. Average loans totaled \$580.9 million, \$470.0 million, and \$402.8 million for the years ended December 31, 2007, 2006 and 2005, respectively. During 2007 average loans increased 23.6% when compared to the year ended December 31, 2006 and increased 44.2% compared to the year ended December 31, 2005.

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

| (In thousands)             | 2007          |            | 2006          |            | 2005          |            | 2004          |            | 2003          |            |
|----------------------------|---------------|------------|---------------|------------|---------------|------------|---------------|------------|---------------|------------|
|                            | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans | Dollar Amount | % of Loans |
| Commercial and industrial  | \$ 204,385    | 34.2%      | \$ 155,811    | 31.1%      | \$ 113,263    | 27.1%      | \$ 123,720    | 31.0%      | \$ 116,991    | 33.9%      |
| Real estate - mortgage     | 142,565       | 23.8       | 113,613       | 22.7       | 89,503        | 21.4       | 88,187        | 22.1       | 96,381        | 27.9       |
| Real estate - construction | 178,296       | 29.8       | 168,378       | 33.7       | 162,873       | 38.9       | 137,523       | 34.5       | 97,930        | 28.3       |
| Agricultural               | 46,055        | 7.7        | 35,102        | 7.0        | 24,935        | 6.0        | 23,416        | 5.9        | 15,162        | 4.4        |
| Installment/other          | 18,171        | 3.0        | 16,712        | 3.3        | 15,002        | 3.6        | 13,257        | 3.3        | 6,617         | 1.9        |
| Lease financing            | 8,748         | 1.5        | 10,952        | 2.2        | 12,334        | 3.0        | 12,581        | 3.2        | 12,581        | 3.6        |
| Total Loans                | \$ 598,220    | 100.0%     | \$ 500,568    | 100.0%     | \$ 417,910    | 100.0%     | \$ 398,684    | 100.0%     | \$ 345,662    | 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 2007 as with 2006, loan growth occurred in all categories except lease financing. During 2007, significant increases occurred in commercial and industrial loans, as well as real estate mortgage loans, with increases of \$48.6 million or 31.2% and \$29.0 million or 25.5% in those two categories, respectively. Agricultural loans increased \$11.0 million or 31.2% during 2007, and real estate construction loans increased \$9.9 million or 5.9% during 2007.

During the fourth quarter of 2007 loan volume declined approximately \$27.7 million or 4.4% as the Company slowed additional loan growth as part of its asset/liability management and liquidity plan. Core deposit growth lagged loan growth throughout much of 2007 and the Company relied to a greater degree on brokered time deposits and the use of credit lines to fund additional loan growth throughout the much of the year. As the loan-to-deposit ratio increased and brokered deposits reached the Company's policy limits, the Company utilized to greater extent its borrowing lines of credit while at the same time controlling additional loan growth to better manage the balance sheet.

Gross loans acquired in the acquisition of Legacy Bank in Campbell, California totaled approximately \$63.9 million at the date of merger (February 16, 2007). Exclusive of the loans acquired from Legacy Bank during the first quarter, loan balances attributable to the Company's previously existing loan portfolio increased approximately \$33.7 million during the year ended December 31, 2007. The following table shows the net change experienced during the year ended December 31, 2007, removing the effect of the loans acquired in the Legacy Bank merger.

|                            | Total Loans<br>Dec 31, 2007 | Legacy Loans<br>at merger | Dec 31, 2007<br>Loans without<br>Legacy Loans | Net Change<br>Year Ended<br>Dec 31, 2007 (1) |
|----------------------------|-----------------------------|---------------------------|---|--|
| Commercial and industrial  | \$ 204,385                  | \$ 31,735                 | \$ 172,650                                    | \$ 16,839                                    |
| Real estate - mortgage     | 142,565                     | 14,417                    | 128,148                                       | 14,535                                       |
| Real estate - construction | 178,296                     | 12,817                    | 165,479                                       | (2,899)                                      |
| Agricultural               | 46,055                      | 0                         | 46,055  | 10,953                                       |
| Installment/other          | 18,171                      | 4,957                     | 13,214  | (3,498)                                      |
| Lease financing            | 8,748                       | 0                         | 8,748   | (2,204)                                      |
| Total Loans                | \$ 598,220                  | \$ 63,926                 | \$ 534,294                                    | \$ 33,726                                    |



(1) Net change in loans between December 31, 2006 and December 31, 2007, excluding balance of loans acquired from Legacy Bank at merger date (2/16/07). At December 31, 2007, loans at the Campbell branch, including new volume since the acquisition, totaled \$63.9 million.

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 remained 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 continued to be a substantial business line for the Company, as housing demand and business development remained 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, 2007, approximately 62% 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.

Although residential housing markets suffered during the later half of 2007, residential construction loans continue to be a significant focus for the Company and increased \$9.9 million or 5.9 % during 2007, increased \$5.5 million or 3.4% during 2006, and increased \$25.4 million or 18.4% during 2005. 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 \$11.0 million or 31.2% between December 31, 2006 and December 31, 2007, while installment loans increased \$1.5 million or 8.7% during that same period.

The real estate mortgage loan portfolio totaling \$142.6 million at December 31, 2007 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 \$102.4 million, \$71.7 million, and \$43.6 million at December 31, 2007, 2006, and 2005, 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 remained stable with balances of \$37.2 million, \$39.2 million, and \$43.3 million at December 31, 2007, 2006 and 2005, respectively. The Company also offers short to medium-term, fixed-rate, home equity loans, which totaled \$3.0 million at December 31, 2007, \$2.7 million at December 31, 2006, and \$2.6 million at December 31, 2005.

*The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2007. Amounts presented are shown by maturity dates rather than repricing periods:*

| <i>(In thousands)</i>       | Due in one<br>year or less | Due after one<br>Year through<br>Five years | Due after<br>Five years | Total      |
|-----------------------------|----------------------------|---|-------------------------|------------|
| Commercial and agricultural | \$ 157,315                 | \$ 68,697                                   | \$ 24,428               | \$ 250,440 |
| Real estate - construction  | 169,990                    | 6,618                                       | 1,688                   | 178,296    |
|                             | 327,305                    | 75,315                                      | 26,116                  | 428,736    |
| Real estate - mortgage      | 17,631                     | 66,928                                      | 58,006                  | 142,565    |
| All other loans             | 10,146                     | 13,871                                      | 2,902                   | 26,919     |
| Total Loans                 | \$ 355,082                 | \$ 156,114                                  | \$ 87,024               | \$ 598,220 |

The average yield on loans was 9.07% for the year ended December 31, 2007, representing a decrease of 7 basis points when compared to the year ended December 31, 2006 and was a result of increased loan pricing pressures experienced during 2007 which more than outweighed an average increase of 9 basis point in the prime rate between the year ended December 31, 2006 and December 31, 2007. For the year ended December 31, 2006, the average yield on loans was 9.13%, 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. 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, 2007, 2006 and 2005, approximately 62.3%, 59.5% and 58.1% 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, 2007. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:*

| <i>(In thousands)</i> | Due in one<br>year or less | Due after one<br>Year through<br>Five years | Due after<br>Five years | Total |
|-----------------------|----------------------------|---|-------------------------|-------|
|-----------------------|----------------------------|---|-------------------------|-------|

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Accruing loans:

|                             |    |                |    |                |    |               |    |                |
|-----------------------------|----|----------------|----|----------------|----|---------------|----|----------------|
| Fixed rate loans            | \$ | 54,256         | \$ | 82,256         | \$ | 73,648        | \$ | 210,160        |
| Floating rate loans         |    | 282,536        |    | 71,324         |    | 12,616        |    | 366,476        |
| <b>Total accruing loans</b> |    | <b>336,792</b> |    | <b>153,580</b> |    | <b>86,264</b> |    | <b>576,636</b> |

Nonaccrual loans:

|                               |    |                |    |                |    |               |    |                |
|-------------------------------|----|----------------|----|----------------|----|---------------|----|----------------|
| Fixed rate loans              |    | 12,673         |    | 2,436          |    | 428           |    | 15,537         |
| Floating rate loans           |    | 5,617          |    | 98             |    | 332           |    | 6,047          |
| <b>Total nonaccrual loans</b> |    | <b>18,290</b>  |    | <b>2,534</b>   |    | <b>760</b>    |    | <b>21,584</b>  |
| <b>Total Loans</b>            | \$ | <b>355,082</b> | \$ | <b>156,114</b> | \$ | <b>87,024</b> | \$ | <b>598,220</b> |

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**Securities**

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

| (In thousands)   | December 31, 2007 |                        |                         |                              | December 31, 2006 |                        |                         |                              |
|--|-------------------|------------------------|-------------------------|------------------------------|-------------------|------------------------|-------------------------|------------------------------|
|  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) |
| <b>Available-for-sale:</b>                                 |                   |                        |                         |                              |                   |                        |                         |                              |
| U.S. Government agencies                                   | \$ 65,764         | \$ 524                 | \$ (302)                | \$ 65,986                    | \$ 69,746         | \$ 51                  | \$ (1,293)              | \$ 68,504                    |
| U.S. Government agency collateralized mortgage obligations | 7,782             | 44                     | (4)                     | 7,822                        | 17                | 0                      | (1)                     | 16                           |
| Obligations of state and political subdivisions            | 2,227             | 54                     | 0                       | 2,281                        | 2,226             | 65                     | (1)                     | 2,290                        |
| Other investment securities                                | 13,752            | 0                      | (426)                   | 13,326                       | 13,000            | 0                      | (444)                   | 12,556                       |
| <b>Total available-for-sale</b>                            | <b>\$ 89,525</b>  | <b>\$ 622</b>          | <b>\$ (732)</b>         | <b>\$ 89,415</b>             | <b>\$ 84,989</b>  | <b>\$ 116</b>          | <b>\$ (1,739)</b>       | <b>\$ 83,366</b>             |

| (In thousands)   | December 31, 2005 |                        |                         |                  |
|--|-------------------|------------------------|-------------------------|------------------|
|  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value       |
| <b>Available-for-sale:</b>                                 |                   |                        |                         |                  |
| U.S. Government agencies                                   | \$ 82,215         | \$ 110                 | \$ (2,002)              | \$ 80,323        |
| U.S. Government agency collateralized mortgage obligations |                   | 22                     | 0                       | 21               |
| Obligations of state and political subdivisions            |                   | 2,226                  | 94                      | 2,320            |
| Other investment securities                                |                   | 13,000                 | 0                       | 12,572           |
| <b>Total available-for-sale</b>                            | <b>\$ 97,463</b>  | <b>\$ 204</b>          | <b>\$ (2,431)</b>       | <b>\$ 95,236</b> |

Included in other investment securities at December 31, 2007, is a short-term government securities mutual fund totaling \$7.7 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$752,000. Included in other investment securities at December 31, 2006, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.8 million. Included in other investment securities at December 31, 2005, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.9 million. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

There were no realized gains or losses on securities available-for-sale during 2007, Realized gains on securities available-for-sale totaled \$27,000 during 2006, and \$163,000 during 2005. There were no realized losses on securities available-for-sale during 2006 or 2005.

Investment securities increased \$6.0 million between December 2006 and December 2007 primarily as the result of the Legacy merger during February 2007 in which approximately \$6.8 million in U.S Agency securities and \$625,000

in other investment securities were added to the Company's portfolio. 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.

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Securities that have been temporarily impaired less than 12 months at December 31, 2007 are comprised of one U.S. government agency collateralized mortgage obligation with a weighted average life of 1.19 years. As of December 31, 2007, there were nine U.S. government agency securities, and two other investment securities with a total weighted average life of 0.97 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, 2007.

The following summarizes temporarily impaired investment securities at December 31, 2007

| <i>(In thousands)</i>                                      | Less than 12 Months                |                      | 12 Months or More                  |                      | Total                              |                      |
|--|------------------------------------|----------------------|------------------------------------|----------------------|------------------------------------|----------------------|
|  | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses |
| <u>Securities available for sale:</u>                      |                                    |                      |                                    |                      |                                    |                      |
| U.S. Government agencies                                   | \$ 0                               | \$ 0                 | \$ 30,241                          | \$ (302)             | \$ 30,241                          | \$ (302)             |
| U.S. Government agency collateralized mortgage Obligations | 4,129                              | (4)                  | 0                                  | 0                    | 4,129                              | (4)                  |
| Obligations of state and political subdivisions            | 0                                  | 0                    | 0                                  | 0                    | 0                                  | 0                    |
| Other investment securities                                | 0                                  | 0                    | 12,574                             | (426)                | 12,574                             | (426)                |
| Total impaired securities                                  | \$ 4,129                           | \$ (4)               | \$ 42,815                          | \$ (728)             | \$ 46,944                          | \$ (732)             |

Securities that have been temporarily impaired less than 12 months at December 31, 2006 are comprised of one U.S. government agency security with 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

| <i>(In thousands)</i>                                      | Less than 12 Months                |                      | 12 Months or More                  |                      | Total                              |                      |
|--|------------------------------------|----------------------|------------------------------------|----------------------|------------------------------------|----------------------|
|  | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses | Fair Value<br>(Carrying<br>Amount) | Unrealized<br>Losses |
| <u>Securities available for sale:</u>                      |                                    |                      |                                    |                      |                                    |                      |
| 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)           |

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The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2007 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

| <i>(Dollars in thousands)</i>                              | One year or less |           | After one year to five years |           | After five years to ten years |           | After ten years |           | Total     |           |
|--|------------------|-----------|------------------------------|-----------|-------------------------------|-----------|-----------------|-----------|-----------|-----------|
|  | Amount           | Yield (1) | Amount                       | Yield (1) | Amount                        | Yield (1) | Amount          | Yield (1) | Amount    | Yield (1) |
| Available-for-sale:  |                  |           |                              |           |                               |           |                 |           |           |           |
| U.S. Government agencies                                   | \$ 24,058        | 4.09%     | \$ 883                       | 3.80%     | \$ 8,341                      | 5.28%     | \$ 32,704       | 4.53%     | \$ 65,986 | 4.09%     |
| U.S. Government agency collateralized mortgage obligations | —                | —         | —                            | —         | 3,679                         | 4.81%     | 4,143           | 6.38%     | 7,822     | 5.67%     |
| Obligations of state and political subdivisions            | —                | —         | 170                          | 3.03%     | 2,111                         | 4.83%     | —               | —         | 2,281     | 4.76%     |
| Other investment securities                                | 13,326           | 4.94%     | —                            | —         | —                             | —         | —               | —         | 13,326    | 4.94%     |
| Total estimated fair value                                 | \$ 37,384        | 3.76%     | \$ 1,053                     | 3.83%     | \$ 14,131                     | 5.09%     | \$ 36,847       | 4.74%     | \$ 89,415 | 4.36%     |

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

At December 31, 2007 and 2006, available-for-sale securities with an amortized cost of approximately \$71.0 million and \$70.9 million, respectively (fair value of \$71.3 million and \$69.7 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 \$47.5 million or 8.1% during the year to a balance of \$634.6 million at December 31, 2007 and increased \$40.7 million or 7.4% between December 31, 2005 and December 31, 2006. 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 59.9%, 71.0% and 75.7% of the total deposit portfolio at December 31, 2007, 2006 and 2005, 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:*

| <i>(In thousands)</i>           | December 31, |            |            | Change during Year |           |
|---------------------------------|--------------|------------|------------|--------------------|-----------|
|                                 | 2007         | 2006       | 2005       | 2007               | 2006      |
| Noninterest-bearing deposits    | \$ 139,066   | \$ 159,002 | \$ 153,113 | \$ (19,936)        | \$ 5,889  |
| Interest-bearing deposits:      |              |            |            |                    |           |
| NOW and money market accounts   | 153,717      | 184,384    | 175,852    | (30,667)           | 8,532     |
| Savings accounts                | 40,012       | 31,933     | 33,590     | 8,079              | (1,657)   |
| Time deposits:                  |              |            |            |                    |           |
| Under \$100,000                 | 52,297       | 42,428     | 53,254     | 9,869              | (10,826)  |
| \$100,000 and over              | 249,525      | 169,380    | 130,651    | 80,146             | 38,729    |
| Total interest-bearing deposits | 495,551      | 428,125    | 393,347    | 67,427             | 34,778    |
| Total deposits                  | \$ 634,617   | \$ 587,127 | \$ 546,460 | \$ 47,491          | \$ 40,667 |

During the year ended December 31, 2007 increases were experienced primarily in time deposits, and to a lesser degree in saving accounts. Increases in time deposits during 2007 were largely the result brokered time deposits obtained by the Company as part of its liquidity strategy begun during 2006 to fund loan growth as core deposits became increasingly difficult to obtain and pricing became more competitive. This liquidity strategy has allowed the Company to obtain the additional funding sources need to fund loan growth without adversely impacting the cost of its core deposit base. The Company has utilized brokered deposits over the past several years to enhance its funding needs, with brokered deposits totaling \$139.3 million, \$67.7 million, and \$32.8 million at December 31, 2007, 2006 and 2005, respectively. In addition, the Company has been able to obtain time deposits from the State of California, which totaled \$45.0 million at both December 31, 2007 and December 31, 2006, and \$40.0 million at December 31, 2005. 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. NOW and money market accounts, as well as noninterest-bearing deposits declined \$30.7 million and \$19.9 million, respectively, between December 31, 2006 and December 31, 2007 as these deposits became increasingly competitive. 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 year ended December 31, 2006 increases were experienced in all deposit categories, except in time deposits under \$100,000 and savings deposits. Increases experienced during 2006 in money market accounts and time deposits in excess of \$100,000 are primarily the result of depositors seeking higher yields during the year as competitors such as brokerage firms and credit unions have drove 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 overall level of time deposits declined during 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'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 \$67.4 million or 15.6% between December 31, 2006 and December 31, 2007, while noninterest-bearing deposits decreased \$19.9 million or 12.5% between the same two periods presented. Between December 31, 2005 and December 31, 2006, total interest-bearing deposits increased \$34.8 million or 8.8%, while noninterest-bearing deposits increased \$5.9 million or 3.9%.

Deposit balances acquired in the acquisition of Legacy Bank totaled approximately \$69.6 million at the date of merger (February 16, 2007). Exclusive of the deposits acquired from Legacy Bank during the first quarter, deposit balances attributable to the Company's previously existing deposit base decreased approximately \$22.1 million during the year ended December 31, 2007. The following table shows the net change experienced during the year ended December 31, 2007, removing the effect of the deposit balances acquired in the Legacy Bank merger.

|                                 | Total Deposits<br>Dec 31, 2007 | Legacy<br>Deposits<br>at merger | Dec 31, 2007<br>Deposits<br>Without Legacy | Net Change<br>Year Ended<br>Dec 31, 2007 (1) |
|---------------------------------|--------------------------------|---------------------------------|--|--|
| Noninterest bearing deposits    | \$ 139,066                     | \$ 17,970                       | \$ 121,096                                 | (\$37,906)                                   |
| Interest bearing deposits:      |                                |                                 |  |  |
| NOW and money market accounts   | 153,717                        | 10,541                          | 143,176                                    | (41,208)                                     |
| Savings accounts                | 40,012                         | 28,752                          | 11,260                                     | (20,673)                                     |
| Time deposits:                  |                                |                                 |  |  |
| Under \$100,000                 | 52,297                         | 2,860                           | 49,437                                     | 7,009  |
| \$100,000 and over              | 249,525                        | 9,477                           | 240,048                                    | 70,668                                       |
| Total interest bearing deposits | 495,551                        | 51,630                          | 443,921                                    | 15,796                                       |
| Total deposits                  | \$ 634,617                     | \$ 69,600                       | \$ 565,017                                 | \$ (22,110)                                  |

(1) Net change between December 31, 2006 and December 31, 2007 in deposit balances, excluding deposits acquired from Legacy Bank at merger date (2/16/07). At December 31, 2007, deposits at the Campbell branch, including new volume since the acquisition, totaled \$42.1 million

On a year-to-date average, the Company experienced an increase of \$74.3 million or 3.2 % in total deposits between the years ended December 31, 2006 and December 31, 2007. Between these two periods, average interest-bearing deposits increased \$74.1 million or 17.7%, while total noninterest-bearing checking increased \$232,000 or 0.16% on a year-to-date average basis. On average, the Company experienced increases in savings accounts and time deposits between the years ended December 31, 2006 and December 31, 2007, while other deposit categories experienced moderate declines on average during 2007. On a year-to-date average basis, total deposits increased \$17.5 million or

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3.2% between the years ended December 31, 2005 and December 31, 2006. Of that total, interest-bearing deposits increased by \$14.9 million or 3.7%, while noninterest-bearing deposits increased \$2.6 million or 1.8% during 2006.

*The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2007, 2006 and 2005:*

| <i>(Dollars in thousands)</i> | 2007               |        | 2006               |        | 2005               |        |
|-------------------------------|--------------------|--------|--------------------|--------|--------------------|--------|
|                               | Average<br>Balance | Rate % | Average<br>Balance | Rate % | Average<br>Balance | Rate % |
| Interest-bearing deposits:    |                    |        |                    |        |                    |        |
| Checking accounts             | \$ 183,102         | 2.48%  | \$ 187,360         | 2.10%  | \$ 171,361         | 1.50%  |
| Savings                       | 46,225             | 1.91%  | 35,135             | 0.56%  | 35,500             | 0.49%  |
| Time deposits (1)             | 263,196            | 4.94%  | 195,922            | 4.32%  | 196,642            | 2.94%  |
| Noninterest-bearing deposits  | 146,954            |        | 146,722            |        | 144,146            |        |

(1) Included at December 31, 2007, are \$249.5 million in time certificates of deposit of \$100,000 or more, of which \$111.0 million matures in three months or less, \$80.6 million matures in 3 to 6 months, \$44.2 million matures in 6 to 12 months, and \$13.7 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 \$386.7 million and \$308.3 million, as well as FHLB lines of credit totaling \$22.0 million and \$28.0 million at December 31, 2007 and 2006, respectively. At December 31, 2007, the Company had total outstanding balances of \$21.9 million drawn against its FHLB line of credit. Of the \$21.9 million in FHLB borrowings outstanding at December 31, 2007, \$11.9 million was in overnight borrowings, and the other \$10.0 million consists of a two-year FHLB advance, at a fixed rate of 4.92%, and a maturity date of March 30, 2009. 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, 2007, 2006 and 2005:*

| <i>(Dollars in thousands)</i>   | December 31,     |                  |                 |
|---|------------------|------------------|-----------------|
|   | 2007             | 2006             | 2005            |
| <b>At period end:</b>   |                  |                  |                 |
| Federal funds purchased   | \$ 10,380        | \$ 0             | \$ 0            |
| Repurchase agreements   | 0                | 0                | 0               |
| FHLB advances   | 21,900           | 0                | 0               |
| <b>Total at period end</b>  | <b>\$ 32,280</b> | <b>\$ 0</b>      | <b>\$ 0</b>     |
| Average ending interest rate - total  | 4.10%            | 0.00%            | 0.00%           |
| <b>Average for the year:</b>  |                  |                  |                 |
| Federal funds purchased   | \$ 4,660         | \$ 4,209         | \$ 1,331        |
| Repurchase agreements   | 0                | 0                | 0               |
| FHLB advances   | 13,231           | 0                | 0               |
| <b>Total average for the year</b>   | <b>\$ 17,891</b> | <b>\$ 4,209</b>  | <b>\$ 1,331</b> |
| Average interest rate - total   | 5.17%            | 5.30%            | 3.32%           |
| <b>Maximum total borrowings outstanding at any month-end during the year:</b> |                  |                  |                 |
| Federal funds purchased   | \$ 16,400        | \$ 17,100        | \$ 8,255        |
| Repurchase agreements/FHLB advances   | 20,000           | 0                | 0               |
| <b>Total</b>  | <b>\$ 36,400</b> | <b>\$ 17,100</b> | <b>\$ 8,255</b> |



**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<br>(dollars in 000's) |                                    | Loan Balance at December 31, |            |            |            |            |
|--|------------------------------------|------------------------------|------------|------------|------------|------------|
|  |                                    | 2007                         | 2006       | 2005       | 2004       | 2003       |
| 1  | Commercial and Business Loans      | \$ 196,682                   | \$ 152,070 | \$ 109,783 | \$ 115,831 | \$ 107,068 |
| 2  | Government Program Loans           | 7,703                        | 3,741      | 3,480      | 7,889      | 9,923      |
|  | Total Commercial and Industrial    | 204,385                      | 155,811    | 113,263    | 123,720    | 116,991    |
| 3  | Commercial Real Estate Term Loans  | 102,399                      | 71,697     | 43,644     | 62,501     | 86,142     |
| 4  | Single Family Residential Loans    | 37,194                       | 39,184     | 43,308     | 21,567     | 5,240      |
| 5  | Home Improvement/Home Equity Loans | 2,972                        | 2,732      | 2,551      | 4,119      | 4,999      |
|  | Total Real Estate Mortgage         | 142,565                      | 113,613    | 89,503     | 88,187     | 96,381     |
| 6  |                                    | 178,296                      | 168,378    | 162,873    | 137,523    | 97,930     |

Total Real Estate Construction  
Loans

|    |                            |            |            |            |            |            |
|----|----------------------------|------------|------------|------------|------------|------------|
| 7  | Total Agricultural Loans   | 46,055     | 35,102     | 24,935     | 23,416     | 15,162     |
| 8  | Consumer Loans             | 17,521     | 16,327     | 14,373     | 12,476     | 6,134      |
| 9  | Overdraft protection Lines | 85         | 82         | 102        | 117        | 142        |
| 10 | Overdrafts                 | 565        | 303        | 527        | 664        | 341        |
|    | Total Installment/other    | 18,171     | 16,712     | 15,002     | 13,257     | 6,617      |
| 11 | Total Lease Financing      | 8,748      | 10,952     | 12,334     | 12,581     | 12,581     |
|    | Total Loans                | \$ 598,220 | \$ 500,568 | \$ 417,910 | \$ 398,684 | \$ 345,662 |

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 “loss.” Certain loans are homogenous in nature and are therefore pooled by risk grade. These homogenous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends, which if not corrected, could jeopardize repayment of the loan and result in further downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as “doubtful” has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard, doubtful, and loss.

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

The formula allowance includes reserves for certain off-balance sheet risks including letters of credit, unfunded loan commitments, and lines of credit. Reserves for undisbursed commitments are generally formula allocations based on the Company’s historical loss experience and other loss factors, rather than specific loss contingencies. At December 31, 2007, 2006 and 2005 the formula reserve allocated to undisbursed commitments totaled \$548,000, \$526,000 and \$542,000, respectively. 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.

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 2007 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, 2007 and 2006, the Company's recorded investment in loans for which impairment has been recognized totaled \$20.6 million and \$8.9 million, respectively. Included in total impaired loans at December 31, 2007, are \$10.7 million of impaired loans for which the related specific allowance is \$4.5 million, as well as \$9.9 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, 2006 included \$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. The average recorded investment in impaired loans was

\$15.9 million, \$10.1 million and \$15.9 million during the years ended December 31, 2007, 2006 and 2005, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method. For the year ended December 31, 2007, the Company recognized no income on such loans. For the years ended December 31, 2006 and 2005, the Company recognized income of \$65,000 and \$34,000, respectively, 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 decreasing 100 basis points during the fourth quarter of 2007, and another 75 basis points during January 2008, indications are that rates will continue to drop in the near future as a result of sub-prime lending problems, a weakened real estate market, and tight credit markets. Both business and consumer spending have improved during the past several years, but current GDP projections for the next year have softened. It is difficult to determine to what degree the Federal Reserve will adjust short-term interest rates in its efforts to influence the economy. 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 remained relatively stable economically during the past several years while much of the rest of the state and the nation have experienced more volatile economic trends. Although the local area residential housing markets have softened to some degree, they continue to perform better than other parts of the state, which should bode well for sustained growth in the Company's market areas of Fresno and Madera, Kern, and Santa Clara Counties. Local unemployment rates in the San Joaquin Valley 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. 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.

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

| <i>(Dollars in thousands)</i>  | December 31, |            |            |            |            |
|--|--------------|------------|------------|------------|------------|
|  | 2007         | 2006       | 2005       | 2004       | 2003       |
| Total loans outstanding at end of period before deducting allowances for credit losses | \$ 596,480   | \$ 499,570 | \$ 417,156 | \$ 397,584 | \$ 344,797 |
| Average net loans outstanding during period  | \$ 580,873   | \$ 469,959 | \$ 402,820 | \$ 374,748 | \$ 353,562 |
| Balance of allowance at beginning of period  | \$ 8,365     | \$ 7,748   | \$ 7,251   | \$ 6,081   | \$ 5,556   |
| Loans charged off:   |              |            |            |            |            |
| Real estate  | (22)         | 0          | 0          | 0          | 0          |
| Commercial and industrial  | (4,286)      | (290)      | (323)      | (14)       | (1,080)    |
| Lease financing  | (8)          | (164)      | (364)      | (496)      | (161)      |
| Installment and other  | (177)        | (48)       | (86)       | (80)       | (33)       |
| Total loans charged off  | (4,493)      | (502)      | (773)      | (590)      | (1,274)    |
| Recoveries of loans previously charged off:  |              |            |            |            |            |
| Real estate  | 0            | 0          | 0          | 0          | 0          |
| Commercial and industrial  | 46           | 195        | 108        | 82         | 61         |
| Lease financing  | 0            | 1          | 3          | 29         | 25         |
| Installment and other  | 18           | 43         | 54         | 25         | 0          |
| Total loan recoveries  | 64           | 239        | 165        | 136        | 86         |
| Net loans charged off  | (4,429)      | (263)      | (608)      | (454)      | (1,188)    |
| Reclassification of off-balance sheet reserve  | 0            | 0          | (35)       | (507)      | 0          |
| Reserve acquired in business acquisition   | 1,268        | 0          | 0          | 986        | 0          |
| Provision charged to operating expense   | 5,697        | 880        | 1,140      | 1,145      | 1,713      |
| Balance of allowance for credit losses at end of period                                | \$ 10,901    | \$ 8,365   | \$ 7,748   | \$ 7,251   | \$ 6,081   |
| Net loan charge-offs to total average loans  | 0.76%        | 0.06%      | 0.15%      | 0.12%      | 0.34%      |
| Net loan charge-offs to loans at end of period   | 0.74%        | 0.05%      | 0.15%      | 0.11%      | 0.34%      |
| Allowance for credit losses to total loans at end of period                            | 1.83%        | 1.67%      | 1.86%      | 1.82%      | 1.76%      |
| Net loan charge-offs to allowance for credit losses                                    | 40.63%       | 3.14%      | 7.85%      | 6.26%      | 19.54%     |
| Net loan charge-offs to provision for credit losses                                    | 77.74%       | 29.89%     | 53.33%     | 39.65%     | 69.35%     |

Management believes that the 1.83% credit loss allowance to total loans at December 31, 2007 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that the economic conditions which may adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio. Management is not currently aware of any conditions that may adversely affect the levels of losses incurred in the Company's loan portfolio.

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

|                            | 2007      |        | 2006      |        | 2005      |        | 2004      |        | 2003      |        |
|----------------------------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|
|                            | Allowance |        | Allowance |        | Allowance |        | Allowance |        | Allowance |        |
|                            | for       | % of   | for       | % of   | For       | % of   | for       | % of   | for       | % of   |
| (Dollars in thousands)     | Credit    | Loans  | Credit    | Loans  | Credit    | Loans  | Credit    | Loans  | Credit    | Loans  |
| Commercial and industrial  | \$ 3,254  | 34.2%  | \$ 1,905  | 31.1%  | \$ 1,397  | 27.1%  | \$ 2,497  | 31.0%  | \$ 1,755  | 33.9%  |
| Real estate - mortgage     | 593       | 23.8%  | 619       | 22.7%  | 330       | 21.4%  | 386       | 22.1%  | 508       | 27.9%  |
| Real estate - construction | 2,824     | 29.8%  | 1,039     | 33.7%  | 1,598     | 38.9%  | 1,753     | 34.5%  | 1,067     | 28.3%  |
| Agricultural               | 559       | 7.7%   | 310       | 7.0%   | 316       | 6.0%   | 197       | 5.9%   | 188       | 4.4%   |
| Installment/other          | 133       | 3.0%   | 187       | 3.3%   | 112       | 3.6%   | 103       | 3.3%   | 97        | 1.9%   |
| Lease financing            | 3,538     | 1.5%   | 4,165     | 2.2%   | 3,619     | 3.0%   | 2,312     | 3.2%   | 2,466     | 3.6%   |
| Not allocated              | 0         | —      | 140       | —      | 376       | —      | 3         | —      | 0         | —      |
|                            | \$ 10,901 | 100.0% | \$ 8,365  | 100.0% | \$ 7,748  | 100.0% | \$ 7,251  | 100.0% | \$ 6,081  | 100.0% |

During 2007, reserve allocations increased significantly for commercial and industrial loans, construction loans, and to lesser extent, agricultural loans. As with prior years, the significant reserve allocation for lease financing loans is the result of specific reserves allocated to a lease portfolio that has been nonperforming since 2002 and is in the process of litigation (see discussion following). Increased reserve allocations for commercial and industrial loans, as well as agricultural loans are the result of increased loan volume, as well as increases in substandard loans in those categories. Increases in reserve allocations for construction loans are primarily the result of increases in special mention and substandard loans in those categories. Reserve allocations decreased for lease financing loans as a result of positive results in the litigation process related to the Company's nonperforming purchased lease portfolio.

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 increased reserve allocations for lease financing loans since 2003 are 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 \$3.5 million and \$4.0 million allocated at December 31, 2007 and 2006, respectively, and a net carrying value of \$2.0 million at December 31, 2007. The specific allowance was determined based on an estimate of expected future cash flows, based upon the probable outcome of the current litigation.

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 \$3.5 million calculated for the impaired lease portfolio at December 31, 2007 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 Financial Code 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.

The following summarizes the Company's allowance for credit losses related to the specific, formula, and unallocated reserves for the year-ends shown:

| (Dollars in 000's)    | December 31, |          |          |          |          |
|-----------------------|--------------|----------|----------|----------|----------|
|                       | 2007         | 2006     | 2005     | 2004     | 2003     |
| Formula allowance     | \$ 3,990     | \$ 3,637 | \$ 2,976 | \$ 2,827 | \$ 3,737 |
| Specific allowance    | 6,911        | 4,588    | 4,396    | 4,421    | 2,344    |
| Unallocated allowance | 0            | 140      | 376      | 3        | 0        |
| Total allowance       | \$ 10,901    | \$ 8,365 | \$ 7,748 | \$ 7,251 | \$ 6,081 |

At December 31, 2007, the allowance for credit losses totaled \$10.9 million, and consisted of \$4.0 million in formula allowance, and \$6.9 million in specific allowance. At December 31, 2007, \$3.5 million of the specific allowance was allocated to lease financing loans, and the remaining \$40,000, \$311,000, \$38,000, \$1.0 million and \$2.0 million were allocated to commercial real estate, agricultural, installment, commercial and industrial loans, and real estate construction loans, respectively.

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.

The total formula allowance increased approximately \$353,000 between 2006 and 2007, 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, 2006 and December 31, 2007, and so most changes in the formula allowance during 2007 were the result of volume changes. Between December 31, 2006 and December 31, 2007, sub-substandard loans increased \$35.0 million, while special mention and doubtful loans increased \$8.6 million and \$891,000 million, respectively. Increases in loan downgrades experienced during 2007 were primarily the result of deteriorating economic factors in the residential construction market, which in turn has impacted other sectors of the lending portfolio.

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.

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, 2007, the Company had no unallocated allowance. 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. Management's estimates of the unallocated allowance are based upon a number of underlying factors including 1) the effect of deteriorating national and local economic trends, 2) the effects of export market conditions on certain agricultural and manufacturing borrowers, 3) the effects of abnormal weather patterns on agricultural borrowers, as well as other borrowers that may be impacted by such conditions, 4) the effect of increased competition in the Company's market area and the resultant potential impact of more relaxed underwriting standards to borrowers with multi-bank relationships, 5) the effect of soft real estate markets, and 6) the effects of having a larger number of borrowing relationships which are close to the Company's lending limit, any one of which were not to perform to contractual terms, would have a material impact on the allowance.



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

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

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

| (Dollars in thousands, except<br>footnote)         | December 31, |           |           |           |           |
|--|--------------|-----------|-----------|-----------|-----------|
|  | 2007         | 2006      | 2005      | 2004      | 2003      |
| Nonaccrual loans (1)                               | \$ 21,583    | \$ 8,138  | \$ 13,930 | \$ 16,682 | \$ 18,656 |
| Restructured loans                                 | 23           | 4,906     | 0         | 0         | 9         |
| Total non-performing loans                         | 21,606       | 13,044    | 13,930    | 16,682    | 18,665    |
| Other real estate owned                            | 6,666        | 1,919     | 4,356     | 1,615     | 2,718     |
| Total non-performing assets                        | \$ 28,272    | \$ 14,963 | \$ 18,286 | \$ 18,297 | \$ 21,383 |
| Loans, past due 90 days or more,<br>still accruing | \$ 189       | \$ 0      | \$ 0      | \$ 375    | \$ 0      |
| Non-performing loans to total<br>gross loans       | 3.61%        | 2.61%     | 3.33%     | 4.18%     | 5.40%     |
| Non-performing assets to total<br>gross loans      | 4.73%        | 2.99%     | 4.38%     | 4.59%     | 6.19%     |

(1) There are no nonaccrual loans at December 31, 2007 and 2006, which are restructured. Included in nonaccrual loans at December 31, 2005 are restructured loans totaling \$5,114. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2007 in accordance with their original terms is approximately \$1.5 million.

Non-performing assets increased between December 31, 2006 and December 2007 as housing markets and related sectors experienced declines during the second half of the year as a result of sub-prime lending problems which impacted credit markets and the overall economy worldwide. Economic conditions in the San Joaquin Valley remained strong during much of 2007, although as a result of the decline in the housing sector and related real estate valuations, nonperforming assets increased during the years and additional charge-offs were taken during the third and fourth quarters of 2007. Non-performing assets increased during 2007, totaling 4.73% of total loans at December 31, 2007 as compared to 2.99% of total loans at December 31, 2006. Non-performing loans, a component of non-performing assets, increased nearly \$8.6 million during 2007 primarily as the result of real estate construction and real estate development loans which become impaired during the period. Some, but not all, of these nonperforming real estate credits were outside the Company's immediate market area, specifically Southern California and the San Francisco Bay area.

A nonaccrual land development loan transferred to other real estate owned during the fourth quarter of 2007 with a principal balance of \$6.0 million and accrued interest of \$865,000 (\$6.9 million total) is a shared appreciation credit, and as such, the Company agreed to receive interest on the loan as lots sold rather than monthly, and the borrower agreed to share in the profits of the project. Interest was accrued and recognized in income on an ongoing basis. Upon

moving the credit to nonaccrual status during the first quarter of 2007, the Company ceased to accrue additional interest on the loan and continued to carry, on its books, the previously accrued interest amount of \$865,000, because it was supported by the most recent appraised value of the property at that time plus an added value for the recording of the approved map for the 177 lots which was imminent. Upon foreclosure and transfer to other real estate owned during the fourth quarter of 2007, the Company obtained an updated appraisal to determine the current fair value of the property. As a result of significant deterioration in the housing markets during this period, the Company adjusted the carrying value of the property down by \$2.4 million during the fourth quarter of 2007 with a charge against the allowance for credit losses.

Other real estate owned through foreclosure increased to \$6.7 million or 0.86% of total assets at December 31, 2007, as compared to \$1.9 million or 0.28% of total assets at December 31, 2006. During 2007, three properties with net collateral value totaling \$5.3 million were transferred from nonaccrual loans, one of which was subsequently sold during the year. The Company increased its focus on the resolution of impaired assets during the later part of 2007 and will continue to do so until nonperforming assets return to minimal levels.

A \$4.9 million loan classified as restructured at December 31, 2006, paid off during the first quarter of 2007, resulting in the recognition of approximately \$1.1 million in previously unrecognized interest income during 2007, and the overall reduction of restructured loans at December 31, 2007.

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

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

Except for the loans included in the above table, and the land development loan discussed above, there were no loans at December 31, 2007 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

### **Liquidity and Asset/Liability Management**

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

#### ***Liquidity***

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2007 include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$376.4 million. The Company has maintained significant positive cash flows from operations over the past three years, which amounted to \$19.0 million, \$16.2 million, and \$14.0 million for the years ended December 31, 2007, 2006, and 2005, respectively. The Company has experienced net cash outflows from investing activities over the past three years as loan growth has exceeded proceeds received from maturities and sales of investment securities, as well as other investment instruments. Net cash flows from financing activities, including deposit growth and borrowings, have traditionally provided funding sources for loan growth, but during 2007 the Company experienced net cash outflows

totaling \$6.3 million as declines in demand deposit and savings accounts, as well as repurchases of the Company's common stock, exceeded growth in other deposit and financing categories, including borrowings. The Company has the ability to decrease loan growth, increase deposits and borrowings, or a combination of both, to manage balance sheet liquidity.

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

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to lines of credit from other banks totaling \$408.7 million, the contingency plan includes steps that may be taken in the event the total liquidity ratio falls or is projected to fall below 15% for any extended period of time. The Bank ALCO committee shall take steps to correct this condition using one or more of the following methods as needed:

- 1) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits.
- 2) Unsecured Fed Funds lines with correspondents may be used to fund short-term peaks in loan demand or deposit run-off. Other off-balance sheet funding sources such as credit lines at FHLB or the FRB may be used for longer periods.
- 3) The Bank will not rely on brokered money as a primary source of funds. However, it may be prudent to utilize brokered deposits particularly at times when the interest costs are lower than could be obtained in the local market. However, the sum of all brokered deposits will not exceed 15% of the total deposits of the Bank.
- 4) The Bank may elect to operate a Telemarketing Money Desk for the purpose of acquiring Certificates of Deposits from both the local market and national market. The Board of Directors and management recognize that deposits acquired through money desk operations may be considered a higher cost and more volatile type of deposit than traditional bank deposits.
- 5) Selling whole loans or participation in loans or by increasing the amounts sold in existing participation loans are additional means for increasing liquidity.
- 6) The State of California Treasurer is a reliable source of deposits. The bank can typically accept CD's from this source up to 90% of equity as long as it has sufficient collateral pledged.
- 7) Marketing for CD's within our marketplace is another means for raising funds or through programs that post our rates on their Website, deposits from these sources should not exceed 15% of the banks total deposits for extended periods beyond 90 days without board approval.
- 8) Should the Bank become illiquid in spite of these steps, it will curtail its lending activities. The first step in this process will be to curtail credit marketing and tighten pricing guidelines. The second step will be to encourage loan payoffs on a selective basis where circumstances and loan documentation provide this opportunity. Only as a last resort will the Bank totally curtail lending activities to credit worthy customers.

The Company continues to utilize liability management, when needed, as part of its overall asset/liability management strategy. Through the discretionary acquisition of short term borrowings, the Company has been able to provide liquidity to fund asset growth while, at the same time, better utilizing its capital resources, and better controlling interest rate risk. The borrowings are generally short-term and more closely match the repricing characteristics of floating rate loans, which comprise approximately 62.3% of the Company's loan portfolio at December 31, 2007. This does not preclude the Company from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Company has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Company has the ability to utilize an asset management approach and, either control asset growth or, fund further growth with maturities or sales of investment securities.

The Company's liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell ("reverse repos") and investment securities, is maintained at a level deemed

sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At December 31, 2007, the Bank had 75.9% of total assets in the loan portfolio and a loan-to-deposit ratio of 94.0%. Liquid assets at December 31, 2007 include cash and cash equivalents totaling \$25.3 million as compared to \$43.1 million at December 31, 2006.

Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings. Core deposits, which comprise approximately 59.9% of total deposits at December 31, 2007, provide a significant and stable funding source for the Company. At December 31, 2007, unused lines of credit with the Federal Home Loan Bank and the Federal Reserve Bank totaling \$321.8 million are collateralized in part by certain qualifying loans in the Company's loan portfolio. The carrying value of loans pledged on these used and unused borrowing lines totaled \$475.4 million at December 31, 2007. For further discussion of the Company's borrowing lines, see "Short Term Borrowings" included in previously in the financial condition section of this financial review.

The liquidity of the parent company, United Security Bancshares, is primarily dependent on the payment of cash dividends by its subsidiary, United Security Bank, subject to limitations imposed by the Financial Code of the State of California. During 2007 and 2006, total dividends paid by the Bank to the parent company totaled \$17.6 million and \$7.3 million, respectively. As a bank holding company formed under the Bank Holding Act of 1956, United Security Bancshares continues to provide a source of financial strength for its subsidiary bank(s). To help provide financial strength to the Bank, United Security Bancshares' trust subsidiary, United Security Bancshares Capital Trust I completed a \$15 million offering in Trust Preferred Securities during 2001, the proceeds of which were used to purchase Junior Subordinated Debentures of the Company. Of the \$14.5 million in net proceeds received by the Company, \$13.7 million in cash was contributed as capital to United Security Bank enhancing the liquidity and capital positions of the Bank, and the remainder provided liquidity to the holding company. The Trust Preferred Securities issued under United Security Bancshares Capital Trust I were redeemed during July 2007, and subsequently, new Trust Preferred Securities totaling \$15 million were issued under United Security Bancshares Capital Trust II. The issuance of the new Trust Preferred Securities reduced the Company's cost of the debt by 246 basis points.

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

The following table presents, as of December 31, 2007, the Company's significant fixed and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, or other similar carrying value adjustments. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

| (In thousands)                          | Note Reference | One Year Or Less | Payments Due In    |                     |                 | Total      |
|---|----------------|------------------|--------------------|---------------------|-----------------|------------|
|   |                |                  | One to Three Years | Three to Five Years | Over Five Years |            |
| Deposits without a stated maturity      | 7              | \$ 332,795       | \$ —               | \$ —                | \$ —            | \$ 332,795 |
| Time Deposits                           | 7              | 282,259          | 18,572             | 382                 | 610             | 301,823    |
| Junior Subordinated Debt (at FV)        | 9, 10          |                  |                    |                     | 13,341          | 13,341     |
| Operating Leases                        | 14             | 637              | 1,363              | 781                 | 1,403           | 4,184      |
| Contingent tax liabilities under FIN 48 | 11             | 1,385            |                    |                     |                 | 1,385      |

A schedule of significant commitments at December 31, 2007 follows:

| (In thousands)                              |           |
|---|-----------|
| Commitments to extend credit:               |           |
| Commercial and industrial                   | \$ 87,082 |
| Real estate - mortgage                      | 779       |
| Real estate - construction                  | 81,114    |
| Agricultural                                | 22,425    |
| Installment                                 | 4,136     |
| Revolving home equity and credit card lines | 722       |
| Standby letters of credit                   | 6,726     |

Further discussion of these commitments is included in Notes 3 and 14 to the consolidated financial statements.

**Regulatory Matters**

*Capital Adequacy*

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

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During July 2007, the Company redeemed its \$15.0 million in Trust Preferred Securities originally issued during 2001 under United Security Bancshares Capital Trust I. During the same month, the Company issued \$15.0 million in new Trust Preferred Securities with similar terms under newly formed United Security Bancshares Capital Trust II. Under applicable regulatory guidelines, the Trust Preferred Securities qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital. Any additional portion will qualify as Tier 2 capital. As shareholders' equity increases, the amount of Tier 1 capital that can be comprised of Trust Preferred Securities will increase.

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

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

*The following table sets forth the Company's and the Bank's actual capital positions at December 31, 2007 and the regulatory minimums for the Company and the Bank to be well capitalized under the guidelines discussed above:*

|  | Company<br>Actual<br>Capital Ratios | Bank<br>Actual<br>Capital Ratios | Regulatory<br>Minimums -<br>Well Capitalized |
|--|-------------------------------------|----------------------------------|--|
| Total risk-based capital ratio         | 12.18%                              | 11.79%                           | 10.00%                                       |
| Tier 1 capital to risk-weighted assets | 10.93%                              | 10.54%                           | 6.00%  |
| Leverage ratio                         | 10.30%                              | 9.93%                            | 5.00%  |

Under Federal Reserve guidelines, the Company and the Bank are required to maintain a total risk-based capital ratio of 10%, tier 1 capital to risk-weighted assets of 8%, and a leverage ratio of 7%, to be considered well capitalized. As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at December 31, 2007. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

### **Dividends**

Dividends paid to shareholders by the Company are subject to restrictions set forth in the California General Corporation Law. The California General Corporation Law provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal the amount of the proposed distribution. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank. During the year ended December 31, 2007, the Company received \$17.6 million in cash dividends from the Bank, from which the Company declared \$6.0 million in dividends

to shareholders.

The Bank as a state-chartered bank is subject to dividend restrictions set forth in California state banking law, and administered by the California Commissioner of Financial Institutions (“Commissioner”). Under such restrictions, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank’s net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the Commissioner, in an amount not exceeding the Bank’s net income for its last fiscal year or the amount of its net income for the current fiscal year. Such restrictions do not apply to stock dividends, which generally require neither the satisfaction of any tests nor the approval of the Commissioner. Notwithstanding the foregoing, if the Commissioner finds that the shareholders’ equity is not adequate or that the declarations of a dividend would be unsafe or unsound, the Commissioner may order the state bank not to pay any dividend. The FRB may also limit dividends paid by the Bank. This is not the case with the Bank. Year-to-date dividends of \$6.0 million and \$17.6 million paid to shareholders and the Company, respectively, through December 31, 2007 were well within the maximum allowed under those regulatory guidelines, and did not require prior approval of the Commissioner.

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

|                           | For the Quarters Ended |          |               |              |          | YTD |
|---------------------------|------------------------|----------|---------------|--------------|----------|-----|
|                           | March 31,              | June 30, | September 30, | December 31, |          |     |
| Shares repurchased - 2007 | 117,403                | 306,758  | 28,916        | 59,255       | 512,332  |     |
| Average price paid - 2007 | \$ 21.48               | \$ 19.89 | \$ 18.32      | \$ 18.32     | \$ 19.71 |     |
| Shares repurchased - 2006 | 84                     | 13,121   | 84,215        | 10,585       | 108,005  |     |
| Average price paid - 2006 | \$ 16.57               | \$ 23.13 | \$ 22.21      | \$ 24.58     | \$ 22.55 |     |
| Shares repurchased - 2005 | 7,152                  | 4,936    | 0             | 14,074       | 26,162   |     |
| Average price paid - 2005 | \$ 12.28               | \$ 12.78 | \$ —          | \$ 16.16     | \$ 14.46 |     |
| Shares repurchased - 2004 | 19,800                 | 109,490  | 45,986        | 3,564        | 178,840  |     |
| Average price paid - 2004 | \$ 12.85               | \$ 11.41 | \$ 11.29      | \$ 12.11     | \$ 11.55 |     |
| Shares repurchased - 2003 | 33,226                 | 14,696   | 22,000        | 0            | 69,922   |     |
| Average price paid - 2003 | \$ 8.54                | \$ 10.80 | \$ 11.32      | N/A          | \$ 9.89  |     |

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.

On February 25, 2004 the Company announced a second 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.

On May 16, 2007, the Company announced another stock repurchase plan to repurchase, as conditions warrant, up to 610,000 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Company canceled the remaining 75,733 shares available under the 2004 repurchase plan.

During the year ended December 31, 2007, 512,332 shares were repurchased at a total cost of \$10.1 million and an average per share price of \$19.71. Of the shares repurchased during 2007, 166,660 shares were repurchased under the 2004 plan at an average cost of \$20.46 per shares, and 345,672 shares were repurchased under the 2007 plan at an average cost of \$19.35 per share.

### **Reserve Balances**

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a

third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2007 the Bank's qualifying balance with the Federal Reserve was approximately \$25,000.

## **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

### ***Interest Rate Sensitivity and Market Risk***

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

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

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

Under the interest rate swap agreement, the Company receives a fixed rate and pays a variable rate based on the Prime Rate ("Prime"). The swap qualifies as a cash flow hedge under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended, and is designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement is measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that is deemed effective in hedging the cash flows of the designated assets are recorded in accumulated other comprehensive income and reclassified into interest income when such cash flow occurs in the future. Any ineffectiveness resulting from the hedge is recorded as a gain or loss in the consolidated statement of income as part of noninterest income. The amortizing hedge has a remaining notional value of \$1.8 million and duration of approximately three months. As of December 31, 2007, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately nine months. As of December 31, 2007, the loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$2,000. During the year ended December 31, 2007, \$310,000 was reclassified from accumulated other comprehensive income as a reduction to interest income.

The Company performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2007. As a result of a correlation analysis, the Company has determined that the swap remains highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continues to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. As a result, the notional value of the hedge instrument was approximately \$3.8 million greater than the underlying loans being hedged at June 30, 2006, \$3.3 million greater than the underlying loans being hedged at September 30, 2006, and \$3.3 million greater than the underlying loans being hedged at December 31, 2006. This difference between the notional value of the hedge and the underlying hedged assets is considered an "overhedge" pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than

temporary. At June 30, 2006, the Company determined that the difference was other than temporary and, as a result, reclassified \$147,000 of the pretax hedge loss reported in other comprehensive income into earnings. During the third and fourth quarters of 2006, the Company adjusted the pretax loss reported in other comprehensive income by \$72,000 resulting in a year-to-date loss related to swap ineffectiveness of \$75,000 reported in earnings at December 31, 2006.

As of December 31, 2007, the notional value of the hedge was still in excess of the value of the underlying loans being hedged by approximately \$1.3 million, but had improved from the \$3.3 million difference existing at December 31, 2006. As a result, the Company recorded a pretax hedge gain related to swap ineffectiveness of approximately \$66,000 during the year ended December 31, 2007. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

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

From the "Gap" report below, the Company is apparently subject to interest rate risk to the extent that its liabilities have the potential to reprice more quickly than its assets within the next year. At December 31, 2007, the Company had a cumulative negative 12-month Gap of \$9.0 million or -1.3% of total earning assets. Management believes the Gap analysis shown below is not entirely indicative of the Company's actual interest rate sensitivity, because certain interest-sensitive liabilities would not reprice to the same degree as interest-sensitive assets. For example, if the prime rate were to change by 50 basis points, the floating rate loans included in the \$350.0 million immediately adjustable category would change by the full 50 basis points. Interest bearing checking and savings accounts which are also included in the immediately adjustable column probably would move only a portion of the 50 basis point rate change and, in fact, might not even move at all. The effects of market value risk have been mitigated to some degree by the makeup of the Bank's balance sheet. Loans are generally short-term or are floating-rate instruments. At December 31, 2007, \$458.0 million or 79.4% of the loan portfolio matures or reprices within one year, and only 1.0% of the portfolio matures or reprices in more than 5 years.

Total investment securities including call options and prepayment assumptions, have a combined duration of approximately 1.7 years. Nearly \$516.3 million or 95.4% of interest-bearing liabilities mature or can be repriced within the next 12 months, even though the rate elasticity of deposits with no defined maturities may not necessarily be the same as interest-earning assets.

*The following table sets forth the Company's gap, or estimated interest rate sensitivity profile based on ending balances as of December 31, 2007, representing the interval of time before earning assets and interest-bearing liabilities may respond to changes in market rates of interest. Assets and liabilities are categorized by remaining interest rate maturities rather than by principal maturities of obligations.*

#### Maturities and Interest Rate Sensitivity

December 31, 2007

| <i>(In thousands)</i>                          | Immediately | Next Day But<br>Within Three<br>Months | After Three<br>Months<br>Within 12<br>Months | After One<br>Year But<br>Within Five<br>Years | After<br>Five<br>Years | Total      |
|--|-------------|--|--|---|------------------------|------------|
| <b>Interest Rate Sensitivity Gap:</b>          |             |  |  |   |                        |            |
| Loans (1)                                      | \$ 350,022  | \$ 52,814                              | \$ 55,119                                    | \$ 113,009                                    | \$ 5,673               | \$ 576,637 |
| Investment securities                          |             | 21,572                                 | 25,091                                       | 15,608  | 27,144                 | 89,415     |
| Interest bearing deposits<br>in other banks    |             |  | 2,742  | 167   | 0                      | 2,909      |
| Federal funds sold and<br>reverse repos        |             |  |  |   |                        | 0          |
| Total earning assets                           | \$ 350,022  | \$ 74,386                              | \$ 82,952                                    | \$ 128,784                                    | \$ 32,817              | \$ 668,961 |
| Interest-bearing<br>transaction accounts       | 153,717     |  |  |   |                        | 153,717    |
| Savings accounts                               | 40,012      |  |  |   |                        | 40,012     |
| Time deposits (2)                              | 17,991      | 126,039                                | 142,941                                      | 14,241  | 610                    | 301,822    |
| Federal funds<br>purchased/other<br>borrowings | 22,280      |  |  | 10,000  |                        | 32,280     |
| Junior subordinated debt                       |             | 13,341                                 |  |   |                        | 13,341     |
| Total interest-bearing<br>liabilities          | \$ 234,000  | \$ 139,380                             | \$ 142,941                                   | \$ 24,241                                     | \$ 610                 | \$ 541,172 |

|   |            |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|------------|
| Interest rate sensitivity gap                     | \$ 116,022 | (\$64,994) | (\$59,989) | \$ 104,543 | \$ 32,207  | \$ 127,789 |
| Cumulative gap                                    | \$ 116,022 | \$ 51,028  | (\$8,961)  | \$ 95,582  | \$ 127,789 |            |
| Cumulative gap percentage to Total earning assets | 17.3%      | 7.6%       | -1.34%     | 14.3%      | 19.1%      |            |

(1) Loan balance does not include nonaccrual loans of \$21.583 million.

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

The Company utilizes a vendor-purchased simulation model to analyze net interest income sensitivity to movements in interest rates. The simulation model projects net interest income based on a 100, 200, and 300 basis point rise and a 100, 200, and 300 basis point fall in interest rates ramped over a twelve-month period, with net interest impacts projected out as far as twenty-four months. In addition, a "most likely" scenario is projected based upon expected rate changes over the 24-month period. The model is based on the actual maturity and repricing characteristics of the Company's interest-sensitive assets and liabilities. The model incorporates assumptions regarding the impact of changing interest rates on the prepayment of certain assets and liabilities. Projected net interest income is calculated assuming customers will reinvest maturing deposit accounts and the Company will originate new loans. The balance sheet growth assumptions utilized correspond closely to the Company's strategic growth plans and annual budget. Excess cash is invested in overnight funds or other short-term investments such as U.S. Treasuries. Cash shortfalls are covered through additional borrowing of overnight or short-term funds. The Board of Directors has adopted an interest rate risk policy which establishes maximum decreases in net interest income of 12% and 15% in the event of a 100 BP and 200 BP increase or decrease in market interest rates over a twelve month period. Based on the information and assumptions utilized in the simulation model at December 31, 2007, the resultant projected impact on net interest income falls within policy limits set by the Board of Directors for all rate scenarios simulated.



The Company also utilizes the same vendor-purchased simulation model to project the impact of changes in interest rates on the underlying market value of all the Company's assets, liabilities, and off-balance sheet accounts under alternative interest rate scenarios. The resultant net value, as impacted under each projected interest rate scenario, is referred to as the market value of equity ("MV of Equity"). This technique captures the interest rate risk of the Company's business mix across all maturities. The market analysis is performed using an immediate rate shock of 100, 200, and 300 basis points up and down calculating the present value of expected cash flows under each rate environment at applicable discount rates. The market value of loans is calculated by discounting the expected future cash flows over either the term to maturity for fixed rate loans or scheduled repricing for floating rate loans using the current rate at which similar loans would be made to borrowers with similar credit ratings. The market value of investment securities is based on quoted market prices obtained from reliable independent brokers. The market value of time deposits is calculated by discounting the expected cash flows using current rates for similar instruments of comparable maturities. The market value of deposits with no defined maturities, including interest-bearing checking, money market and savings accounts is calculated by discounting the expected cash flows at a rate equal to the difference between the cost of these deposits and the alternate use of the funds, federal funds in this case. Assumed maturities for these deposits are estimated using decay analysis and are generally assumed to have implied maturities of less than five years. For noninterest sensitive assets and liabilities, the market value is equal to their carrying value amounts at the reporting date. The Company's interest rate risk policy establishes maximum decreases in the Company's market value of equity of 12% and 15% in the event of an immediate and sustained 100 BP and 200 BP increase or decrease in market interest rates. As shown in the table below, the percentage changes in the net market value of the Company's equity are within policy limits for both rising and falling rate scenarios.

*The following sets forth the analysis of the Company's market value risk inherent in its interest-sensitive financial instruments as they relate to the entire balance sheet at December 31, 2007 and December 31, 2006 (\$ in thousands). Fair value estimates are subjective in nature and involve uncertainties and significant judgment and, therefore, cannot be determined with absolute precision. Assumptions have been made as to the appropriate discount rates, prepayment speeds, expected cash flows and other variables. Changes in these assumptions significantly affect the estimates and as such, the obtained fair value may not be indicative of the value negotiated in the actual sale or liquidation of such financial instruments, nor comparable to that reported by other financial institutions. In addition, fair value estimates are based on existing financial instruments without attempting to estimate future business.*

| Change in Rates | December 31, 2007      |                           |                          | December 31, 2006      |                           |                          |
|-----------------|------------------------|---------------------------|--------------------------|------------------------|---------------------------|--------------------------|
|                 | Estimated MV of Equity | Change in MV Of Equity \$ | Change in MV Of Equity % | Estimated MV of Equity | Change in MV of Equity \$ | Change in MV Of Equity % |
| + 200 BP        | \$ 105,596             | \$ 3,028                  | 2.95%                    | \$ 90,317              | \$ 912                    | 1.02%                    |
| + 100 BP        | 105,207                | 2,639                     | 2.57%                    | 90,524                 | 1,118                     | 1.25%                    |
| 0 BP            | 102,568                | 0                         | 0.00%                    | 89,406                 | 0                         | 0.00%                    |
| - 100 BP        | 97,410                 | (5,158)                   | -5.03%                   | 87,291                 | (2,115)                   | -2.37%                   |
| - 200 BP        | 91,212                 | (11,356)                  | -11.07%                  | 84,278                 | (5,128)                   | -5.74%                   |

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

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**Moss Adams LLP**  
**Certified Public Accountants**

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors  
United Security Bancshares

We have audited the accompanying consolidated balance sheets of United Security Bancshares and Subsidiaries (Company) as of December 31, 2007 and 2006, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2007. These consolidated financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of United Security Bancshares and Subsidiaries as of December 31, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 14, 2008 expressed an unqualified opinion thereon.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company changed its method of accounting for share-based payment arrangements to conform to Statement of Financial Accounting Standard (SFAS) No. 123R, *Share -Based Payments*. As discussed in Note 10 and 15 to the consolidated financial statements, effective January 1, 2007, the Company adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157, *Fair Value Measurements*. As discussed in Note 11 to the consolidated financial statements, effective January 1, 2007, the Company adopted the provisions of FIN 48, *Accounting for uncertainty in Income Taxes*.

/s/ Moss Adams LLP

Stockton, California  
March 14, 2008

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of  
United Security Bancshares and Subsidiaries

We have audited United Security Bancshares and Subsidiaries (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, United Security Bancshares and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of United Security Bancshares and Subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007, and our report dated March 14, 2008 expressed an unqualified opinion thereon.

/s/ Moss Adams LLP

Stockton, California  
March 14 2008

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**United Security Bancshares and Subsidiaries**  
**Consolidated Balance Sheets**  
**December 31, 2007 and 2006**

|   | December 31,      |                   |
|---|-------------------|-------------------|
|   | 2007              | 2006              |
| <i>(in thousands except shares)</i>                     |                   |                   |
| <b>Assets</b>   |                   |                   |
| Cash and due from banks                                 | \$ 25,300         | \$ 28,771         |
| Federal funds sold                                      | 0                 | 14,297            |
| Cash and cash equivalents                               | 25,300            | 43,068            |
| Interest-bearing deposits in other banks                | 2,909             | 7,893             |
| Investment securities available for sale at fair value  | 89,415            | 83,366            |
| Loans and leases  | 598,220           | 500,568           |
| Unearned fees   | (1,739)           | (999)             |
| Allowance for credit losses                             | (10,901)          | (8,365)           |
| Net loans   | 585,580           | 491,204           |
| Accrued interest receivable                             | 3,658             | 4,237             |
| Premises and equipment - net                            | 15,574            | 15,302            |
| Other real estate owned                                 | 6,666             | 1,919             |
| Intangible assets                                       | 4,621             | 2,264             |
| Goodwill  | 10,417            | 750               |
| Cash surrender value of life insurance                  | 13,852            | 13,668            |
| Investment in limited partnerships                      | 3,134             | 3,564             |
| Deferred income taxes                                   | 4,301             | 5,307             |
| Other assets  | 6,288             | 5,772             |
| <b>Total assets</b>                                     | <b>\$ 771,715</b> | <b>\$ 678,314</b> |
| <b>Liabilities &amp; Shareholders' Equity</b>           |                   |                   |
| <b>Liabilities</b>                                      |                   |                   |
| Deposits  |                   |                   |
| Noninterest bearing                                     | \$ 139,066        | \$ 159,002        |
| Interest bearing  | 495,551           | 428,125           |
| Total deposits  | 634,617           | 587,127           |
| Other borrowings  | 32,280            | 0                 |
| Accrued interest payable                                | 1,903             | 2,477             |
| Accounts payable and other liabilities                  | 7,143             | 7,204             |
| Junior subordinated debt                                | 13,341            | 15,464            |
| Total liabilities                                       | 689,284           | 612,272           |
| <b>Commitments and Contingent Liabilities</b>           |                   |                   |
| <b>Shareholders' Equity</b>                             |                   |                   |
| Common stock, no par value                              |                   |                   |
| 20,000,000 shares authorized, 11,855,192 and 11,301,113 |                   |                   |
| issued and outstanding, in 2007 and 2006, respectively  | 32,587            | 20,448            |
| Retained earnings                                       | 49,997            | 46,884            |
| Accumulated other comprehensive loss                    | (153)             | (1,290)           |
| Total shareholders' equity                              | 82,431            | 66,042            |
| <b>Total liabilities and shareholders' equity</b>       | <b>\$ 771,715</b> | <b>\$ 678,314</b> |

See notes to consolidated financial statements

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**United Security Bancshares and  
Subsidiaries**  
**Consolidated Statements of Income  
and Comprehensive Income**  
**Years Ended December 31, 2007, 2006  
and 2005**

| <i>(in thousands except shares and EPS)</i>                       | 2007      | 2006      | 2005      |
|---|-----------|-----------|-----------|
| <b>Interest Income</b>  |           |           |           |
| Loans, including fees   | \$ 52,690 | \$ 42,902 | \$ 33,078 |
| Investment securities - AFS - taxable                             | 3,896     | 3,254     | 4,163     |
| Investment securities - AFS - nontaxable                          | 108       | 108       | 112       |
| Federal funds sold and securities<br>purchased                    |           |           |           |
| under agreements to resell  | 191       | 768       | 1,237     |
| Interest on deposits in other banks                               | 271       | 324       | 308       |
| Total interest income   | 57,156    | 47,356    | 38,898    |
| <b>Interest Expense</b>   |           |           |           |
| Interest on deposits  | 18,414    | 12,597    | 8,523     |
| Interest on other borrowed funds                                  | 2,159     | 1,578     | 1,135     |
| Total interest expense  | 20,573    | 14,175    | 9,658     |
| <b>Net Interest Income Before<br/>Provision for Credit Losses</b> | 36,583    | 33,181    | 29,240    |
| <b>Provision for Credit Losses</b>                                | 5,697     | 880       | 1,140     |
| <b>Net Interest Income</b>  | 30,886    | 32,301    | 28,100    |
| <b>Noninterest Income</b>   |           |           |           |
| Customer service fees   | 4,790     | 3,779     | 4,399     |
| Gain on sale of securities  | 0         | 27        | 163       |
| Gain on sale of other real estate owned                           | 209       | 50        | 325       |
| Gains from life insurance   | 483       | 482       | 0         |
| Gain (loss) on interest swap<br>ineffectiveness                   | 66        | (75)      | 0         |
| Gain on sale of investment  | 0         | 1,877     | 0         |
| Gain on fair value option of financial<br>liability               | 2,504     | 0         | 0         |
| Gain (loss) on sale of premises and<br>equipment                  | 2         | 1,018     | (5)       |
| Shared appreciation income  | 42        | 567       | 393       |
| Other   | 1,568     | 1,306     | 1,005     |
| Total noninterest income  | 9,664     | 9,031     | 6,280     |
| <b>Noninterest Expense</b>  |           |           |           |
| Salaries and employee benefits                                    | 10,830    | 9,915     | 8,046     |
| Occupancy expense   | 3,787     | 2,556     | 2,327     |
| Data processing   | 420       | 470       | 624       |
| Professional fees   | 1,811     | 998       | 1,234     |
| Director fees   | 268       | 222       | 210       |
| Amortization of intangibles                                       | 1,021     | 537       | 537       |
| Correspondent bank service charges                                | 476       | 204       | 359       |
| Writedown on investments  | 17        | 0         | 702       |
| Loss on lease assets held for sale                                | 820       | 0         | 0         |



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|  |               |    |               |    |               |
|--|---------------|----|---------------|----|---------------|
| Loss in equity of limited partnership  | 430           |    | 440           |    | 458           |
| Expense on other real estate owned   | 209           |    | 2,193         |    | 38            |
| Other  | 2,643         |    | 2,402         |    | 2,447         |
| <b>Total noninterest expense</b>   | <b>22,732</b> |    | <b>19,937</b> |    | <b>16,982</b> |
| <b>Income Before Provision for Taxes on</b>  |               |    |               |    |               |
| <b>Income</b>  | 17,818        |    | 21,395        |    | 17,398        |
| <b>Provision for Taxes on Income</b>   | 6,561         |    | 8,035         |    | 6,390         |
| <b>Net Income</b>  | \$ 11,257     | \$ | 13,360        | \$ | 11,008        |
| <b>Other comprehensive income, net of tax</b>  |               |    |               |    |               |
| Unrealized income (loss) on available for sale securities, interest rate swaps, and unrecognized post-retirement costs - net income tax (benefit) of \$757, \$382, and (\$733), respectively | 1,137         |    | 631           |    | (854)         |
| <b>Comprehensive Income</b>  | \$ 12,394     | \$ | 13,991        | \$ | 10,154        |
| <b>Net Income per common share</b>   |               |    |               |    |               |
| Basic  | \$ 0.94       | \$ | 1.18          | \$ | 0.97          |
| Diluted  | \$ 0.94       | \$ | 1.17          | \$ | 0.96          |
| <b>Weighted shares on which net income per common share were based</b>   |               |    |               |    |               |
| Basic  | 11,925,767    |    | 11,344,385    |    | 11,369,848    |
| Diluted  | 11,960,514    |    | 11,462,313    |    | 11,453,152    |

See notes to consolidated financial statements

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**Years Ended**  
**December 31, 2007**

| <i>(in thousands except shares)</i>   | Common stock Number of Shares | Amount    | Retained Earnings | Accumulated          |                                   |           |
|---|-------------------------------|-----------|-------------------|----------------------|-----------------------------------|-----------|
|   |                               |           |                   | Unearned ESOP Shares | Other Comprehensive Income (Loss) | Total     |
| <b>Balance January 1, 2005</b>  | 11,367,588                    | \$ 22,322 | \$ 31,879         | \$ (67)              | \$ (898)                          | \$ 53,236 |
| Director/Employee stock options exercised   | 12,000                        | 118       |                   |                      |                                   | 118       |
| Tax benefit of stock options exercised  |                               | 13        |                   |                      |                                   | 13        |
| Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$709 ) |                               |           |                   |                      | (1,064)                           | (1,064)   |
| Net changes in unrealized gain on interest rate swaps (net of income tax benefit of \$24)             |                               |           |                   |                      | 210                               | 210       |
| Dividends on common stock (\$0.37 per share)  |                               |           | (4,205)           |                      |                                   | (4,205)   |
| Repurchase and retirement of common shares  | (26,162)                      | (377)     |                   |                      |                                   | (377)     |
| Release of unearned ESOP shares   | 7,692                         | 8         |                   | 67                   |                                   | 75        |
| Net Income  |                               |           | 11,008            |                      |                                   | 11,008    |
| <b>Balance December 31, 2005</b>  | 11,361,118                    | 22,084    | 38,682            | 0                    | (1,752)                           | 59,014    |
| Director/Employee stock options exercised   | 48,000                        | 335       |                   |                      |                                   | 335       |
| Tax benefit of stock options exercised  |                               | 218       |                   |                      |                                   | 218       |
| Net changes in unrealized gain on available for sale securities                                       |                               |           |                   |                      | 363                               | 363       |

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|  |            |          |         |   |         |          |
|--|------------|----------|---------|---|---------|----------|
| (net of income tax of \$242 )  |            |          |         |   |         |          |
| Net changes in unrealized gain on interest rate swaps (net of income tax of \$140)           |            |          |         |   | 268     | 268      |
| Adjustment to initially apply SFAS No. 158 (net of income tax benefit of \$112)              |            |          |         |   | (169)   | (169)    |
| Dividends on common stock (\$0.445 per share)  |            |          | (5,158) |   |         | (5,158)  |
| Repurchase and retirement of common shares   | (108,005)  | (2,437)  |         |   |         | (2,437)  |
| Stock-based compensation expense   |            | 248      |         |   |         | 248      |
| Net Income   |            |          | 13,360  |   |         | 13,360   |
| <b>Balance December 31, 2006</b>   | 11,301,113 | 20,448   | 46,884  | 0 | (1,290) | 66,042   |
| Director/Employee stock options exercised  | 90,000     | 510      |         |   |         | 510      |
| Net changes in unrealized gain on available for sale securities (net of income tax of \$605) |            |          |         |   | 909     | 909      |
| Net changes in unrealized gain on interest rate swaps (net of income tax of \$97)            |            |          |         |   | 145     | 145      |
| Net changes in unrecognized past service   |            |          |         |   |         |          |
| Costs of employee benefit plans (net of income tax of \$55)                                  |            |          |         |   | 83      | 83       |
| Dividends on common stock (\$0.50 per share)   |            |          | (6,001) |   |         | (6,001)  |
| Repurchase and retirement of common shares   | (512,332)  | (10,094) |         |   |         | (10,094) |
| Issuance of shares for business combination  | 976,411    | 21,536   |         |   |         | 21,536   |
|  |            | 187      |         |   |         | 187      |

|  |         |         |
|--|---------|---------|
| Stock-based compensation expense   |         |         |
| Cumulative effect of adoption of SFAS No. 159(net income tax benefit of \$613) | (845)   | (845)   |
| Cumulative effect of adoption of FIN48   | (1,298) | (1,298) |
| Net Income   | 11,257  | 11,257  |

|                                  |            |    |        |    |        |    |   |    |       |    |        |
|----------------------------------|------------|----|--------|----|--------|----|---|----|-------|----|--------|
| <b>Balance December 31, 2007</b> | 11,855,192 | \$ | 32,587 | \$ | 49,997 | \$ | 0 | \$ | (153) | \$ | 82,431 |
|----------------------------------|------------|----|--------|----|--------|----|---|----|-------|----|--------|

See notes to consolidated financial statements

**United Security Bancshares and  
Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**Years December 31, 2007, 2006 and 2005**

| <i>(in thousands)</i>   | 2007      | 2006      | 2005      |
|---|-----------|-----------|-----------|
| <b>Cash Flows From Operating Activities:</b>                                  |           |           |           |
| Net income  | \$ 11,257 | \$ 13,360 | \$ 11,008 |
| Adjustments to reconcile net income to cash provided by operating activities: |           |           |           |
| Provision for credit losses   | 5,697     | 880       | 1,140     |
| Depreciation and amortization   | 2,655     | 1,658     | 1,459     |
| Accretion of investment securities  | (95)      | (70)      | (74)      |
| Gain on sale of securities  | 0         | (27)      | (163)     |
| Gain on sale of stock   | 0         | (1,877)   | 0         |
| Decrease (increase) in accrued interest receivable                            | 930       | (843)     | (871)     |
| (Decrease) increase in accrued interest payable                               | (339)     | 602       | 709       |
| Increase (decrease) in unearned fees  | 509       | 246       | (346)     |
| Increase (decrease) in income taxes payable                                   | 150       | (245)     | 575       |
| Excess tax benefits from stock-based payment arrangements                     | 0         | (1)       | 0         |
| Stock-based compensation expense  | 187       | 248       | 0         |
| Deferred income taxes   | 248       | (382)     | 86        |
| (Increase) decrease in accounts payable and accrued liabilities               | (130)     | 1,290     | 229       |
| Write-down of other investments   | 17        | 0         | 702       |
| Loss on lease assets held for sale  | 820       | 0         | 0         |
| (Gain) loss on sale of other real estate owned                                | (209)     | (50)      | (325)     |
| (Gain) loss on swap ineffectiveness   | (66)      | 75        | 0         |
| Gain on fair value option of financial assets                                 | (2,504)   | 0         | 0         |
| Income from life insurance proceeds   | (483)     | (482)     | 0         |
| (Gain) loss on sale of premises and equipment                                 | (2)       | (1,018)   | 5         |
| (Increase) decrease in surrender value of life insurance                      | (184)     | 88        | (379)     |
| Loss in limited partnership interest  | 430       | 440       | 458       |
| Net decrease (increase) in other assets                                       | 84        | 2,268     | (214)     |
| Net cash provided by operating activities                                     | 18,972    | 16,160    | 13,999    |
| <b>Cash Flows From Investing Activities:</b>                                  |           |           |           |
| Net decrease (increase) in interest-bearing deposits with banks               | 4,984     | (237)     | (227)     |
| Purchases of available-for-sale securities                                    | (33,859)  | 0         | (4,804)   |
| Net redemption (purchase) of FHLB/FRB and other bank stock                    | 103       | 51        | (267)     |
|   | 36,833    | 12,571    | 13,486    |

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|  |                  |                  |                  |
|--|------------------|------------------|------------------|
| Maturities, calls, and principal payments on available-for-sale securities                 |                  |                  |                  |
| Proceeds from sales of available-for-sale securities                                       | 0                | 0                | 6,795            |
| Investment in limited partnership  | 0                | 0                | (126)            |
| Investment in bank stock   | (372)            | 0                | 0                |
| Proceeds from sale of investment in title company  | 0                | 149              | 527              |
| Premiums paid on life insurance  | 0                | (227)            | (579)            |
| Net increase in loans  | (43,454)         | (84,795)         | (25,971)         |
| Cash and equivalents received in bank acquisitions, net of assets and liabilities acquired | 6,373            | 0                | 0                |
| Cash proceeds from sale of correspondent bank stock  | 0                | 2,607            | 0                |
| Cash proceeds from sales of foreclosed leased assets                                       | 39               | 1,946            | 258              |
| Cash proceeds from sales of other real estate owned  | 72               | 2,487            | 1,895            |
| Capital expenditures for premises and equipment  | (1,200)          | (5,880)          | (3,857)          |
| Cash proceeds from sales of premises and equipment   | 9                | 1,520            | 21               |
| Net cash used in investing activities  | (30,472)         | (69,808)         | (12,849)         |
| <b>Cash Flows From Financing Activities:</b>   |                  |                  |                  |
| Net increase in demand deposit and savings accounts  | (99,787)         | 12,764           | 25,867           |
| Net increase (decrease) in certificates of deposit   | 77,677           | 27,903           | (16,079)         |
| Net increase in federal funds purchased  | 22,280           | 0                | 0                |
| Net increase in FHLB borrowings  | 10,000           | 0                | 0                |
| Redemption of junior subordinated debt   | (15,923)         | 0                | 0                |
| Proceeds from issuance of junior subordinated debt   | 15,000           | 0                | 0                |
| Director/Employee stock options exercised  | 510              | 335              | 118              |
| Excess tax benefits from stock-based payment arrangements                                  | 0                | 1                | 0                |
| Repurchase and retirement of common stock  | (10,095)         | (2,436)          | (377)            |
| Repayment of ESOP borrowings   | 0                | 0                | (75)             |
| Payment of dividends on common stock   | (5,930)          | (4,881)          | (3,980)          |
| Net cash (used in) provided by financing activities  | (6,268)          | 33,686           | 5,474            |
| <b>Net (decrease) increase in cash and cash equivalents</b>                                | <b>(17,768)</b>  | <b>(19,962)</b>  | <b>6,624</b>     |
| <b>Cash and cash equivalents at beginning of year</b>                                      | <b>43,068</b>    | <b>63,030</b>    | <b>56,406</b>    |
| <b>Cash and cash equivalents at end of year</b>  | <b>\$ 25,300</b> | <b>\$ 43,068</b> | <b>\$ 63,030</b> |

See notes to consolidated statements

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**Notes to Consolidated Financial Statements**  
**Years Ended December 31, 2007, 2006, and 2005**

**I. Organization and Summary of Significant Accounting and Reporting Policies**

**Basis of Presentation** - The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary, United Security Bank and subsidiary (the "Bank"). United Security Bancshares Capital Trust II (the "Trust") is deconsolidated pursuant to FIN46. As a result, the Trust's Trust Preferred Securities are not presented on the Company's consolidated financial statements, but instead the Company's Subordinated Debentures are presented as a separate liability category. (see Note 10 to the Company's consolidated financial statements). Intercompany accounts and transactions have been eliminated in consolidation. In the following notes, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares, (including the Bank and Trust). United Security Bancshares operates as one business segment providing banking services to commercial establishments and individuals primarily in the San Joaquin Valley of California.

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

United Security Bancshares Capital Trust I was formed during June 2001 as a Delaware statutory business trust for the exclusive purpose of issuing and selling Trust Preferred Securities. The Trust was deconsolidated in 2004 pursuant to FIN46. During July 2007, the Trust Preferred Securities were redeemed by USB Capital Trust I, and upon retirement, the Trust was dissolved. During July 2007 the Company formed United Security Bancshares Capital Trust II and issued \$15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I. (See Note 10. "Junior Subordinated Debt/Trust Preferred Securities").

USB Investment Trust Inc was incorporated effective December 31, 2001 as a special purpose real estate investment trust ("REIT") under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust (See Note 11. "Income Taxes").

On February 16, 2007, the Company completed its merger with Legacy Bank, N.A., located in Campbell, California, with the acquisition of 100 percent of Legacy's outstanding common shares. At merger, Legacy Bank's one branch was merged with and into United Security Bank, a wholly owned subsidiary of the Company. The total value of the merger transaction was \$21.5 million, and the shareholders of Legacy Bank received merger consideration consisting of 976,411 shares of common stock of the Company. The merger transaction was accounted for as a purchase transaction, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The net of assets acquired and liabilities assumed totaled approximately \$8.6 million at the date of the merger. Fair value of Legacy assets and liabilities acquired, including resultant goodwill of approximately \$8.8 million, has been determined, with final purchase adjustments made during the fourth quarter of 2007. (See Note 24 to the Company's consolidated financial statements contained herein for details of the merger).

During November 2007, the Company purchased the recurring revenue stream and certain fixed assets from ICG Financial, LLC. Additionally, the Company hired all but one of the former employees of ICG Financial, LLC and its subsidiaries. The total purchase price was \$414,000 including \$378,000 for the recurring revenue stream and \$36,000



for the fixed assets. ICG Financial, LLC provided wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients. Now operating as a newly formed department of the Bank, USB Financial Services provides those same services utilizing the employees hired from ICG Financial LLC. The Company believes the wealth management and related services provided by USB Financial Services will enhance the products and services offered by the Company, and increase noninterest income. The capitalized cost of \$378,000 for the recurring revenue stream will be amortized over a period of approximately three years, and will be tested periodically for impairment.

The Bank was founded in 1987 and currently operates eleven branches and one construction lending office in an area from eastern Madera County to western Fresno County, as well as Taft and Bakersfield in Kern County, and Campbell in Santa Clara County. The Bank also operates one financial services department located in Fresno, California. The Bank's primary source of revenue is providing loans to customers, who are predominantly small and middle-market businesses and individuals. The Bank engages in a full compliment of lending activities, including real estate mortgage, commercial and industrial, real estate construction, agricultural and consumer loans, with particular emphasis on short and medium term obligations.

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

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

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

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

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

- a. ***Cash and cash equivalents*** - Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. At times throughout the year, balances can exceed FDIC insurance limits. Generally, federal funds sold and repurchase agreements are sold for one-day periods. Repurchase agreements are with a registered broker-dealer affiliated with a correspondent bank and work much like federal funds sold, except that the transaction is collateralized by various investment securities. The securities collateralizing such transactions generally consist of U.S. Treasuries, U.S. Government and U.S. Government-sponsored agencies. The Bank did not have any repurchase agreements during 2007 or 2006, or at December 31, 2007 or 2006. All cash and cash equivalents have maturities when purchased of three months or less.
- b. ***Securities*** - Debt and equity securities classified as available for sale are reported at fair value, with unrealized gains and losses excluded from net income and reported, net of tax, as a separate component of comprehensive income and shareholders' equity. Debt securities classified as held to maturity are carried at amortized cost. Gains and losses on disposition are reported using the specific identification method for the adjusted basis of the securities sold.

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

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

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

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

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

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

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

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

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

obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard, doubtful, and loss.

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

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

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

e. *Loans held-for-sale* - Loans originated and designated as held-for-sale are carried at the lower of cost or estimated fair value, as determined by quoted market prices, in aggregate. Net unrealized losses are recognized in a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. The Company held no loans for sale at December 31, 2007 or 2006.

f. *Premises and Equipment* - Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally on the straight-line method over the estimated useful lives of the assets. Estimated useful lives are as follows:

Buildings 31 Years

Furniture and equipment 3-7 Years

g. *Other Real Estate Owned* - Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense at foreclosure.

h. *Intangible Assets and Goodwill* - Intangible assets are comprised of core deposit intangibles, other specific identifiable intangibles, and goodwill acquired in branch acquisitions in which the fair value of the liabilities assumed exceeded the fair value of the assets acquired. Core deposit intangibles of \$3,611,000 and \$1,475,000 (net of accumulated amortization of \$3,386,000 and \$2,121,000) at December 31, 2007 and 2006 are amortized over the estimated useful lives of the existing deposit bases (average of 7 years) using a method which approximates the interest method. Other specific identifiable intangibles resulting from the purchase of certain bank branches during 1997, which were non self-sustaining businesses, of \$653,000 and \$790,000 (net accumulated amortization of \$1.3 million and \$1.4 million) at December 31, 2007 and 2006 are being amortized using a method which approximates the interest method over a period of 15 years. The identifiable intangible asset resulting from the purchase of the recurring income stream from ICG Financial Services totaled \$357,000 at December 31, 2007 (net accumulated amortization of \$21,000) and will be amortized over a period of three years. As with other intangible assets, we will review them for impairment on an annual basis, or sooner if circumstances or events warrant such a review.

The estimated aggregate amortization expense related to intangible assets for each of the five succeeding years is as follows (in 000’s):

| Year | Amortization<br>expense |
|------|-------------------------|
| 2008 | \$ 944                  |
| 2009 | 874                     |
| 2010 | 770                     |

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|       |    |       |
|-------|----|-------|
| 2011  |    | 565   |
| 2012  |    | 446   |
| Total | \$ | 3,599 |

Goodwill amounts resulting from the acquisitions of Taft National Bank during April 2004, and Legacy Bank during February 2007 are considered to have an indefinite life and are not amortized. At December 31, 2007 goodwill related to Taft National Bank totaled \$1.6 million, and goodwill related to Legacy Bank totaled \$8.8 million. Pursuant to SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is evaluated annually for impairment. Impairment testing of goodwill is performed during April of each year at a reporting unit level for Taft, and will be performed during March of each year for Legacy. The Company had no impairment adjustments during 2007, 2006, or 2005.

- i. *Income Taxes* - Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled.
- j. *Net Income per Share* - Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method. Leveraged ESOP shares, if any, are only considered outstanding for earnings per share calculations when they are committed to be released. The Company had no leveraged ESOP shares outstanding at December 31, 2007, 2006 or 2005. (see Note 18).
- k. *Cash Flow Reporting* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods.
- l. *Transfers of Financial Assets* - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.
- m. *Advertising Costs* - The Company expenses marketing costs as they are incurred. Advertising expense was \$113,000, \$105,000, and \$98,000 for the years ended December 31, 2007, 2006 and 2005, respectively.
- n. *Stock Based Compensation* - At December 31, 2006, the Company has a stock-based employee compensation plan, which is described more fully in Note 12. On January 1, 2006 the Company adopted the disclosure provisions of Financial Accounting Standards Board (FASB) Statement No. 123 R, "Accounting for Share-Based Payments". SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on the grant-date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the years ended December 31, 2007 and 2006 is \$187,000 and \$248,000, respectively, of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was not significant.
- Prior to January 1, 2006, the Company accounted for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25, "Accounting for Stock Issued to Employees", and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. See Note 12 to the Company's consolidated financial statements for a table that illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure an amendment of FASB Statement No. 123" during 2005.
- o. *Long-Lived Assets* - The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other specific intangible assets, and core deposit intangible assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Based on such evaluation, the Bank determined that there is no impairment loss to be recognized in 2007, 2006, or 2005.
- p. *Employee Stock Ownership Plan ("ESOP")* - The Company accounts for shares acquired by leveraged ESOP's, if any, in accordance with the guidelines established by the American Institute of Certified Public Accounts Statement of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans" ("SOP 93-6"). Under SOP 93-6, the Company recognizes compensation cost equal to the fair value of the ESOP shares during the periods in which they



become committed to be released. To the extent that the fair value of the Company's ESOP shares committed to be released differ from the cost of those shares, the differential is charged or credited to equity. For externally leveraged ESOPs, the ESOP debt is recorded as a liability and interest expense is recorded on that debt. The ESOP shares not yet committed to be released are accounted for as a reduction of shareholders' equity. The credit line related to the Company's leveraged ESOP matured during 2005, and as result, all remaining balances were repaid during the first quarter of 2005. The Company had no leveraged ESOP transactions during 2007 or 2006.

q. *Derivative Financial Instruments* - All derivative instruments (including certain derivative instruments embedded in other contracts) are recognized in the consolidated balance sheet at fair value. The Company's accounting treatment for gains or losses from changes in the derivative instrument's fair value is contingent on whether the derivative instrument qualifies as a hedge. On the date the Company enters into a derivative contract, the Company designates the derivative instruments as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge) or (3), a hedge for trading, customer accommodation or not qualifying for hedge accounting (free-standing derivative instruments). For a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability or of an unrecognized firm commitment attributable to the hedged risk are recorded in current period net income. For a cash flow hedge, changes in the fair value of the derivative instrument to the extent that it is highly effective are recorded in other comprehensive income, net of tax, within shareholders' equity and subsequently reclassified to net income in the same period(s) that the hedged transaction impacts net income. For freestanding derivative instruments, changes in the fair values are reported in current period net income. The Company formally documents the relationship between hedging instruments and hedged items, as well as the risk management objective and strategy for undertaking any hedge transaction. This process includes relating all derivative instruments that are designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific forecasted transactions. The Company also formally assesses both at the inception of the hedge and on an ongoing basis, whether the derivative instruments used are highly effective in offsetting changes in fair values or cash flows of hedged items. If it is determined that the derivative instrument is not, and will not be, highly effective as a hedge, hedge accounting is discontinued.

r. *Federal Home Loan Bank stock and Federal Reserve Stock* - As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB.

s. *Comprehensive Income* - Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes items previously recorded directly to equity, such as unrealized gains and losses on securities available-for-sale, unrecognized costs of salary continuation defined benefit plans, and certain derivative instruments used as a cash flow hedge. Comprehensive income is presented in the consolidated statement of shareholders' equity.

t. *Segment Reporting* - The Company's operations are solely in the financial services industry and include providing to its customers traditional banking and other financial services. The Company operates primarily in the San Joaquin Valley region of California. Management makes operating decisions and assesses performance based on an ongoing review of the Company's consolidated financial results. Therefore, the Company has a single operating segment for financial reporting purposes.

u. *New Accounting Standards:*

#### Statements of Financial Accounting Standards

In December 2007, the FASB issued SFAS No. 160, "*Noncontrolling Interests in Consolidated Financial Statements*," which provides guidance for accounting and reporting of noncontrolling (minority) interests in consolidated financial statements. The statement is effective for fiscal years and interim periods within fiscal years beginning on or after December 15, 2008. The Company does not hold minority interests in subsidiaries, therefore it is expected that SFAS No. 160 will have no impact on its financial condition or results of operations.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*. SFAS 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial position. Lastly, SFAS 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS 157. Effective January 1, 2007, the Company elected early adoption of the fair value option to value its junior subordinated debt. The initial impact upon adoption of SFAS No. 159 was to record a \$1.3 million loss, reflected as an adjustment to beginning retained earnings at January 1, 2007. Subsequent to adoption, the Company recorded total gains resulting from fair value adjustments on its junior subordinated debt totaling \$2.5 million during the year ended December 31, 2007, which are reflected as a component of other noninterest income. (see Note 10).

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* ("SFAS No. 158"). SFAS No. 158 amends SFAS No. 87 and SFAS No. 106. SFAS No. 158 amends previous applicable accounting statements and requires companies to better disclose, among other things, the funded status of benefit plans, and to recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, *Employers' Accounting for Pensions*, or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. SFAS No. 158 is effective for public companies with fiscal years ending after December 15, 2006. The Company adopted SFAS No. 158 effective December 31, 2006, and has made required disclosures since December 31, 2006. As a result, the Company upon adoption at December 31, 2006, recorded \$169,000 in accumulated other comprehensive income (net tax of \$112,000) for the previously unrecognized cost of post-retirement benefits related to the Company's Salary Continuation Plan, and had \$85,000 in other comprehensive income (net tax of \$57,000) for the previously unrecognized at December 31, 2007 (see Note 13, *Employee Benefit Plans*).

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS No. 157 clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This statement applies whenever other accounting pronouncements require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. Effective January 1, 2007, the Company adopted SFAS No. 157 as a result of its early adoption of SFAS No. 159 (see Note 15).

#### Financial Accounting Standards Board Staff Positions and Interpretations

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109*. FIN 48 clarifies SFAS No. 109, *Accounting for Income Taxes*, to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of the Interpretation, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term "more likely than not" means "a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority. The scope of FIN 48 is broad and includes *all* tax positions accounted for in accordance with SFAS No. 109. Additionally, besides business enterprises, FIN 48 applies to pass-through entities, and entities whose tax liability is subject to 100 percent credit for dividends paid (such as real estate investment trusts). FIN 48 is effective for the Company beginning after January 1, 2007. The cumulative effect of applying FIN 48 totaling \$1.3 million was reported as an adjustment to retained earnings at January 1, 2007 (see Note 11).

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 064-4 (EITF 06-4), *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. EITF 06-4 requires employers to recognize a liability for future benefits provided through endorsement split-dollar life insurance arrangements that extend into postretirement periods in accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* or APB Opinion No. 12, *Omnibus Opinion-1967*. The provisions of EITF 06-4 become effective on January 1, 2008 and are to be applied as a change in accounting principle either through a cumulative-effect adjustment to retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption, or through retrospective application to all prior periods. The Company's split-dollar life insurance benefits are limited to the employee's active

service period. Therefore it is expected that EITF 06-4 will have no impact on financial condition or results of operations.

*v. Reclassifications* - Certain reclassifications have been made to the 2006 and 2005 financial statements to conform to the classifications used in 2007.

## 2.

**Investment Securities**

Following is a comparison of the amortized cost and approximate fair value of investment securities for the years ended December 31, 2007 and December 31, 2006:

| <i>(In thousands)</i>                                      | Amortized |        | Gross      |            | Fair Value |
|--|-----------|--------|------------|------------|------------|
| <b>December 31, 2007:</b>                                  | Cost      |        | Unrealized | Unrealized | (Carrying  |
| <u>Securities available for sale:</u>                      |           |        | Gains      | Losses     | Amount)    |
| U.S. Government agencies                                   | \$        | 65,764 | \$         | 524        | \$ 65,986  |
| U.S. Government agency collateralized mortgage obligations |           | 7,782  |            | 44         | 7,822      |
| Obligations of state and political subdivisions            |           | 2,227  |            | 54         | 2,281      |
| Other investment securities                                |           | 13,752 |            | 0          | 13,326     |
| Total securities available for sale                        | \$        | 89,525 | \$         | 622        | \$ 89,415  |
| <b>December 31, 2006:</b>                                  |           |        |            |            |            |
| <u>Securities available for sale:</u>                      |           |        |            |            |            |
| U.S. Government agencies                                   | \$        | 69,746 | \$         | 51         | \$ 68,504  |
| U.S. Government agency collateralized mortgage obligations |           | 17     |            | 0          | 16         |
| Obligations of state and political subdivisions            |           | 2,226  |            | 65         | 2,290      |
| Other investment securities                                |           | 13,000 |            | 0          | 12,556     |
| Total securities available for sale                        | \$        | 84,989 | \$         | 116        | \$ 83,366  |

Included in other investment securities at December 31, 2007, is a short-term government securities mutual fund totaling \$7.7 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$752,000. 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. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

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

The following summarizes temporarily impaired investment securities at December 31, 2007 and 2006:

| <i>(In thousands)</i>                           | Less than 12 Months |            | 12 Months or More |            | Total      |            |
|---|---------------------|------------|-------------------|------------|------------|------------|
|   | Fair Value          | Unrealized | Fair Value        | Unrealized | Fair Value | Unrealized |
| <b>December 31, 2007:</b>                       | (Carrying           | Losses     | (Carrying         | Losses     | (Carrying  | Losses     |
| <u>Securities available for sale:</u>           | Amount)             |            | Amount)           |            | Amount)    |            |
| U.S. Government agencies                        | \$ 0                | \$ 0       | \$ 30,241         | \$ (302)   | \$ 30,241  | \$ (302)   |
| U.S. Govt. agency CMO's                         | 4,129               | (4)        | 0                 | 0          | 4,129      | (4)        |
| Obligations of state and political subdivisions | 0                   | 0          | 0                 | 0          | 0          | 0          |

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|                             |          |        |           |          |           |          |
|-----------------------------|----------|--------|-----------|----------|-----------|----------|
| Other investment securities | 0        | 0      | 12,574    | (426)    | 12,574    | (426)    |
| Total impaired securities   | \$ 4,129 | \$ (4) | \$ 42,815 | \$ (728) | \$ 46,944 | \$ (732) |

**December 31, 2006:**

Securities available for sale:

|   |        |        |           |            |           |            |
|---|--------|--------|-----------|------------|-----------|------------|
| U.S. Government agencies                        | \$ 506 | \$ (6) | \$ 65,626 | \$ (1,287) | \$ 66,132 | \$ (1,293) |
| U.S. Govt. agency CMO's                         | 0      | 0      | 12        | (1)        | 12        | (1)        |
| Obligations of state and political subdivisions | 0      | 0      | 34        | (1)        | 34        | (1)        |
| Other investment securities                     | 0      | 0      | 12,556    | (444)      | 12,556    | (444)      |
| Total impaired securities                       | \$ 506 | \$ (6) | \$ 78,228 | \$ (1,733) | \$ 78,734 | \$ (1,739) |

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Temporarily impaired securities at December 31, 2007 are comprised of nine (9) U.S. government agency securities, one U.S. agency collateralized mortgage obligation, and two other investment securities, with a total weighted average life of 1.0 years. Temporarily impaired securities at December 31, 2006 are comprised of nineteen (19) U.S. government agency securities, two other investment securities, one municipal bond, and one U.S. agency collateralized mortgage obligation with a total weighted average life of 2.4 years.

There were no gross realized gains or losses on available-for-sale securities during the year ended December 31, 2007. There were gross realized gains on sales of available-for-sale securities totaling \$27,000, and \$163,000 during the years ended December 31, 2006, and 2005, respectively. There were no gross realized losses on available-for-sale securities during the year ended December 31, 2006 or 2005.

The amortized cost and fair value of securities available for sale at December 31, 2007, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns.

| <i>(In thousands)</i>                  | December 31, 2007 |                              |
|--|-------------------|------------------------------|
|  | Amortized Cost    | Fair Value (Carrying Amount) |
| Due in one year or less                | \$ 37,980         | \$ 37,419                    |
| Due after one year through five years  | 1,110             | 1,104                        |
| Due after five years through ten years | 10,103            | 10,365                       |
| Due after ten years                    | 32,550            | 32,704                       |
| Collateralized mortgage obligations    | 7,782             | 7,823                        |
|  | \$ 89,525         | \$ 89,415                    |

At December 31, 2007 and 2006, available-for-sale securities with an amortized cost of approximately \$71.0 million and \$70.9 million (fair value of \$71.3 million and \$69.7 million) were pledged as collateral for public funds, treasury tax and loan balances, and repurchase agreements.

The Company had no held-to-maturity or trading securities at December 31, 2007 or 2006.

### 3. *Loans*

*Loans are comprised of the following:*

| <i>(In thousands)</i>      | December 31, |            |
|----------------------------|--------------|------------|
|                            | 2007         | 2006       |
| Commercial and industrial  | \$ 204,385   | \$ 155,811 |
| Real estate - mortgage     | 142,565      | 113,613    |
| Real estate - construction | 178,296      | 168,378    |
| Agricultural               | 46,055       | 35,102     |
| Installment                | 18,171       | 16,712     |
| Lease financing            | 8,748        | 10,952     |
| Total Loans                | \$ 598,220   | \$ 500,568 |

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





Commercial and industrial loans represent 34.2% of total loans at December 31, 2007 and have a high degree of industry diversification. A substantial portion of the commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 23.8% of total loans at December 31, 2007, are secured by trust deeds on primarily commercial property. Repayment of real estate mortgage loans is generally from the cash flow of the borrower.

Real estate construction loans, representing 29.8% of total loans at December 31, 2007, consist of loans to residential contractors, which are secured by single-family residential properties. All real estate loans have established equity requirements. Repayment on construction loans is generally from long-term mortgages with other lending institutions.

Agricultural loans represent 7.7% of total loans at December 31, 2007 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Lease financing loans, representing 1.5% of total loans at December 31, 2007, consist of loans to small businesses, which are secured by commercial equipment. Repayment of the lease obligation is from the cash flow of the borrower.

Occasionally, shared appreciation agreements are made between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of shared appreciation projects. Shared appreciation income totaled \$42,000, \$567,000, and \$393,000 for the years ended December 31, 2007, 2006, and 2005, respectively.

Loans over 90 days past due and still accruing consisted of one loan totaling \$189,000 at December 31, 2007. There were no loans over 90 days past due and still accruing at December 31, 2006. Nonaccrual loans totaled \$21.6 million and \$8.1 million at December 31, 2007 and 2006, respectively. There were remaining undisbursed commitments to extend credit on nonaccrual loans of \$12,000 at December 31, 2007, and no remaining undisbursed commitments at December 31, 2006. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2007 in accordance with their original terms is approximately \$1.5 million. There was no interest income recorded on such loans during the year ended December 31, 2007. The interest income recorded on such loans during 2006 and 2005 totaled \$65,000 and \$34,000, respectively.

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

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

| <i>(In thousands)</i>                           | December 31, |          |
|---|--------------|----------|
|   | 2007         | 2006     |
| Aggregate amount outstanding, beginning of year | \$ 1,605     | \$ 2,440 |
| New loans or advances during year               | 9,734        | 1,897    |
| Repayments during year                          | (3,903)      | (2,732)  |
| Aggregate amount outstanding, end of year       | \$ 7,436     | \$ 1,605 |
| Loan commitments                                | \$ 6,799     | \$ 2,241 |

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

| <i>(In thousands)</i>                      | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2007                     | 2006     | 2005     |
| Balance, beginning of year                 | \$ 8,365                 | \$ 7,748 | \$ 7,251 |
| Provision charged to operations            | 5,697                    | 880      | 1,140    |
| Losses charged to allowance                | (4,493)                  | (502)    | (773)    |
| Recoveries on loans previously charged off | 64                       | 239      | 165      |
| Reserve acquired in merger                 | 1,268                    | —        | —        |
| Reclass off-balance sheet reserve          | —                        | —        | (35)     |
| Balance at end-of-period                   | \$ 10,901                | \$ 8,365 | \$ 7,748 |

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

At December 31, 2007 and 2006, the Company's recorded investment in loans for which impairment has been recognized totaled \$20.6 million and \$8.9 million, respectively. Included in total impaired loans at December 31, 2007 are \$10.7 million of impaired loans for which the related specific allowance is \$4.5 million, as well as \$9.9 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. At December 31, 2006, total impaired loans included \$5.7 million 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 to the fair value of the collateral did not have a specific allowance. The average recorded investment in impaired loans was \$15.9 million, \$10.1 million, and \$15.9 million for the years ended December 31, 2007, 2006, and 2005, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method. For the year ended December 31, 2007, the Company recognized no income on impaired loans. For the year ended December 31, 2006 and 2005, the Company recognized income of \$65,000 and \$34,000, respectively, on such loans.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2007 and 2006 these financial instruments include commitments to extend credit of \$196.3 million and \$188.2 million, respectively, and standby letters of credit of \$6.7 million and \$4.9 million, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

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

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

#### **4.**

#### ***Lease Assets held for Sale***

The Company had a lease portfolio totaling \$8.7 million and \$11.0 million at December 31, 2007 and December 31, 2006, respectively. The lease portfolio is included as a component of total loans. Leases, like other types of loans, may become nonperforming at which time they are foreclosed upon and the remaining lease assets, including equipment and furniture, are transferred to lease assets held for sale which is included in other assets. Valuation adjustments, if required, at the time of foreclosure are charged to the allowance for loan losses. The Company discontinued making new leases during the first quarter of 2007, and since that time the balances in the lease portfolio have declined. The Company previously utilized a third-party broker to aid in the collection and ultimate disposition of lease assets held for sale. During the third quarter of 2007, the Company determined that the third-party broker no longer wished to

continue collection and disposition efforts for the Company due to the Company's exit strategy from the leasing business. During the fourth quarter of 2007, the Company increased its efforts to dispose of existing lease assets held through foreclosure, while during the same period, additional lease assets were being foreclosed upon due to general declines in the economy. As a result, the Company reviewed the collectability of values recorded for lease assets held for sale during the fourth quarter of 2007 and charged-off \$820,000 of the lease assets held for sale. The expense is recorded as a component of noninterest expense for the year ended December 31, 2007.

## 5. *Premises and Equipment*

The components of premises and equipment are as follows:

| <i>(In thousands)</i>                          | December 31, |           |
|--|--------------|-----------|
|  | 2007         | 2006      |
| Land   | \$ 968       | \$ 968    |
| Buildings and improvements                     | 14,160       | 13,017    |
| Furniture and equipment                        | 8,776        | 7,399     |
|  | 23,904       | 21,384    |
| Less accumulated depreciation and amortization | (8,330)      | (6,082)   |
| Total premises and equipment                   | \$ 15,574    | \$ 15,302 |

During February 2007, the Company purchased Legacy Bank, N.A. in Campbell, California which included net fixed assets totaling \$729,000. Included in this amount were buildings and improvements of \$631,000, furniture and equipment of \$713,000, and accumulated depreciation of \$615,000. The Company determined that the net carrying value of Legacy fixed assets reasonably approximated fair value, and therefore did not make any fair value adjustments pursuant to purchase accounting guidelines.

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

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

Total depreciation expense on Company premises and equipment totaled \$1.6 million, \$1.1 million, and \$906,000 for the years ended December 31, 2007, 2006 and 2005, respectively, and is included in occupancy expense in the accompanying consolidated statements of income.

## 6. *Investment in Limited Partnership*

The Bank owns limited interests in a private limited partnerships that acquire affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Bank's limited partnership investment is accounted for under the equity method. The Bank's noninterest expense associated with the utilization and expiration of these tax credits for the year ended December 31, 2007, 2006 and 2005 was \$430,000, \$440,000, and \$458,000, respectively. The limited partnership investments are expected to generate remaining tax credits of approximately \$3.1 million over the life of the investment. The tax credits expire between 2009 and 2014. Tax credits utilized for income tax purposes for the years ended December 31, 2007, 2006, and 2005 totaled \$545,000, \$547,000, and \$547,000, respectively.

7.

**Deposits***Deposits include the following:*

| <i>(In thousands)</i>           | December 31, |            |
|---------------------------------|--------------|------------|
|                                 | 2007         | 2006       |
| Noninterest-bearing deposits    | \$ 139,066   | \$ 159,002 |
| Interest-bearing deposits:      |              |            |
| NOW and money market accounts   | 153,717      | 184,384    |
| Savings accounts                | 40,012       | 31,933     |
| Time deposits:                  |              |            |
| Under \$100,000                 | 52,297       | 42,428     |
| \$100,000 and over              | 249,525      | 169,380    |
| Total interest-bearing deposits | 495,551      | 428,125    |
| Total deposits                  | \$ 634,617   | \$ 587,127 |

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At December 31, 2007, the scheduled maturities of all certificates of deposit and other time deposits are as follows:

(In thousands)

|   |            |
|---|------------|
| One year or less  | \$ 282,258 |
| More than one year, but less than or equal to two years     | 16,725     |
| More than two years, but less than or equal to three years  | 1,847      |
| More than three years, but less than or equal to four years | 300        |
| More than four years, but less than or equal to five years  | 82         |
| More than five years  | 610        |
|   | \$ 301,822 |

The Company may utilize brokered deposits as an additional source of funding. At December 31, 2007 and 2006, the Company held brokered time deposits totaling \$139.3 million and \$67.7 million, with average rates of 4.93% and 5.06%, respectively. Of this balance at December 31, 2007, \$134.0 million is included in time deposits of \$100,000 or more, and the remaining \$5.3 million is included in time deposits of less than \$100,000. Included in brokered time deposits at December 31, 2007 are balances totaling \$40.4 million maturing in three months or less, \$59.9 million maturing in three to six months, \$30.5 million maturing in 6 to twelve months, and \$8.5 million maturing in more than one year.

Deposit balances representing overdrafts reclassified as loan balances totaled \$565,000 and \$303,000 as of December 31, 2007 and 2006, respectively.

Deposits of directors, officers and other related parties to the Bank totaled \$5.9 million and \$6.2 million at December 31, 2007 and 2006, respectively. The rates paid on these deposits were those customarily paid to the Bank's customers in the normal course of business.

#### 8. *Short-term Borrowings/Other Borrowings*

At December 31, 2007, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$386.7 million, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$22.0 million. At December 31, 2007, the Company had total outstanding balances of \$32.3 million in borrowings, including \$10.4 million in federal funds purchased from correspondent banks at an average rate of 4.2%, and \$21.9 million drawn against its FHLB lines of credit. Of the \$21.9 million in FHLB borrowings outstanding at December 31, 2007, \$11.9 million was in overnight borrowings at an average rate of 3.3%, and the other \$10.0 million consists of a two-year FHLB advance, at a fixed rate of 4.92%, and a maturity date of March 30, 2009. The weighted average cost of borrowings for the year ended December 31, 2007 was 5.17%. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company's stock in the FHLB and certain qualifying mortgage loans. As of December 31, 2007, \$46.5 million in real estate-secured loans were pledged as collateral for FHLB advances. Additionally, \$428.9 million in real estate-secured loans were pledged at December 31, 2007 as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$321.7 million. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time.

The Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$308.3 million, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$20.8 million at December 31, 2006. At December 31, 2006, the Company had no advances on its lines of credit.

#### 9. *Fair Value - Adoption of SFAS No. 159*



Effective January 1, 2007, the Company elected early adoption of SFAS No.159, “The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115”. The Company also adopted the provisions of SFAS No. 157, “Fair Value Measurements”, effective January 1, 2007, in conjunction with the adoption of SFAS No. 159. SFAS No. 159 generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. Upon adoption of SFAS No. 159, the Company elected the fair value measurement option for all the Company’s pre-existing junior subordinated debentures with a carrying cost of \$15.5 million, prior to the adoption of SFAS No. 159.

The Company believes its adoption of SFAS No. 159 will have a positive impact on its ability to better manage the balance sheet and interest rate risks associated with this liability while potentially benefiting the net interest margin, net interest income, net income and earnings per common share in future periods. Specifically, the Company believes the election of fair value accounting for the junior subordinated debentures better reflects the true economic value of the debt instrument on the balance sheet. The Company's junior subordinated debentures were issued in 2001 when the Trust Preferred Securities market was new and less liquid than today. As a result, subordinated debentures are available in the market at narrower spreads and lower issuing costs. With a higher-than-market spread to LIBOR, and remaining capitalized issuance costs of more than \$400,000 on the balance sheet, the Company's cost-basis of the subordinated debentures recorded on the balance sheet does not properly reflect the true opportunity costs to the Company.

The initial fair value measurement at adoption resulted in a \$1,053,000 cumulative-effect adjustment to the opening balance of retained earnings at January 1, 2007. The adjustment resulted in an increase of \$1,053,000 in the reported balance of the junior subordinated debentures, an increase in deferred tax assets of \$443,000 and the corresponding reduction in retained earnings of \$610,000. Under SFAS No. 159, this one-time charge to shareholders' equity was not recognized in earnings. In addition to the fair value adjustment of the junior subordinated debentures recorded effective January 1, 2007, the Company also removed the remaining \$405,000 in unamortized issuance costs of the debt instrument. The remaining issuance costs were removed in accordance with SFAS 159 effective January 1, 2007, with corresponding charges of \$170,000 to deferred taxes and \$235,000 to retained earnings.

As a requirement of electing early adoption of SFAS 159, the Company also adopted SFAS 157, "Fair Value Measurement" effective January 1, 2007. The Company utilized the guidelines of SFAS No. 157 to perform the fair value analysis on the junior subordinated debentures. In its analysis, the Company used a net-present-value approach based upon observable market rates of interest, over a term that considers the most advantageous market for the liability, and the most reasonable behavior of market participants.

The following table summarizes the effects of the adoption of SFAS No. 159 at both adoption date and December 31, 2007 (in 000's) on the Company's junior subordinated debentures. Changes in fair value (FV) for periods subsequent to adoption are recorded in current earnings. The pretax change in fair value for the year ended December 31, 2007 totaled \$2.5 million and is included as a gain in other noninterest income.

|  |    |        |
|--|----|--------|
| Balance of junior subordinated debentures at December 31, 2006           | \$ | 15,464 |
| Adjustments upon adoption:   |    |        |
| Combine accrued interest 1/1/07  |    | 613    |
| Total carrying value 1/1/07  |    | 16,077 |
| FV adjustment upon adoption of SFAS No. 159                              |    | 1,053  |
| Total FV of junior subordinated debentures at adoption - January 1, 2007 | \$ | 17,130 |
| Total FV of junior subordinated debentures at December 31, 2007          | \$ | 13,341 |

#### **10. Junior Subordinated Debt/Trust Preferred Securities**

At June 30, 2007, the Company held junior subordinated debentures issued to capital trusts commonly known as "Trust Preferred securities." The debt instrument was issued by the Company's wholly-owned special purpose trust entity, USB Capital Trust I on July 25, 2001 in the amount of \$15,000,000 with a thirty-year maturity, interest benchmarked at the 6-month-LIBOR rate (re-priced in January and July each year) plus 3.75%. The Company had the ability to redeem the debentures at its option. The prepayment provisions of the instrument allowed repayment after five years (July 25, 2006) with certain prepayment penalties. On July 25, 2007, the Company redeemed the \$15.0 million in subordinated debentures plus accrued interest of \$690,000 and a 6.15% prepayment penalty totaling

\$922,500. Concurrently, the Trust Preferred securities issued by Capital Trust I were redeemed. The prepayment penalty of \$922,500 had previously been a component of the fair value adjustment for the junior subordinated debt at the initial adoption of SFAS No. 159, and as a result was recorded through retained earnings effective January 1, 2007.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. Like USB Capital Trust I formed in July 2001, USB Capital Trust II is a Variable Interest Entity (VIE) and will be considered a deconsolidated entity pursuant to FIN 46. On July 23, 2007 USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate (initial coupon rate of 6.65%). Interest will be paid quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company will pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company may redeem the junior subordinated debentures at anytime before October 2008 at a redemption price of 103.3, and thereafter each October as follows: 2008 at 102.64, 2009 at 101.98, 2010 at 101.32, 2011 at 100.66, and at par anytime after October 2012.

As with the previous junior subordinated securities issued under USB Capital Trust I, the Company has elected the fair value measurement option for all the Company's new junior subordinated debentures issued under USB Capital Trust II. During the year ended December 31, 2007, the Company recorded pre-tax gains of \$2.5 million pursuant to SFAS No. 159 as measured under fair value measurement guidelines of SFAS No. 157. The initial gain of \$2.1 million realized on USB Capital Trust II during the third quarter resulted from an overall deterioration of the credit markets during the third quarter of 2007 which increased pricing spreads from base rates on similar debt instruments. The Company recorded an additional gain on the junior subordinated debt of \$270,000 during the fourth quarter of 2007 bring the year-to-date gain on the junior subordinated debt issued by USB Capital Trust II to \$2.4 million.

## 11. *Taxes on Income*

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

| <i>(In thousands)</i>                            | December 31, |          |
|--|--------------|----------|
|  | 2007         | 2006     |
| Deferred tax assets:                             |              |          |
| Credit losses not currently deductible           | \$ 4,646     | \$ 3,688 |
| State franchise tax                              | 525          | 777      |
| Deferred compensation                            | 1,249        | 1,051    |
| Net operating losses                             | 1,830        | —        |
| Startup/organizational costs                     | 113          | —        |
| Accrued reserves                                 | 133          | 3        |
| Amortization of core deposit intangible          | —            | 353      |
| Write-down on other real estate owned            | 15           | 15       |
| Deferred gain on sale of other real estate owned | 0            | 89       |
| Unrealized gain on interest rate swap            | 39           | 136      |
| Unrealized loss on AFS securities                | 44           | 649      |
| Unrecognized costs on post-retirement benefits   | 57           | 112      |
| Amortization of premium on time deposits         | 46           | 70       |
| Other  | 38           | 93       |
| Total deferred tax assets                        | 8,735        | 7,036    |
| Deferred tax liabilities:                        |              |          |
| Depreciation                                     | (24)         | (56)     |
| FHLB dividend                                    | (204)        | (50)     |
| Loss on limited partnership investment           | (1,590)      | (1,354)  |
| Amortization of core deposit intangible          | (1,249)      | —        |
| Deferred gain SFAS No. 159 - fair value option   | (998)        | —        |

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|                                |    |         |    |         |
|--------------------------------|----|---------|----|---------|
| Prepaid expenses               |    | (369)   |    | (269)   |
| Total deferred tax liabilities |    | (4,434) |    | (1,729) |
| Net deferred tax assets        | \$ | 4,301   | \$ | 5,307   |

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. The Company has concluded that it is more likely than not that the deferred tax assets will be recognized in the normal course of business, therefore no valuation allowance is considered necessary at December 31, 2007 and 2006.

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

(In thousands)

|          | Federal  | State    | Total    |
|----------|----------|----------|----------|
| 2007:    |          |          |          |
| Current  | \$ 3,640 | \$ 1,507 | \$ 5,147 |
| Deferred | 1,091    | 323      | 1,414    |
|          | \$ 4,731 | \$ 1,830 | \$ 6,561 |
| 2006:    |          |          |          |
| Current  | \$ 6,284 | \$ 2,133 | \$ 8,417 |
| Deferred | (390)    | 8        | (382)    |
|          | \$ 5,894 | \$ 2,141 | \$ 8,035 |
| 2005:    |          |          |          |
| Current  | \$ 4,686 | \$ 1,618 | \$ 6,304 |
| Deferred | (86)     | 172      | 86       |
|          | \$ 4,600 | \$ 1,790 | \$ 6,390 |

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

|  | Years Ended December 31, |       |       |
|--|--------------------------|-------|-------|
|  | 2007                     | 2006  | 2005  |
| Statutory federal income tax rate                      | 35.0%                    | 35.0% | 34.3% |
| State franchise tax, net of federal income tax benefit | 7.0                      | 7.0   | 7.2   |
| Tax exempt interest income                             | (0.2)                    | (0.2) | (0.6) |
| Low Income Housing - federal credits                   | (3.1)                    | (2.6) | (3.1) |
| Other  | (1.9)                    | (1.4) | (1.1) |
|  | 36.8%                    | 37.8% | 36.7% |

At December 31, 2007 the Company has remaining federal net operating loss carry-forwards totaling \$4.4 million which expire between 2023 and 2027, and remaining state net operating loss carry-forwards totaling \$4.2 million which expire between 2014 and 2017.

The Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN48), on January 1, 2007. FIN 48 clarifies SFAS No. 109, "Accounting for Income Taxes," to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of FIN48, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term, "more likely than not", means a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority and all available information is known to the taxing authority.

The Company and a subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. The Company is not currently aware of any tax jurisdictions where the Company or any subsidiary is subject examination by federal, state, or local taxing authorities before 2001. The Internal Revenue Service (IRS) has not examined the Company's or any subsidiaries federal tax returns since before 2001, and the Company currently is not aware of any examination planned or contemplated by the IRS. The California Franchise Tax Board (FTB) concluded an audit of the Company's 2004 state tax return during the fourth quarter of 2007, resulting in a disallowance of approximately \$19,000 related to Enterprise Zone loan interest deductions taken during 2004. The \$19,000 was recorded as a component of tax expense for the year ended December 31, 2007.



During the second quarter of 2006, the FTB issued the Company a letter of proposed adjustments to, and assessments for, (as a result of examination of the tax years 2001 and 2002) certain tax benefits taken by the REIT during 2002. 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 is pursuing its tax claims and will defend its use of these entities and transactions. The Company will continue to assert 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 Company reviewed its REIT tax position as of January 1, 2007 (adoption date) and again during subsequent quarter during 2007 in light of the adoption of FIN48. The Bank, with guidance from advisors believes that the case has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is "more than likely" (as defined in FIN48) that the Bank will prevail in its case with the FTB. As a result of the implementation of FIN48, the Company recognized approximately a \$1.3 million increase in the liability for unrecognized tax benefits (included in other liabilities), which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. The adjustment provided at adoption included penalties proposed by the FTB of \$181,000 and interest totaling \$210,000. During the year ended December 31, 2007, the Company recorded an additional \$87,000 in interest liability pursuant to the provisions of FIN48. The Company had approximately \$456,000 accrued for the payment of interest and penalties at December 31, 2007. Subsequent to the initial adoption of FIN48, it is the Company's policy to recognize interest expense related to unrecognized tax benefits, and penalties, as a component tax expense. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in 000's):

|   |          |
|---|----------|
| Balance at January 1, 2007                  | \$ 1,298 |
| Additions for tax provisions of prior years | 87       |
| Balance at December 31, 2007                | \$ 1,385 |

## **12. *Stock Options and Stock Based Compensation***

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

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

As of January 1, 2006, options have been granted to officers and key employees at an exercise price equal to estimated fair value at the date of grant as determined by the Board of Directors. All options granted are service awards, and as such are based solely upon fulfilling a requisite service period (the vesting period). In May 2005, the Company's shareholders approved the adoption of the United Security Bancshares 2005 Stock Option Plan (2005 Plan). At the same time, all previous plans, including the 1995 Plan, were terminated. The 2005 Plan provides for the granting of up to 500,000 shares (adjusted for the 2-for-1 stock split effective May 2006) of authorized and unissued shares of



common stock at option prices per share which must not be less than 100% of the fair market value per share at the time each option is granted. The 2005 Plan further provides that the maximum aggregate number of shares that may be issued as incentive stock options under the 2005 Plan is 500,000 (as adjusted for stock split).

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

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The number of shares granted remaining under the 1995 Plan was 36,000 shares (24,000 exercisable) as of December 31, 2007. Under the 2005 Plan, 176,500 shares granted shares remain (168,500 incentive stock options and 8,000 nonqualified stock options) as of December 31, 2007, of which 46,700 are vested.

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

|                                       | 2005<br>Plan | Weighted<br>Average<br>Exercise Price | 1995<br>Plan | Weighted<br>Average<br>Exercise Price |
|---------------------------------------|--------------|---------------------------------------|--------------|---------------------------------------|
| Options outstanding January 1, 2005   | —            | —                                     | 216,000      | \$ 8.02                               |
| Granted during the year               | 70,000       | \$ 14.18                              | 30,000       | 12.16                                 |
| Exercised during the year             | 0            | —                                     | (12,000)     | \$ 9.86                               |
| Canceled or expired                   | 0            | —                                     | (62,000)     | \$ 12.20                              |
| Options outstanding December 31, 2005 | 0            | —                                     | 172,000      | \$ 7.11                               |
| Granted during the year               | 103,500      | \$ 18.91                              | —            | —                                     |
| Exercised during the year             | (2,000)      | \$ 12.65                              | (46,000)     | \$ 6.73                               |
| Options outstanding December 31, 2006 | 171,500      | \$ 17.05                              | 126,000      | \$ 7.25                               |
| Granted during the year               | 5,000        | \$ 20.24                              | —            | —                                     |
| Exercised during the year             | —            | —                                     | (90,000)     | \$ 5.67                               |
| Options outstanding December 31, 2007 | 176,500      | \$ 17.14                              | 36,000       | \$ 11.21                              |

Included in total outstanding options at December 31, 2007, are 24,000 exercisable shares under the 1995 plan, at a weighted average price of \$10.74, and 46,700 exercisable shares under the 2005 plan, at a weighted average price of \$16.34. Included in total outstanding options at December 31, 2006, are 108,000 exercisable shares under the 1995 plan, at a weighted average price of \$6.43, and 12,000 exercisable shares under the 2005 plan, at a weighted average price of \$14.44. Included in total outstanding options at December 31, 2005, are 70,000 exercisable shares under the 1995 plan, at a weighted average price of \$12.31. There were no shares exercisable under the 2005 Plan at December 31, 2005.

*Additional information regarding options as of December 31, 2007 is as follows:*

| Options Outstanding         |                       | Options Exercisable                                    |                                   |                       |                                      |
|-----------------------------|-----------------------|--|-----------------------------------|-----------------------|--------------------------------------|
| Range of<br>Exercise Prices | Number<br>Outstanding | Weighted<br>Avg<br>Remaining<br>Contract<br>Life (yrs) | Weighted<br>Avg Exercise<br>Price | Number<br>Exercisable | Weighted<br>Avg<br>Exercise<br>Price |
| \$8.75                      | 10,000                | 3.2  | \$ 8.75                           | 10,000                | \$ 8.75                              |
| \$12.08 to \$14.44          | 94,000                | 7.5  | \$ 13.65                          | 40,000                | \$ 13.55                             |
| \$16.88 to \$18.10          | 58,000                | 8.1  | \$ 17.04                          | 11,600                | \$ 17.04                             |
| \$19.38 to \$22.54          | 50,500                | 8.4  | \$ 21.18                          | 9,100                 | \$ 21.28                             |
| Total                       | 212,500               |  |                                   | 70,700                |                                      |

Included in salaries and employee benefits for the years ended December 31, 2007 and 2006 is \$187,000 and \$248,000 of share-based compensation, respectively. The related tax benefit on share-based compensation recorded in the provision for income taxes was not material to either year.

As of December 31, 2007 and 2006, there was \$223,500 and \$388,000, respectively, of total unrecognized compensation expense related to nonvested stock options. This cost is expected to be recognized over a weighted average period of approximately 1.0 years and 1.5 years, respectively. The Company received \$510,000 and \$335,000

in cash proceeds on options exercised during the year ended December 31, 2007 and 2006, respectively. No tax benefits were realized on stock options exercised during the year ended December 31, 2007, because all options exercised during the period were incentive stock options. Tax benefits realized on options exercised during the year ended December 31, 2006 totaled \$218,000.

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|   | Year Ended<br>December 31,<br>2007 |           | Year Ended<br>December 31,<br>2006 |         |
|---|------------------------------------|-----------|------------------------------------|---------|
| Weighted average grant-date fair value of stock options granted | \$                                 | 4.51      | \$                                 | 4.30    |
| Total fair value of stock options vested                        | \$                                 | 167,028   | \$                                 | 61,030  |
| Total intrinsic value of stock options exercised                | \$                                 | 1,517,000 | \$                                 | 661,840 |

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

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

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

|                           | Year Ended           |                      |
|---------------------------|----------------------|----------------------|
|                           | December 31,<br>2007 | December 31,<br>2006 |
| Risk Free Interest Rate   | 4.53%                | 4.60%                |
| Expected Dividend Yield   | 2.47%                | 2.65%                |
| Expected Life in Years    | 6.50 Years           | 6.50 Years           |
| Expected Price Volatility | 20.63%               | 18.38%               |

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

As stated previously, the Company has adopted SFAS No. 123 R using the modified-prospective-transition method, and as such, the results for prior periods have not been restated. The following table illustrates the effect on net income and earnings per share for the year ended December 31, 2005, if the Company had applied the fair value recognition provisions of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", an amendment of FASB Statement No. 123" (earnings per share information has been restated to reflect 2-for-1 stock split effective May 1, 2006).

Year Ended Dec  
31,

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

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### 13. Employee Benefit Plans

#### Employee Stock Ownership Plan

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

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

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

ESOP compensation expense totaled \$501,000, \$409,000, and \$467,000 for the years ended December 31, 2007, 2006, and 2005 respectively. Interest expense incurred on the ESOP loan totaled \$408 for the year ended December 31, 2005.

*Allocated, committed-to-be-released, and unallocated ESOP shares as of December 31, 2007, 2006 and 2005 were as follows (shares adjusted for 2-for-1 stock split of May 2006):*

|                                 | 2007    | 2006    | 2005    |
|---------------------------------|---------|---------|---------|
| Allocated                       | 402,988 | 375,639 | 349,564 |
| Committed-to-be-released        | 0       | 0       | 7,692   |
| Unallocated                     | 0       | 0       | 0       |
| Total ESOP shares               | 402,988 | 375,639 | 357,256 |
| Fair value of unreleased shares | N/A     | N/A     | N/A     |

#### 401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the “401(k) Plan”) organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 5% of the employees’ eligible annual

compensation. Company contributions are subject to certain vesting requirements over a period of six years. Contributions made by the Company are invested in Company stock. During 2007, 2006 and 2005, the Company contributed a total of \$286,000, \$242,000, and \$214,000, respectively, to the Deferral Plan.

### Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 15 years. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company's current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2007 and 2006, \$3.0 million and \$2.7 million, respectively, had been accrued to date, based on a discounted cash flow using a discount rate of 6.40% and 6.42%, respectively, and is included in other liabilities. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$3.7 million and \$3.6 million December 31, 2007 and 2006, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company's general creditors.

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

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

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

As of December 31, 2007 and 2006, the Company had approximately \$142,000 and \$281,000, respectively, in unrecognized net periodic benefit costs arising from changes in interest rates used in calculating the current post-retirement liability required under the plan. This amount represents the difference between the plan liabilities calculated under net present value calculations, and the net plan liabilities actually recorded on the Company's books at December 31, 2007 and 2006. Pursuant to the adoption of SFAS No. 158, the Company recorded \$169,000 (net of tax of \$112,000), as a component of other comprehensive income at December 31, 2006. The average remaining life of the service terms of the Salary Continuation contracts to which the unrecognized service costs related at the time of adoption, was approximately two years. During the year ended December 31, 2007, approximately \$140,000 of the



unrecognized prior service cost was recognized in earnings as additional salary expense, reflected as an adjustment to accumulated other comprehensive income.

For the for the year ended December 31, 2006, a transition adjustment in the amount of \$169,000 net of tax benefit of \$112,000, was recognized as a component of the ending balance of Accumulated Other Comprehensive Income/(Loss) on the Company's balance sheet as the result of the adoption of SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans". This adjustment was misapplied as a component of Comprehensive Income on the Company's consolidated statement of income and comprehensive income for the year ended December 31, 2006. The table below reflects the effects of the misapplication of this adjustment at December 31, 2006.

| <i>(in 000's)</i>                             | As Reported | Adjustment | As Adjusted |
|---|-------------|------------|-------------|
| Other comprehensive income (loss), net of tax | \$ 462      | \$ (169)   | \$ 631      |
| Comprehensive income                          | \$ 13,822   | \$ (169)   | \$ 13,991   |

The Company has corrected the other comprehensive income presentations in the financial statements for the fiscal years ended December 31, 2007 and 2006 to reflect the adjusted amounts shown above.

Salary continuation expense is included in salaries and benefits expense, and totaled \$504,000, \$448,000, and \$331,000 for the years ended December 31, 2007, 2006, and 2005, respectively.

#### Officer Supplemental Life Insurance Plan

During 2004, the Company purchased single premium Bank-owned life insurance policies (BOLI) on certain officers with a portion of the death benefits available to the officers' beneficiaries. The single premium paid at policy commencement of the BOLI in 2004 totaled \$9.0 million. Additional BOLI policies totaling \$227,000 and \$579,000 were purchased during 2006 and 2005, respectively. The BOLI's initial net cash surrender value is equivalent to the premium paid, and it adds income through non-taxable increases in its cash surrender value, net of the cost of insurance, plus any death benefits ultimately received by the Company. The cash surrender value of these insurance policies totaled \$10.2 million and \$10.1 million at December 31, 2007 and December 31, 2006, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$408,000, \$400,000, and \$353,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

#### ***14. Commitments and Contingent Liabilities***

*Lease Commitments:* The Company leases land and premises for its branch banking offices and administration facilities. The initial terms of these leases expire at various dates through 2019. Under the provisions of most of these leases, the Company has the option to extend the leases beyond their original terms at rental rates adjusted for changes reported in certain economic indices or as reflected by market conditions. The total expense on land and premises leased under operating leases was \$877,000, \$407,000, and \$455,000 during 2007, 2006, and 2005, respectively. Total rent expense of \$877,000 for the year ended December 31, 2007 included approximately \$165,000 related to adjustments made under SFAS No. 13, "Accounting for Leases".

During the fourth quarter of 2007 the Company reviewed accounting methods for recording rent expense under operating leases pursuant to SFAS No. 13 "Accounting for Leases". The Company had previously recognized periodic rent expense as those contractual rent payments became payable to the lessor, rather than on a straight-line basis throughout the life of the lease. The difference in methodology was not previously considered material, but as the Company has grown, it was determined that adjustments should be made to properly comply with SFAS No. 13. The expense adjustment to record the difference between the contractual rental payment amounts and straight-line expense over the lease terms as applicable under SFAS No. 13 totaled \$165,000 (\$95,000 net of tax, and less than \$0.01 per share) and was recorded as a liability as of December 31, 2007. This timing difference will result in an increase of approximately \$19,000 in the liability for rental obligations between December 31, 2007 and December 31, 2009, then should reverse and decline over the remaining term of the Company's leases through 2019.

*Future minimum rental commitments under existing non-cancelable leases as of December 31, 2007 are as follows:*

*(In thousands):*

|            |    |       |
|------------|----|-------|
| 2007       | \$ | 637   |
| 2008       |    | 671   |
| 2009       |    | 692   |
| 2010       |    | 389   |
| 2011       |    | 392   |
| Thereafter |    | 1,403 |
|            | \$ | 4,184 |

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

| <i>(in thousands)</i>        | Contractual amount -<br>December 31, |            |
|------------------------------|--------------------------------------|------------|
|                              | 2007                                 | 2006       |
| Commitments to extend credit | \$ 196,258                           | \$ 188,166 |
| Standby letters of credit    | 6,726                                | 4,936      |

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company's letters of credit are short-term guarantees and have terms from less than one month to approximately 2.5 years. At December 31, 2007, the maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit totaled \$6.7 million.

### **15. Fair Value Measurements and Disclosure**

The following summary disclosures are made in accordance with the provisions of Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments," which requires the disclosure of fair value information about both on- and off- balance sheet financial instruments where it is practicable to estimate that value.

| <i>(In thousands)</i>              | December 31, 2007  |                            | December 31, 2006  |                            |
|------------------------------------|--------------------|----------------------------|--------------------|----------------------------|
|                                    | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
| <b>Financial Assets:</b>           |                    |                            |                    |                            |
| Cash and cash equivalents          | \$ 25,300          | \$ 25,300                  | \$ 43,068          | \$ 43,068                  |
| Interest-bearing deposits          | 2,909              | 2,918                      | 7,893              | 7,779                      |
| Investment securities              | 89,415             | 89,415                     | 83,366             | 83,366                     |
| Loans, net                         | 596,481            | 594,054                    | 499,569            | 494,695                    |
| Bank-owned life insurance          | 13,852             | 13,852                     | 13,668             | 13,668                     |
| Investment in limited partnerships | 3,134              | 3,134                      | 3,564              | 3,564                      |
| Investment in bank stock           | 372                | 372                        | 0                  | 0                          |
| Interest rate swap contracts       | (12)               | (12)                       | (320)              | (320)                      |
| <b>Financial Liabilities:</b>      |                    |                            |                    |                            |
| Deposits                           | 634,617            | 633,408                    | 587,127            | 587,438                    |
| Borrowings                         | 32,280             | 32,162                     | 0                  | 0                          |
| Junior Subordinated Debt           | 13,341             | 13,341                     | 15,464             | 15,464                     |

|                              |   |   |   |   |
|------------------------------|---|---|---|---|
| Commitments to extend credit | — | — | — | — |
| Standby letters of credit    | — | — | — | — |

Effective January 1, 2007, the Company adopted SFAS 157, "Fair Value Measurements", concurrent with its early adoption of SFAS No. 159. SFAS No. 157 clarifies the definition of fair value, describes methods generally used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. Fair value is defined in SFAS No. 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The statement applies whenever other accounting pronouncements require or permit fair value measurements.

The fair value hierarchy under SFAS No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3). Level 1 inputs are unadjusted quoted prices in active markets (as defined) for identical assets or liabilities that the Company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, and reflect the Company's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk) in a principal market.

The Company performs fair value measurements on certain assets and liabilities as the result of the application of accounting guidelines and pronouncements that were relevant prior to the adoption of SFAS No. 157. Some fair value measurements, such as for available-for-sale securities, junior subordinated debt, impaired loans that are collateral dependent, and interest rate swaps, are performed on a recurring basis, while others, such as impairment of goodwill and other intangibles, are performed on a nonrecurring basis.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring basis during the year ended December 31, 2007 (in 000's):

| Description of Assets | December 31,<br>2007 | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-----------------------|----------------------|--|---|--|
| AFS Securities        | \$ 89,415            | \$ 89,415  |   |  |
| Interest Rate Swap    | (12)                 |  | (\$12)  |  |
| Impaired Loans        | 16,175               |  | 13,964  | \$ 2,211   |
| Total                 | \$ 105,578           | \$ 89,415  | \$ 13,952   | \$ 2,211   |

| Description of Liabilities | December 31,<br>2007 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|----------------------------|----------------------|--|--|--|
| Junior subordinated debt   | \$ 13,341            |  | \$ 13,341  |  |
| Total                      | \$ 13,341            | \$ 0   | \$ 13,341  | \$ 0   |

Upon adoption of SFAS No. 159 on January 1, 2007, the Company elected the fair value measurement option for all the Company's pre-existing junior subordinated debentures, and subsequently for new junior subordinated debentures issued during July 2007 under USB Capital Trust II. The fair value of the debentures was determined based upon discounted cash flows utilizing observable market rates and credit characteristics for similar instruments. In its analysis, the Company used characteristics that distinguish market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. The adjustment for fair value at adoption was recorded as a cumulative-effect adjustment to the opening balance of retained earnings at January 1, 2007. Fair value adjustments subsequent to adoption were recorded in current earnings.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a nonrecurring basis during the year ended December 31, 2007 (in 000's):

| (in 000's)<br>Dec 31 | Quoted Prices in<br>Active Markets | Significant<br>Other | Significant<br>Unobservable |
|----------------------|------------------------------------|----------------------|-----------------------------|
|----------------------|------------------------------------|----------------------|-----------------------------|

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| Description of Assets           | 2007      | for Identical<br>Assets<br>(Level 1) | Observable<br>Inputs<br>(Level 2) | Inputs<br>(Level 3) |
|---------------------------------|-----------|--------------------------------------|-----------------------------------|---------------------|
| <u>Business combination:</u>    |           |                                      |                                   |                     |
| Securities - AFS                | \$ 7,414  | \$ 7,414                             |                                   |                     |
| Loans, net allowance for losses | 62,426    |                                      |                                   | \$ 62,426           |
| Premises and Equipment          | 729       |                                      |                                   | 729                 |
| Goodwill                        | 8,790     |                                      |                                   | 8,790               |
| Other assets                    | 6,928     |                                      |                                   | 6,928               |
| Total assets                    | \$ 86,287 | \$ 7,414                             | \$ 0                              | \$ 78,873           |

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| Description of Liabilities   | (in 000's)<br>Dec 31,<br>2007 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|------------------------------|-------------------------------|--|---|--|
| <b>Business combination:</b> |                               |  |   |  |
| Deposits (net CDI)           | \$ 66,600                     |  |   | \$ 66,600  |
| Other liabilities            | 286                           |  |   | 286  |
| Total liabilities            | \$ 66,886                     | \$ 0   | \$ 0  | \$ 66,886  |

The Company completed its merger with Legacy Bank in February 2007. The merger 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 Legacy Bank based on the fair value of those assets and liabilities. The allocations of purchase price based upon the fair value of assets acquired and liabilities assumed were finalized during the fourth quarter of 2007. The fair value measurements for Legacy's loan portfolio included certain market rate assumptions on segmented portions of the loan portfolio with similar credit characteristics, and credit risk assumptions specific to the individual loans within that portfolio. Available-for sale securities were valued based upon open-market quotes obtained from third-party sources. Legacy's deposits were valued based upon anticipated net present cash flows related to Legacy's deposit base, and resulted in a core deposit intangible (CDI) adjustment of \$3.0 million that is carried as an asset on the Company's balance sheet. Assumptions used to determine the CDI included anticipated costs of, and revenues generated by, those deposits, as well as the estimated life of the deposit base. Other assets and liabilities generally consist of short-term items including cash, overnight investments, and accrued interest receivable or payable, and as such, it was determined that carrying value approximated fair value.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on both a recurring (impaired loans) and nonrecurring (business combination) basis during the period (in 000's):

| Reconciliation of Assets:   | Impaired Loans |
|---|----------------|
| Beginning balance   | \$ 1,521       |
| Total gains or (losses) included in earnings (or changes in net assets) | (203)          |
| Transfers in and/or out of Level 3                                      | 893            |
| Ending balance  | \$ 2,211       |

The amount of total gains or (losses) for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

(\$203)

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

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

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

**Investments** - Available-for-sale securities are valued based upon open-market quotes obtained from reputable third-party brokers. Market pricing is based upon specific CUSIP identification for each individual security.

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

**Impaired Loans** - Fair value measurements for impaired loans are performed pursuant to SFAS No. 114, and are based upon either collateral values supported by appraisals, or observed market prices. The change in fair value of impaired assets that were valued based upon level three inputs was approximately \$690,000 for the year ended December 31, 2007. This loss is not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve. Such adjustments to the estimated fair value of impaired loans may result in increases or decreases to the provision for credit losses recorded in current earnings.

**Bank-owned Life Insurance** - Fair values of life insurance policies owned by the Company are based upon the insurance contract's cash surrender value.

**Investment in limited partnerships** - Investment in limited partnerships which invest in qualified low-income housing projects generate tax credits to the Company. The investment is amortized using the effective yield method based upon the estimated remaining utilization of low-income housing tax credits. The Company's carrying value approximates fair value.

**Investments in Bank Stock** - Equity investments in bank stock are carried at fair value. Fair values are based upon quoted market prices.

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

**Deposits** - In accordance with SFAS No. 107, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at December 31, 2007 and 2006 (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed by SFAS No. 107. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

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

**Junior Subordinated Debt** - The fair value of junior subordinated debt is estimated using discounted cash flows based upon rates currently offered for junior subordinated debt with similar remaining repricing characteristics.



**Off-balance sheet Instruments** - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. The contract amounts of commitments to extend credit and standby letters of credit are disclosed in Note 14. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at December 31, 2007 and 2006.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are deferred and recognized over the term of the commitment, and are not material to the Company's consolidated balance sheet and results of operations.

## 16. Regulatory Matters

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

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

| <i>(In thousands)</i>                    | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|-----------|--------|-------------------------------|-------|--|-------|
|  | Amount    | Ratio  | Amount                        | Ratio | Amount   | Ratio |
| <u>As of December 31, 2007</u>           |           |        |                               |       |  |       |
| <u>(Company):</u>                        |           |        |                               |       |  |       |
| Total Capital (to Risk Weighted Assets)  | \$ 89,136 | 12.18% | \$ 58,531                     | 8.00% | N/A  | N/A   |
| Tier 1 Capital (to Risk Weighted Assets) | 79,986    | 10.93% | 29,265                        | 4.00% | N/A  | N/A   |
| Tier 1 Capital ( to Average Assets)      | 79,986    | 10.30% | 23,299                        | 3.00% | N/A  | N/A   |

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As of December 31, 2007

(Bank):

|  |    |        |        |    |        |       |    |        |        |
|--|----|--------|--------|----|--------|-------|----|--------|--------|
| Total Capital (to Risk Weighted Assets)  | \$ | 86,294 | 11.79% | \$ | 58,531 | 8.00% | \$ | 73,164 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) |    | 77,144 | 10.54% |    | 29,265 | 4.00% |    | 43,898 | 6.00%  |
| Tier 1 Capital ( to Average Assets)      |    | 77,144 | 9.93%  |    | 23,299 | 3.00% |    | 38,832 | 5.00%  |

As of December 31, 2006

-(Company):

|  |    |        |        |    |        |       |  |     |     |
|--|----|--------|--------|----|--------|-------|--|-----|-----|
| Total Capital (to Risk Weighted Assets)  | \$ | 84,826 | 13.85% | \$ | 48,989 | 8.00% |  | N/A | N/A |
| Tier 1 Capital (to Risk Weighted Assets) |    | 77,891 | 12.72% |    | 24,494 | 4.00% |  | N/A | N/A |
| Tier 1 Capital ( to Average Assets)      |    | 77,891 | 11.55% |    | 20,228 | 3.00% |  | N/A | N/A |

As of December 31, 2006

-(Bank):

|  |    |        |        |    |        |       |    |        |        |
|--|----|--------|--------|----|--------|-------|----|--------|--------|
| Total Capital (to Risk Weighted Assets)  | \$ | 82,644 | 13.52% | \$ | 48,884 | 8.00% | \$ | 61,105 | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) |    | 75,709 | 12.39% |    | 24,442 | 4.00% |    | 36,663 | 6.00%  |
| Tier 1 Capital ( to Average Assets)      |    | 75,709 | 11.23% |    | 20,228 | 3.00% |    | 33,714 | 5.00%  |

The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. Insured institutions are required to maintain a ratio of qualifying total capital to risk weighted assets of 8%, at least one-half of which must be in the form of Tier 1 capital. Management believes, as of December 31, 2007, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2007 and 2006, the most recent notifications from the Bank's regulators categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum total capital and Tier 1 capital (as defined) to risk-based assets (as defined), and a minimum leverage ratio of Tier 1 capital to average assets (as defined) as set forth in the proceeding discussion. There are no conditions or events since the notification that management believes have changed the institution's category.

Under regulatory guidelines, the \$15 million in Trust Preferred Securities issued by USB Capital Trust II in July of 2007 qualifies as Tier 1 capital up to 25% of Tier 1 capital. Any additional portion of Trust Preferred Securities qualifies as Tier 2 capital.

**Dividends** - Dividends paid to shareholders are paid by the bank holding company, subject to restrictions set forth in the California General Corporation Law. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank. Year-to-date as of December 31, 2007, the Company received \$17.6 million in cash dividends from the Bank, from which the Company has declared \$6.0 million in dividends to shareholders.

Under California state banking law, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the California State Department of Financial Institutions, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. As of December 31, 2007, approximately \$7.5 million was available to the Bank for cash dividend distributions without prior approval. Year-to-date, the Bank has paid dividends of \$17.6 million to the Company.

**Cash Restrictions** - The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At both December 31, 2007 and 2006, the Bank's qualifying balance with the Federal Reserve Bank was \$25,000 consisting of vault cash and balances.

### 17. Supplemental Cash Flow Disclosures

| (In thousands)                                    | Years Ended December 31, |           |          |
|---|--------------------------|-----------|----------|
|   | 2007                     | 2006      | 2005     |
| Cash paid during the period for:                  |                          |           |          |
| Interest  | \$ 21,147                | \$ 13,574 | \$ 8,949 |
| Income Taxes                                      | 6,411                    | 8,287     | 5,689    |
| Noncash investing activities:                     |                          |           |          |
| Loans transferred to foreclosed property          | 7,837                    | 0         | 4,311    |
| Dividends declared not paid                       | 1,483                    | 1,413     | 1,135    |
| Supplemental disclosures related to acquisitions: |                          |           |          |

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|                                       |          |   |   |
|---------------------------------------|----------|---|---|
| Deposits                              | 69,600   | — | — |
| Other liabilities                     | 286      | — | — |
| Securities available for sale         | (7,414)  | — | — |
| Loans, net of allowance for loan loss | (62,426) | — | — |
| Premises and equipment                | (728)    | — | — |
| Intangibles                           | (11,085) | — | — |
| Accrued interest and other assets     | (3,396)  | — | — |
| Stock issued                          | 21,536   | — | — |
| Net cash and equivalents acquired     | 6,373    | — | — |

**18. Net Income Per Share**

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

| (In thousands, except earnings per share data)                      | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2007                     | 2006      | 2005      |
| Net income available to common shareholders                         | \$ 11,257                | \$ 13,360 | \$ 11,008 |
| Weighted average shares outstanding                                 | 11,926                   | 11,344    | 11,370    |
| Add: dilutive effect of stock options                               | 35                       | 118       | 84        |
| Weighted average shares outstanding adjusted for potential dilution | 11,961                   | 11,462    | 11,454    |
| Basic earnings per share  | \$ 0.94                  | \$ 1.18   | \$ 0.97   |
| Diluted earnings per share  | \$ 0.94                  | \$ 1.17   | \$ 0.96   |
| Anti-dilutive shares excluded from earnings per share calculation   | 57                       | 33        | 30        |

**19. Other Comprehensive Income**

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

| (In thousands)   | Years Ended December 31 |          |            |
|--|-------------------------|----------|------------|
|  | 2007                    | 2006     | 2005       |
| Unrealized (loss) gain on available-for-sale securities:   |                         |          |            |
| Unrealized (loss) gain on sale securities - net of income tax (benefit) of \$605, \$253, and \$(644)   | \$ 909                  | \$ 379   | \$ (966)   |
| Less: Reclassification adjustment for loss (gain) on sale of available-for-sale securities included in net income - net of income tax (benefit) of \$0, \$11, and \$65 | 0                       | (16)     | (98)       |
| Net unrealized (loss) gain on available-for-sale securities - net income tax (benefit) of \$605, \$242, and \$(709)  | \$ 909                  | \$ 363   | \$ (1,064) |
| Unrealized loss on interest rate swaps:  |                         |          |            |
| Unrealized losses arising during period - net of income tax benefit of \$110, \$150 and \$24   | \$ (165)                | \$ (225) | \$ (36)    |

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|  |    |       |    |     |    |       |
|--|----|-------|----|-----|----|-------|
| Less: reclassification adjustments to interest income  |    | 310   |    | 493 |    | 246   |
| Net change in unrealized loss on interest rate swaps -<br>net of income tax \$97, \$140 and \$24 | \$ | 145   | \$ | 268 | \$ | 210   |
| Previously unrecognized past service costs of<br>employee benefit plans (net tax of \$55)        | \$ | 85    |    | —   |    | —     |
| Total other comprehensive income (loss)  | \$ | 1,137 | \$ | 631 | \$ | (854) |

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**20. Derivative Financial Instruments and Hedging Activities**

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

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

At December 31, 2007 and 2006, the information pertaining to the outstanding interest rate swap is as follows:

| (000's in millions)                             | December 31,<br>2007 | December 31,<br>2006 |
|---|----------------------|----------------------|
| Notional amount                                 | \$ 1,753             | \$ 14,107            |
| Weighted average pay rate                       | 8.05%                | 7.86%                |
| Weighted average receive rate                   | 4.88%                | 4.88%                |
| Weighted average maturity in years              | 0.3                  | 1.0                  |
| Unrealized loss relating to interest rate swaps | \$ 12                | \$ 320               |

The amortizing hedge has a remaining notional value of \$1.8 million and a duration of approximately three months. As of December 31, 2007, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately nine months. As of December 31, 2007, the net loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$2,000. During the year ended December 31, 2007, \$310,000 was reclassified from accumulated other comprehensive income as a reduction to interest income. As of December 31, 2007, the amounts in accumulated OCI associated with these cash flows that are expected to be reclassified into interest income during the remainder of the hedge instrument in 2008 total \$9,000.

The Company performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2007. As a result of a correlation analysis, the Company has determined that the swap remains highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continues to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. This difference between the notional value of the hedge and the underlying hedged assets is considered an "overhedge" pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than temporary. The Company determined during 2006 that the difference was other than temporary and, as a result, reclassified a net total of \$75,000 of the pretax hedge loss reported in other comprehensive income into earnings during 2006. As of December 31, 2007, the notional value of the hedge was still in excess of the value of the underlying loans being hedged by approximately \$1.3 million, but had improved from the \$3.3 million difference existing at December 31, 2006. As a result, the Company recorded a pretax hedge gain related to swap ineffectiveness of approximately \$66,000 during the December 31, 2007. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

***21. Investment in Bank Stock***

During December 2007, the Company purchased 33,854 common shares of Northern California Bancorp, Inc. (NRLB) in a privately negotiated transaction for a price of \$11.50 per share or approximately \$389,000. This purchase equals approximately 1.9% of NRLB's outstanding stock and will be treated as a marketable equity investment by the Company with changes in fair value recorded in earnings. NRLB is the holding company of Monterey County Bank. At December 31, 2007, the Company recorded a loss in its equity investment in NRLB of \$17,000 based on a quoted market price of \$11.00 per share at that date. The Company may purchase additional common shares of NRLB as shares become available.

## **22. Stock Split**

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

## **23. Common Stock Repurchase Plan**

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

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

On May 16, 2007, the Company announced a third stock repurchase plan to repurchase, as conditions warrant, up to 610,000 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Company canceled the remaining 75,733 shares available under the 2004 repurchase plan.

During the year ended December 31, 2007, 512,332 shares were repurchased at a total cost of \$10.1 million and an average per share price of \$19.71. Of the shares repurchased during 2007, 166,660 shares were repurchased under the 2004 plan at an average cost of \$20.46 per shares, and 345,672 shares were repurchased under the 2007 plan at an average cost of \$19.35 per shares.

## **24. Business Combination**

On February 16, 2007, the Company acquired 100 percent of the outstanding common shares of Legacy Bank, N.A., located in Campbell, California. At merger, Legacy Bank's one branch was merged with and into United Security Bank, a wholly owned subsidiary of the Company. The purchase of Legacy Bank provided the Company with an opportunity to expand its market area into Santa Clara County and to serve a loyal and growing small business niche and individual client base build by Legacy.

The aggregate purchase price for Legacy was \$21.7 million, which included \$177,000 in direct acquisition costs related to the merger. At the date of merger, Legacy Bank had 1,674,373 shares of common stock outstanding. Based upon an exchange rate of approximately .58 shares of the Company's stock for each share of Legacy stock, Legacy shareholders received 976,411 shares of the Company's common stock, amounting to consideration of approximately \$12.86 per Legacy common share.



Legacy's results of the operations have been included in the Company's results beginning February 17, 2007.

During the second quarter of 2007, the Company re-evaluated the preliminary estimate of the core deposit intangible related to savings accounts acquired from Legacy and determined that the initial run-off of those deposits was faster than originally anticipated. As a result, the Company reduced the core deposits intangible by approximately \$215,000 from the amount reported at March 31, 2007. Correspondingly, resultant goodwill was increased by that same \$215,000. During the fourth quarter of 2007 recorded the final purchase accounting adjustments which reflected Legacy's final book-to-tax deferred tax amounts, and other deferred tax adjustments related to purchase accounting guidelines under SFAS No. 141. The result of adjustments made during the fourth quarter of 2007 was to increase the recorded NOL benefit by \$22,000, record deferred tax liabilities of \$727,000, and to increase goodwill by \$705,000.

The following summarizes the purchase and the resultant allocation to fair-market-value adjustments and goodwill:

Purchase Price:

|   |    |        |
|---|----|--------|
| Total value of the Company's common stock exchanged                                     | \$ | 21,536 |
| Direct acquisition costs  |    | 177    |
| Total purchase price  |    | 21,713 |
| Allocation of Purchase Price:   |    |        |
| Legacy's shareholder equity   |    | 8,588  |
| Estimated adjustments to reflect assets acquired and liabilities assumed at fair value: |    |        |
| Investments   |    | 23     |
| Loans   |    | (118)  |
| Deferred taxes  |    | 1,430  |
| Core Deposit Intangible   |    | 3,000  |
| Estimated fair value of net assets acquired   |    | 12,923 |
| Goodwill resulting from acquisition   | \$ | 8,790  |

The following condensed balance sheet summarizes the amount assigned for each major asset and liability category of Legacy at the merger date:

Assets:

|  |    |        |
|--|----|--------|
| Cash   | \$ | 3,173  |
| Federal Funds Purchased                        |    | 3,200  |
| Securities available for sale                  |    | 7,414  |
| Loans, net of allowance for loan losses        |    | 62,426 |
| Premises and equipment                         |    | 729    |
| Deferred taxes                                 |    | 1,430  |
| Core deposit intangibles                       |    | 3,000  |
| Goodwill                                       |    | 8,790  |
| Accrued interest and other assets              |    | 1,437  |
| Total Assets                                   | \$ | 91,599 |
| Liabilities:                                   |    |        |
| Deposits:                                      |    |        |
| Non-interest bearing                           | \$ | 17,262 |
| Interest-bearing                               |    | 52,338 |
| Total deposits                                 | \$ | 69,600 |
| Accrued interest payable and other liabilities |    | 286    |
| Total liabilities                              | \$ | 69,886 |
| Net assets assigned to purchase                | \$ | 21,713 |

The merger 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 Legacy Bank based on the fair value of those assets and liabilities. The allocations of purchase price based upon the fair value of assets acquired and liabilities assumed were finalized during the fourth quarter of 2007. Management believes the Company will be able to fully utilize the net operating loss carry-forward (NOL) obtained in the Legacy merger. The Company has utilized a fair value approach for Legacy's loan portfolio which includes certain market rate assumptions on segmented portions of the loan portfolio with similar credit characteristics, and credit risk assumptions specific to the individual loans within that portfolio.

Core deposit intangibles totaling \$3.0 million will be amortized for financial statement purposes over an estimated life of approximately 7 years using a method that approximates the interest method. Core deposit intangibles will be

reviewed for impairment on an annual basis.

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Goodwill totaling \$8.8 million will not be amortized for book purposes under current accounting guidelines. Because the merger was a tax-deferred stock-for-stock purchase, goodwill is not deductible for tax purposes. Goodwill will be reviewed for impairment on an annual basis.

## 25. Parent Company Only Financial Statements

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

### United Security Bancshares - (parent only) Balance Sheets - December 31, 2007 and 2006

(In thousands)

|   | 2007             | 2006             |
|---|------------------|------------------|
| <b>Assets</b>   |                  |                  |
| Cash and equivalents  | \$ 2,546         | \$ 2,417         |
| Investment in bank subsidiary   | 94,589           | 79,835           |
| Investment in nonbank entity  | 122              | 122              |
| Investment in bank stock  | 372              | 0                |
| Other assets  | 470              | 944              |
| <b>Total assets</b>   | <b>\$ 98,099</b> | <b>\$ 83,318</b> |
| <b>Liabilities &amp; Shareholders' Equity</b>   |                  |                  |
| <b>Liabilities:</b>   |                  |                  |
| Junior subordinated debt securities (at fair value) 12/31/07)                                       | \$ 13,341        | \$ 15,464        |
| Accrued interest payable  | 0                | 613              |
| Deferred taxes  | 998              | 0                |
| Other liabilities   | 1,329            | 1,199            |
| <b>Total liabilities</b>  | <b>15,668</b>    | <b>17,276</b>    |
| <b>Shareholders' Equity:</b>  |                  |                  |
| Common stock, no par value  |                  |                  |
| 20,000,000 shares authorized, 11,855,192 and 11,301,113<br>issued and outstanding, in 2007 and 2006 | 32,587           | 20,448           |
| Retained earnings   | 49,997           | 46,884           |
| Accumulated other comprehensive loss  | (153)            | (1,290)          |
| <b>Total shareholders' equity</b>   | <b>82,431</b>    | <b>66,042</b>    |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 98,099</b> | <b>\$ 83,318</b> |

### United Security Bancshares - (parent only)

#### Income Statements

(In thousands)

|   | Years Ended December 31, |              |              |
|---|--------------------------|--------------|--------------|
|   | 2007                     | 2006         | 2005         |
| <b>Income</b>                                 |                          |              |              |
| Dividends from subsidiaries                   | \$ 17,600                | \$ 7,300     | \$ 5,012     |
| Gain on fair value option of financial assets | 2,504                    | 0            | 0            |
| Other income                                  | 0                        | 0            | 20           |
| <b>Total income</b>                           | <b>20,104</b>            | <b>7,300</b> | <b>5,032</b> |
| <b>Expense</b>                                |                          |              |              |
| Interest expense                              | 1,234                    | 1,355        | 1,091        |
| Other expense                                 | 469                      | 378          | 1,033        |

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|  |           |           |           |
|--|-----------|-----------|-----------|
| Total expense  | 1,703     | 1,733     | 2,124     |
| Income before taxes and equity in undistributed income of subsidiary | 18,401    | 5,567     | 2,908     |
| Income tax expense (benefit)   | 337       | (729)     | (866)     |
| (Deficit) equity in undistributed income of subsidiary               | (6,807)   | 7,064     | 7,234     |
| Net Income   | \$ 11,257 | \$ 13,360 | \$ 11,008 |

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United Security Bancshares - (parent only)

Income Statements

(In thousands)

Cash Flows From Operating Activities

|   | Years Ended December 31, |           |           |
|---|--------------------------|-----------|-----------|
|   | 2007                     | 2006      | 2005      |
| Net income  | \$ 11,257                | \$ 13,360 | \$ 11,008 |
| Adjustments to reconcile net earnings to cash provided by operating activities: |                          |           |           |
| Deficit (equity) in undistributed income of subsidiary                          | 6,807                    | (7,064)   | (7,234)   |
| Deferred taxes  | 998                      | 0         | 0         |
| Write-down of other investments   | 17                       | 0         | 702       |
| Gain on fair value option of financial liability                                | (2,504)                  | 0         | 0         |
| Amortization of issuance costs  | 0                        | 17        | 17        |
| Net change in other liabilities   | 381                      | 297       | (92)      |
| Net cash provided by operating activities                                       | 16,956                   | 6,610     | 4,401     |

Cash Flows From Investing Activities

|   |       |     |     |
|---|-------|-----|-----|
| Investment in bank stock                            | (389) | 0   | 0   |
| Proceeds from sale of investment in title company   | 0     | 149 | 527 |
| Net cash (used in) provided by investing activities | (389) | 149 | 527 |

Cash Flows From Financing Activities

|  |          |         |         |
|--|----------|---------|---------|
| Proceeds from stock options exercised                  | 510      | 335     | 118     |
| Net proceeds from issuance of junior subordinated debt | (923)    | 0       | 0       |
| Repurchase and retirement of common stock              | (10,095) | (2,436) | (377)   |
| Payment of dividends on common stock                   | (5,930)  | (4,881) | (3,980) |
| Net cash used in financing activities                  | (16,438) | (6,982) | (4,239) |

|  |          |          |          |
|--|----------|----------|----------|
| Net increase decrease in cash and cash equivalents | 129      | (223)    | 689      |
| Cash and cash equivalents at beginning of year     | 2,417    | 2,640    | 1,951    |
| Cash and cash equivalents at end of year           | \$ 2,546 | \$ 2,417 | \$ 2,640 |

Supplemental cash flow disclosures

Noncash financing activities:

|                             |          |          |          |
|-----------------------------|----------|----------|----------|
| Dividends declared not paid | \$ 1,483 | \$ 1,413 | \$ 1,135 |
|-----------------------------|----------|----------|----------|

**26. Quarterly Financial Data (unaudited)**

Selected quarterly financial data for the years ended December 31, 2007 and 2006 are presented below:

|                                      | 2007      |           |           |           | 2006      |           |           |           |
|--------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| (In thousands except per share data) | 4th       | 3rd       | 2nd       | 1st       | 4th       | 3rd       | 2nd       | 1st       |
| Interest income                      | \$ 14,245 | \$ 14,713 | \$ 13,962 | \$ 14,236 | \$ 12,847 | \$ 12,548 | \$ 11,409 | \$ 10,552 |
| Interest expense                     | 5,450     | 5,494     | 5,126     | 4,503     | 4,126     | 3,999     | 3,311     | 2,739     |
| Net interest income                  | 8,795     | 9,219     | 8,836     | 9,733     | 8,721     | 8,549     | 8,098     | 7,813     |
| Provision for credit losses          | 3,337     | 1,950     | 208       | 202       | 241       | 276       | 123       | 240       |
| Gain (loss) on sale of securities    | 0         | 0         | 0         | 0         | 27        | 0         | 0         | 0         |

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|                                  |          |          |          |          |          |          |          |          |
|----------------------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| Other noninterest income         | 2,110    | 4,019    | 1,954    | 1,581    | 1,872    | 2,331    | 1,594    | 3,207    |
| Noninterest expense              | 6,723    | 5,292    | 5,517    | 5,200    | 5,293    | 5,060    | 5,036    | 4,548    |
| Income before income tax expense | 845      | 5,996    | 5,065    | 5,912    | 5,086    | 5,544    | 4,533    | 6,232    |
| Income tax expense               | 156      | 2,339    | 1,757    | 2,309    | 2,113    | 2,083    | 1,471    | 2,368    |
| Net income                       | \$ 689   | \$ 3,657 | \$ 3,308 | \$ 3,603 | \$ 2,973 | \$ 3,461 | \$ 3,062 | \$ 3,864 |
| Net income per share:            |          |          |          |          |          |          |          |          |
| Basic                            | \$ 0.06  | \$ 0.31  | \$ 0.27  | \$ 0.30  | \$ 0.26  | \$ 0.30  | \$ 0.27  | \$ 0.34  |
| Diluted                          | \$ 0.06  | \$ 0.31  | \$ 0.27  | \$ 0.30  | \$ 0.26  | \$ 0.30  | \$ 0.27  | \$ 0.34  |
| Dividends declared per share     | \$ 0.125 | \$ 0.125 | \$ 0.125 | \$ 0.125 | \$ 0.125 | \$ 0.11  | \$ 0.11  | \$ 0.11  |
| Average shares outstanding       |          |          |          |          |          |          |          |          |
| For net income per share:        |          |          |          |          |          |          |          |          |
| Basic                            | 11,887   | 11,925   | 12,078   | 11,947   | 11,302   | 11,358   | 11,369   | 11,370   |
| Diluted                          | 11,900   | 11,946   | 12,135   | 12,006   | 11,430   | 11,476   | 11,496   | 11,490   |

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

None.

### **Item 9A. Controls and Procedures**

#### Evaluation of Disclosure Controls and Procedures:

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

(b) Changes in Internal Controls over Financial Reporting: There was no change in the Company's internal control over financial reporting that occurred during the fourth quarter of 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

#### Management Report on Internal Control over Financial Reporting:

### **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of United Security Bancshares and Subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2007. The Company's internal control over financial reporting is a process designed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

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

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



Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2007 based upon criteria in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, Management determined that the Company's internal control over financial reporting was effective as of December 31, 2007.

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

Dated March 14, 2008

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**Item 9B. Other Information**

None

**PART III**

**Item 10 - Directors, Executive Officers, and Corporate Governance**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Election of Directors and Executive Officers" and "Corporate Governance Principles and Board Matters" set forth in the Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders ("Proxy Statement").

**Item 11 - Executive Compensation**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Executive Compensation" and "Director Compensation" set forth in the Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders ("Proxy Statement").

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

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Shareholdings of Certain Beneficial Owners and Management" set forth in the Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders ("Proxy Statement").

**Item 13 - Certain Relationships and Related Transactions, and Director Independence**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Certain Transactions" and "Corporate Governance Principles" set forth in the Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders ("Proxy Statement").

**Item 14. Principal Accountant Fees and Services**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Independent Accountant Fees and Services" set forth in the Company's definitive Proxy Statement for its 2008 Annual Meeting of Shareholders ("Proxy Statement").

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**PART IV**

**Item 15 - Exhibits and Financial Statement Schedules**

**(a)(1) Financial Statements**

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

**(a)(2) Financial Statement Schedules**

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

**(a)(3) Exhibits**

- 3.1 Articles of Incorporation of Registrant (1)
- 3.2 Bylaws of Registrant (1)
- 4.1 Specimen common stock certificate of United Security Bancshares (1)
- 10.1 Amended and Restated Executive Salary Continuation Agreement for Dennis Woods
- 10.2 Amended and Restated Employment Agreement for Dennis R. Woods
- 10.3 Amended and Restated Executive Salary Continuation Agreement for Kenneth Donahue
- 10.4 Amended and Restated Change in Control Agreement for Kenneth Donahue
- 10.5 Amended and Restated Executive Salary Continuation Agreement for David Eytcheson
- 10.6 Amended and Restated Change in Control Agreement for David Eytcheson
- 10.7 Amended and Restated Executive Salary Continuation Agreement for Rhodlee Braa
- 10.8 Amended and Restated Change in Control Agreement for Rhodlee Braa
- 10.9 Amended and Restated Executive Salary Continuation Agreement for William F. Scarborough
- 10.10 Amended and Restated Change in Control Agreement for William F. Scarborough
- 10.11 USB 2005 Stock Option Plan. Filed as Exhibit B to the Company's 2005 Schedule 14A Definitive Proxy filed April 18, 2005 and incorporated herein by reference.
- 10.12 Stock Option Agreement for William F. Scarborough dated August 1, 2005 (2)
- 10.13 Stock Option Agreement for Dennis R. Woods dated February 6, 2006 (3)
- 11.1 Computation of earnings per share.

See Note 18 to Consolidated Financial Statements and related documents set forth in “Item 8. Financial Statements and Supplementary Data” of this report are filed as part of this report.

21 Subsidiaries of the Company

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23.1 Consent of Moss Adams LLP, Independent Registered Public Accounting Firm

31.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

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

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

**(b) Exhibits filed:**

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

**(c) Financial statement schedules filed:**

See Item 15(a)(2) above.

**Signatures**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report on Form 10-K for the year ended December 31, 2007 to be signed on its behalf by the undersigned thereunto duly authorized, in Fresno, California, on the 14th day of March, 2008

**United Security Bancshares**

March 14, 2008

/S/ Dennis R. Woods

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Dennis R. Woods  
President and Chief Executive Officer

March 14, 2008

/S/ Kenneth L. Donahue

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Kenneth L. Donahue  
Senior Vice President and  
Chief Financial Officer

March 14, 2008

/S/ Richard B. Shupe

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Richard B. Shupe  
Vice President and  
Controller

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**Signatures**

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

Date: 3/14/2008 /s/ Robert G. Bitter  

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Director

Date: 3/14/2008 /s/ Stanley J. Cavalla  

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Director

Date: 3/14/2008 /s/ Tom Ellithorpe  

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Director

Date: 3/14/2008 /s/ R. Todd Henry  

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Director

Date: 3/14/2008 /s/ Ronnie D. Miller  

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Director

Date: 3/14/2008 /s/ Robert M. Mochizuki  

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Director

Date: 3/14/2008 /s/ Walter Reinhard  

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Director

Date: 3/14/2008 /s/ John Terzian  

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Director

Date: 3/14/2008 /s/ Mike Woolf  

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Director

