

UNITED SECURITY BANCSHARES  
Form 10-Q  
November 17, 2008

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008.

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)

Registrants telephone number, including area code (559) 248-4943

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 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 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

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, 2008: \$121,168,727

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, no par value

(Title of Class)

Shares outstanding as of October 31, 2008: 11,914,589

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**PART I. Financial Information****United Security Bancshares and Subsidiaries  
Consolidated Balance Sheets – (unaudited)  
September 30, 2008 and December 31, 2007**

| <i>(in thousands except shares)</i>   | September 30,<br>2008 | December 31,<br>2007 |
|---|-----------------------|----------------------|
| <b>Assets</b>   |                       |                      |
| Cash and due from banks   | \$ 17,872             | \$ 25,300            |
| Federal funds sold  | 0                     | 0                    |
| Cash and cash equivalents   | 17,872                | 25,300               |
| Interest-bearing deposits in other banks  | 15,101                | 2,909                |
| Investment securities available for sale (at fair value)  | 96,324                | 89,415               |
| Loans and leases  | 607,578               | 598,220              |
| Unearned fees   | (1,366)               | (1,739)              |
| Allowance for credit losses   | (16,106)              | (10,901)             |
| Net loans   | 590,106               | 585,580              |
| Accrued interest receivable   | 2,672                 | 3,658                |
| Premises and equipment – net  | 14,599                | 15,574               |
| Other real estate owned   | 7,728                 | 6,666                |
| Intangible assets   | 3,260                 | 4,621                |
| Goodwill  | 10,417                | 10,417               |
| Cash surrender value of life insurance  | 14,322                | 13,852               |
| Investment in limited partnership   | 2,810                 | 3,134                |
| Deferred income taxes - net   | 6,162                 | 4,301                |
| Other assets  | 6,629                 | 6,288                |
| <b>Total assets</b>   | <b>\$ 788,002</b>     | <b>\$ 771,715</b>    |
| <b>Liabilities &amp; Shareholders' Equity</b>   |                       |                      |
| <b>Liabilities</b>  |                       |                      |
| Deposits  |                       |                      |
| Noninterest bearing   | \$ 154,186            | \$ 139,066           |
| Interest bearing  | 448,099               | 495,551              |
| Total deposits  | 602,285               | 634,617              |
| Federal funds purchased   | 58,809                | 22,280               |
| Other borrowings  | 28,000                | 10,000               |
| Accrued interest payable  | 956                   | 1,903                |
| Accounts payable and other liabilities  | 5,317                 | 7,143                |
| Junior subordinated debentures (at fair value)  | 12,783                | 13,341               |
| Total liabilities   | 708,150               | 689,284              |
| <b>Shareholders' Equity</b>   |                       |                      |
| Common stock, no par value 20,000,000 shares authorized, 11,914,838 and 11,855,192 issued and outstanding, in 2008 and 2007, respectively | 33,588                | 32,587               |
| Retained earnings   | 48,307                | 49,997               |
| Accumulated other comprehensive loss  | (2,043)               | (153)                |
| Total shareholders' equity  | 79,852                | 82,431               |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 788,002</b>     | <b>\$ 771,715</b>    |

See notes to consolidated financial statements

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**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Income and Comprehensive Income (unaudited)**

| <i>(In thousands except shares and EPS)</i>      | Quarter Ended Sept 30, |                 | Nine Months Ended Sept 30, |                  |
|--|------------------------|-----------------|----------------------------|------------------|
|  | 2008                   | 2007            | 2008                       | 2007             |
| <b>Interest Income:</b>                          |                        |                 |                            |                  |
| Loans, including fees                            | \$ 9,525               | \$ 13,633       | \$ 30,960                  | \$ 39,542        |
| Investment securities – AFS – taxable            | 1,310                  | 949             | 3,910                      | 2,882            |
| Investment securities – AFS – nontaxable         | 15                     | 27              | 54                         | 81               |
| Federal funds sold                               | 1                      | 38              | 18                         | 183              |
| Interest on deposits in other banks              | 85                     | 66              | 169                        | 223              |
| <b>Total interest income</b>                     | <b>10,936</b>          | <b>14,713</b>   | <b>35,111</b>              | <b>42,911</b>    |
| <b>Interest Expense:</b>                         |                        |                 |                            |                  |
| Interest on deposits                             | 2,735                  | 4,894           | 9,956                      | 13,482           |
| Interest on other borrowings                     | 774                    | 600             | 2,014                      | 1,641            |
| <b>Total interest expense</b>                    | <b>3,509</b>           | <b>5,494</b>    | <b>11,970</b>              | <b>15,123</b>    |
| <b>Net Interest Income Before</b>                |                        |                 |                            |                  |
| <b>Provision for Credit Losses</b>               | <b>7,427</b>           | <b>9,219</b>    | <b>23,141</b>              | <b>27,788</b>    |
| <b>Provision for Credit Losses</b>               | <b>6,402</b>           | <b>1,950</b>    | <b>7,215</b>               | <b>2,360</b>     |
| <b>Net Interest Income</b>                       | <b>1,025</b>           | <b>7,269</b>    | <b>15,926</b>              | <b>25,428</b>    |
| <b>Noninterest Income:</b>                       |                        |                 |                            |                  |
| Customer service fees                            | 1,085                  | 1,191           | 3,554                      | 3,503            |
| Gain on redemption of securities                 | 0                      | 0               | 24                         | 0                |
| Gain on sale of other real estate owned          | 0                      | 12              | 67                         | 35               |
| Gain on proceeds from bank-owned life insurance  | 0                      | 264             | 0                          | 483              |
| Gain on swap ineffectiveness                     | 0                      | 12              | 9                          | 44               |
| (Loss) gain on fair value of financial liability | (37)                   | 2,121           | 464                        | 2,234            |
| Shared appreciation income                       | 122                    | 10              | 265                        | 34               |
| Other  | 420                    | 409             | 1,261                      | 1,221            |
| <b>Total noninterest income</b>                  | <b>1,590</b>           | <b>4,019</b>    | <b>5,644</b>               | <b>7,554</b>     |
| <b>Noninterest Expense:</b>                      |                        |                 |                            |                  |
| Salaries and employee benefits                   | 2,455                  | 2,490           | 8,200                      | 7,972            |
| Occupancy expense                                | 1,017                  | 922             | 2,977                      | 2,662            |
| Data processing                                  | 67                     | 90              | 216                        | 326              |
| Professional fees                                | 342                    | 485             | 1,059                      | 1,251            |
| Director fees                                    | 65                     | 73              | 196                        | 201              |
| Amortization of intangibles                      | 202                    | 278             | 737                        | 740              |
| Correspondent bank service charges               | 103                    | 138             | 329                        | 343              |
| Impairment loss on core deposit intangible       | 0                      | 0               | 624                        | 0                |
| Loss on California tax credit partnership        | 108                    | 107             | 324                        | 324              |
| Impairment loss on OREO                          | 0                      | 0               | 31                         | 0                |
| OREO expense                                     | 131                    | 43              | 211                        | 118              |
| Other  | 776                    | 666             | 2,122                      | 2,072            |
| <b>Total noninterest expense</b>                 | <b>5,266</b>           | <b>5,292</b>    | <b>17,026</b>              | <b>16,009</b>    |
| <b>(Loss) Income Before Taxes on Income</b>      | <b>(2,651)</b>         | <b>5,996</b>    | <b>4,544</b>               | <b>16,973</b>    |
| <b>(Benefit) Provision for Taxes on Income</b>   | <b>(1,309)</b>         | <b>2,339</b>    | <b>1,316</b>               | <b>6,405</b>     |
| <b>Net (Loss) Income</b>                         | <b>\$ (1,342)</b>      | <b>\$ 3,657</b> | <b>\$ 3,228</b>            | <b>\$ 10,568</b> |

**Other comprehensive (loss) income, net of tax:**

Unrealized (loss) gain on available for sale securities, interest rate swap, and past service costs of employee benefit plans - net income (benefit) tax of \$(328), \$314, \$(1,347) and \$364

|                             |                   |                 |                 |                  |
|-----------------------------|-------------------|-----------------|-----------------|------------------|
|                             | (492)             | 471             | (1,890)         | 546              |
| <b>Comprehensive Income</b> | <b>\$ (1,834)</b> | <b>\$ 4,128</b> | <b>\$ 1,338</b> | <b>\$ 11,114</b> |

**Net (loss) income per common share**

|         |          |         |         |         |
|---------|----------|---------|---------|---------|
| Basic   | \$ -0.11 | \$ 0.30 | \$ 0.27 | \$ 0.88 |
| Diluted | \$ -0.11 | \$ 0.30 | \$ 0.27 | \$ 0.87 |

**Shares on which net (loss) income per common shares were based**

|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Basic   | 11,915,582 | 12,050,478 | 11,938,462 | 12,058,237 |
| Diluted | 11,915,582 | 12,071,341 | 11,943,907 | 12,102,402 |

See notes to consolidated financial statements

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**Periods Ended September 30, 2008**

| <i>(In thousands except shares)</i>  | Common<br>stock<br>Number<br>of Shares | Common<br>stock<br>Amount | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total     |
|--|--|---------------------------|----------------------|--|-----------|
| <b>Balance January 1, 2007</b>   | 11,301,113                             | \$ 20,448                 | \$ 46,884            | \$ (1,290)   | \$ 66,042 |
| Director/Employee stock options exercised  | 90,000                                 | 510                       |                      |  | 510       |
| Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$234) |  |                           |                      | 350  | 350       |
| Net changes in unrealized loss on interest rate swaps (net of income tax of \$88)                    |  |                           |                      | 133  | 133       |
| Net changes in unrecognized past service Cost on employee benefit plans (net of income tax of \$42)  |  |                           |                      | 63   | 63        |
| Dividends on common stock (\$0.375 per share)  |  |                           | (4,518)              |  | (4,518)   |
| Repurchase and cancellation of common shares   | (453,077)                              | (9,148)                   |                      |  | (9,148)   |
| Issuance of shares for business combination  | 976,411                                | 21,537                    |                      |  | 21,537    |
| Stock-based compensation expense   |  | 140                       |                      |  | 140       |
| 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   |  |                           | 10,568               |  | 10,568    |
| <b>Balance September 30, 2007 (Unaudited)</b>  | 11,914,447                             | 33,487                    | 50,791               | (744)  | 83,534    |
| Net changes in unrealized loss on available for sale securities (net of income tax of \$372)         |  |                           |                      | 558  | 558       |
| Net changes in unrealized loss on interest rate swaps (net of income tax of \$8)                     |  |                           |                      | 13   | 13        |
| Net changes in unrecognized past service Cost on employee benefit plans (net of income tax of \$13)  |  |                           |                      | 20   | 20        |
| Dividends on common stock (\$0.125 per share)  |  |                           | (1,483)              |  | (1,483)   |
| Repurchase and cancellation of common shares   | (59,255)                               | (947)                     |                      |  | (947)     |
| Stock-based compensation expense   |  | 47                        |                      |  | 47        |
| Net Income   |  |                           | 689                  |  | 689       |
| <b>Balance December 31, 2007</b>   | 11,855,192                             | 32,587                    | 49,997               | (153)  | 82,431    |



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|  |               |           |           |                  |
|--|---------------|-----------|-----------|------------------|
| Director/Employee stock options exercised  | 8,000         | 70        |           | 70               |
| Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$1,303) |               |           | (1,956)   | (1,956)          |
| Net changes in unrealized loss on interest rate swaps (net of income tax of \$1)                       |               |           | 2         | 2                |
| Net changes in unrecognized past service Cost on employee benefit plans (net of income tax of \$43)    |               |           | 64        | 64               |
| Dividends on common stock (\$0.26 per share)   |               |           | (3,072)   | (3,072)          |
| 1% common stock dividend   | 117,732       | 1,846     | (1,846)   | 0                |
| Repurchase and cancellation of common shares   | (66,086)      | (1,006)   |           | (1,006)          |
| Stock-based compensation expense   |               | 91        |           | 91               |
| Net Income   |               |           | 3,228     | 3,228            |
| <b>Balance September 30, 2008 (Unaudited)</b>  | 11,914,838 \$ | 33,588 \$ | 48,307 \$ | (2,043)\$ 79,852 |

See notes to consolidated financial statements

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Cash Flows (unaudited)**

| <i>(In thousands)</i>   | Nine Months Ended September 30, |           |
|---|---------------------------------|-----------|
|   | 2008                            | 2007      |
| <b>Cash Flows From Operating Activities:</b>                                  |                                 |           |
| Net income  | \$ 3,228                        | \$ 10,568 |
| Adjustments to reconcile net income to cash provided by operating activities: |                                 |           |
| Provision for credit losses   | 7,215                           | 2,360     |
| Depreciation and amortization   | 1,999                           | 1,954     |
| Accretion of investment securities  | (103)                           | (79)      |
| Gain on redemption of securities  | (24)                            | 0         |
| Decrease (increase) in accrued interest receivable                            | 986                             | (454)     |
| Decrease in accrued interest payable  | (948)                           | (92)      |
| (Decrease) increase in unearned fees  | (374)                           | 627       |
| Increase in income taxes payable  | 538                             | 849       |
| Stock-based compensation expense  | 91                              | 140       |
| (Decrease) increase in accounts payable and accrued liabilities               | (467)                           | 734       |
| Gain on sale of other real estate owned                                       | (67)                            | (35)      |
| Impairment loss on other real estate owned                                    | 31                              | 0         |
| Impairment loss on core deposit intangible                                    | 624                             | 0         |
| Gain on swap ineffectiveness  | (9)                             | (44)      |
| Income from life insurance proceeds   | 0                               | (483)     |
| Increase in surrender value of life insurance                                 | (470)                           | (52)      |
| Gain on fair value option of financial liabilities                            | (464)                           | (2,121)   |
| Loss on tax credit limited partnership interest                               | 324                             | 324       |
| Net (increase) decrease in other assets                                       | (1,225)                         | 576       |
| Net cash provided by operating activities                                     | 10,889                          | 14,772    |
| <b>Cash Flows From Investing Activities:</b>                                  |                                 |           |
| Net (increase) decrease in interest-bearing deposits with banks               | (12,192)                        | 2,638     |
| Purchases of available-for-sale securities                                    | (44,526)                        | (19,178)  |
| Maturities and calls of available-for-sale securities                         | 34,765                          | 21,965    |
| Net purchase of correspondent bank stock                                      | 0                               | 255       |
| Net redemption from limited partnerships                                      | 25                              | 0         |
| Investment in other bank stock  | (72)                            | 0         |
| Net increase in loans   | (14,408)                        | (63,815)  |
| Cash and equivalents received in bank acquisition                             | 0                               | 6,373     |
| Proceeds from sales of foreclosed assets                                      | 56                              | 30        |
| Proceeds (expenditures) from settlement of other real estate owned            | 1,710                           | (453)     |
| Capital expenditures for premises and equipment                               | (381)                           | (973)     |
| Net cash used in investing activities   | (35,023)                        | (53,158)  |
| <b>Cash Flows From Financing Activities:</b>                                  |                                 |           |
| Net increase (decrease) in demand deposit and savings accounts                | 42,313                          | (49,882)  |
| Net (decrease) increase in certificates of deposit                            | (74,645)                        | 62,683    |
| Net increase in federal funds purchased                                       | 36,529                          | 15,400    |
| Net increase in FHLB term borrowings  | 18,000                          | 10,000    |
| Redemption of junior subordinated debt  | 0                               | (15,923)  |

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|   |                  |                  |
|---|------------------|------------------|
| Proceeds from issuance of junior subordinated debt      | 0                | 15,000           |
| Proceeds from Director/Employee stock options exercised | 70               | 510              |
| Repurchase and retirement of common stock               | (1,006)          | (9,148)          |
| Payment of dividends on common stock                    | (4,555)          | (4,441)          |
| Net cash provided by financing activities               | 16,706           | 24,199           |
| <b>Net decrease in cash and cash equivalents</b>        | <b>(7,428)</b>   | <b>(14,187)</b>  |
| <b>Cash and cash equivalents at beginning of period</b> | <b>25,300</b>    | <b>43,068</b>    |
| <b>Cash and cash equivalents at end of period</b>       | <b>\$ 17,872</b> | <b>\$ 28,881</b> |

See notes to consolidated financial statements

**United Security Bancshares and Subsidiaries - Notes to Consolidated Financial Statements - (Unaudited)**

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

The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary United Security Bank (the "Bank") and two bank subsidiaries, USB Investment Trust (the "REIT") and United Security Emerging Capital Fund, (collectively the "Company" or "USB"). Intercompany accounts and transactions have been eliminated in consolidation.

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2007 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal recurring, nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole. Certain reclassifications have been made to the 2007 financial statements to conform to the classifications used in 2008. None of these reclassifications were material.

**New Accounting Standards:**

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 06-4 (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 became 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. EITF 06-4 had no impact on the Company's financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *"Business Combinations"* ("SFAS No. 141R"). SFAS No. 141R will change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company does not expect that SFAS No. 141R will have a material impact on accounting for business combinations once adopted, but the effect will be dependent upon acquisitions at that time.

In March 2008, the Financial Accounting Standards Board (FASB) issued SFAS No. 161, *"Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement 133."* SFAS No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how an entity uses derivative instruments and how derivative instruments and related hedged items are accounted for and affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Adoption of SFAS No. 161 as of January 1, 2009 will not have a material impact on the Company's consolidated financial position or results of operations, as it impacts financial statement disclosure only.

2.

*Investment Securities Available for Sale*

Following is a comparison of the amortized cost and approximate fair value of securities available-for-sale, as of September 30, 2008 and December 31, 2007:

| <i>(In thousands)</i>  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value<br>(Carrying<br>Amount) |
|--|-------------------|------------------------------|-------------------------------|------------------------------------|
| <b>September 30, 2008:</b>                                       |                   |                              |                               |                                    |
| U.S. Government agencies   | \$ 44,226         | \$ 252                       | \$ (184)                      | \$ 44,294                          |
| U.S. Government agency<br>collateralized mortgage<br>obligations | 40,082            | 95                           | (2,637)                       | 37,540                             |
| Obligations of state and political<br>subdivisions               | 1,252             | 17                           | 0                             | 1,269                              |
| Other investment securities                                      | 13,853            | 0                            | (632)                         | 13,221                             |
|  | \$ 99,413         | \$ 364                       | \$ (3,453)                    | \$ 96,324                          |
| <b>December 31, 2007:</b>  |                   |                              |                               |                                    |
| U.S. Government agencies   | \$ 65,764         | \$ 524                       | \$ (302)                      | \$ 65,986                          |
| U.S. Government agency<br>collateralized mortgage<br>obligations | 7,782             | 44                           | (4)                           | 7,822                              |
| Obligations of state and political<br>subdivisions               | 2,227             | 54                           | 0                             | 2,281                              |
| Other investment securities                                      | 13,752            | 0                            | (426)                         | 13,326                             |
|  | \$ 89,525         | \$ 622                       | \$ (732)                      | \$ 89,415                          |

Included in other investment securities at September 30, 2008 are a short-term government securities mutual fund totaling \$7.5 million, a CRA-qualified mortgage fund totaling \$4.8 million, and a money-market mutual fund totaling \$853,000. 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. 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 realized gains totaling \$24,000 on calls of available-for-sale securities during the nine months ended September 30, 2008. There were no realized losses on sales or calls of available-for-sale securities during the nine months ended September 30, 2008. There were no realized gains or losses on sales or calls of available-for-sale securities during the nine months ended September 30, 2007.

Securities that have been temporarily impaired less than 12 months at September 30, 2008 are comprised of five collateralized mortgage obligations and three U.S. government agency securities with a total weighted average life of 4.1 years. As of September 30, 2008, there were two other investment securities and one U.S. government agency security with a total weighted average life of 1.5 years that have been temporarily impaired for twelve months or more.

The following summarizes temporarily impaired investment securities at September 30, 2008:

| <i>(In thousands)</i> | Less than 12 Months<br>Fair Value<br>(Carrying | Unrealized | 12 Months or More<br>Fair Value<br>(Carrying | Unrealized | Total<br>Fair Value<br>(Carrying | Unrealized |
|-----------------------|--|------------|--|------------|----------------------------------|------------|
|-----------------------|--|------------|--|------------|----------------------------------|------------|

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| Securities available for sale:                             | Amount)   | Losses     | Amount)   | Losses   | Amount)   | Losses     |
|--|-----------|------------|-----------|----------|-----------|------------|
| U.S. Government agencies                                   | \$ 7,214  | \$ (51)    | \$ 4,746  | \$ (133) | \$ 11,960 | \$ (184)   |
| U.S. Government agency collateralized mortgage obligations | 26,267    | (2,637)    | 0         | 0        | 26,267    | (2,637)    |
| Obligations of state and political subdivisions            | 0         | 0          | 0         | 0        | 0         | 0          |
| Other investment securities                                | 0         | 0          | 12,368    | (632)    | 12,368    | (632)      |
| Total impaired securities                                  | \$ 33,481 | \$ (2,688) | \$ 17,114 | \$ (765) | \$ 50,595 | \$ (3,453) |

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Although there have been declines in the market value and credit quality of some of the Company's investment securities during the nine months ended September 30, 2008, management believes it is probable that the Company will be able to collect all amounts due according to the contractual terms of investment securities considered impaired. The Company has the ability and the intent to hold impaired investment securities until maturity. As a result the Company does not have any investment securities that have been classified as other-than-temporarily-impaired at September 30, 2008.

At September 30, 2008 and December 31, 2007, available-for-sale securities with an amortized cost of approximately \$84.3 million and \$71.0 million (fair value of \$81.8 million and \$71.3 million) were pledged as collateral for public funds, and treasury tax and loan balances.

### 3. *Loans and Leases*

Loans include the following:

| <i>(In thousands)</i>      | September 30,<br>2008 | % of<br>Loans | December 31,<br>2007 | % of<br>Loans |
|----------------------------|-----------------------|---------------|----------------------|---------------|
| Commercial and industrial  | \$ 229,352            | 37.7%         | \$ 204,385           | 34.2%         |
| Real estate – mortgage     | 132,085               | 21.7%         | 142,565              | 23.8%         |
| Real estate – construction | 160,630               | 26.5%         | 178,296              | 29.8%         |
| Agricultural               | 57,663                | 9.5%          | 46,055               | 7.7%          |
| Installment/other          | 20,572                | 3.4%          | 18,171               | 3.0%          |
| Lease financing            | 7,276                 | 1.2%          | 8,748                | 1.5%          |
| Total Gross Loans          | \$ 607,578            | 100.0%        | \$ 598,220           | 100.0%        |

Loans over 90 days past due and still accruing totaled \$894,000 and \$189,000 at September 30, 2008 and December 31, 2007, respectively. Nonaccrual loans totaled \$55.1 million and \$21.6 million at September 30, 2008 and December 31, 2007, respectively.

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

| <i>(In thousands)</i>                      | September 30,<br>2008 | December 31,<br>2007 | September 30,<br>2007 |
|--|-----------------------|----------------------|-----------------------|
| Balance, beginning of year                 | \$ 10,901             | \$ 8,365             | \$ 8,365              |
| Provision charged to operations            | 7,215                 | 5,697                | 2,360                 |
| Losses charged to allowance                | (2,106)               | (4,493)              | (1,916)               |
| Recoveries on loans previously charged off | 96                    | 64                   | 44                    |
| Reserve acquired in merger                 | 0                     | 1,268                | 1,268                 |
| Balance at end-of-period                   | \$ 16,106             | \$ 10,901            | \$ 10,121             |

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. The formula allowance for unfunded loan commitments totaling \$384,000 and \$548,000 at September 30, 2008 and December 31, 2007, respectively, is carried in other liabilities. The Company's market areas of the San Joaquin Valley, the greater Oakhurst area, East Madera County, and Santa Clara County, have all been impacted by the economic downturn related to depressed real estate markets and the tightening of liquidity markets. The Company has taken these events into account when reviewing estimates of factors that may impact the allowance for credit losses.

The Company grades “problem” or “classified” loans according to certain risk factors associated with individual loans within the loan portfolio. Classified loans consist of loans which have been graded substandard, doubtful, or loss based upon inherent weaknesses in the individual loans or loan relationships. Classified loans include not only impaired loans (as defined under SFAS No. 114), but also loans which based upon inherent weaknesses result in a risk grading of substandard, doubtful, or loss. The following table summarizes the Company’s classified loans at September 30, 2008 and December 31, 2007.

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| (in 000's)                               | September 30,<br>2008 | December 31,<br>2007 |
|--|-----------------------|----------------------|
| Impaired loans                           | \$ 53,655             | \$ 20,627            |
| Classified loans not considered impaired | 51,483                | 31,135               |
| Total classified loans                   | \$ 105,138            | \$ 51,762            |

The following table summarizes the Company's investment in loans for which impairment has been recognized for the periods presented:

| (in thousands)   | September 30,<br>2008 | December 31,<br>2007 | September 30,<br>2007 |
|--|-----------------------|----------------------|-----------------------|
| Total impaired loans at period-end   | \$ 53,655             | \$ 20,627            | \$ 23,060             |
| Impaired loans which have specific allowance   | 27,333                | 10,750               | 12,920                |
| Total specific allowance on impaired loans   | 7,953                 | 4,452                | 5,192                 |
| Total impaired loans which as a result of write-downs or the fair value of the collateral, did not have a specific allowance | 26,322                | 9,877                | 10,140                |
| (in thousands)   | YTD – 9/30/08         | YTD - 12/31/07       | YTD – 9/30/07         |
| Average recorded investment in impaired loans during period  | \$ 32,785             | \$ 15,857            | \$ 14,745             |
| Income recognized on impaired loans during period  | 0                     | 0                    | 0                     |

**4. Deposits**

Deposits include the following:

| (In thousands)                  | September 30,<br>2008 | December 31,<br>2007 |
|---------------------------------|-----------------------|----------------------|
| Noninterest-bearing deposits    | \$ 154,186            | \$ 139,066           |
| Interest-bearing deposits:      |                       |                      |
| NOW and money market accounts   | 181,912               | 153,717              |
| Savings accounts                | 39,010                | 40,012               |
| Time deposits:                  |                       |                      |
| Under \$100,000                 | 70,654                | 52,297               |
| \$100,000 and over              | 156,523               | 249,525              |
| Total interest-bearing deposits | 448,099               | 495,551              |
| Total deposits                  | \$ 602,285            | \$ 634,617           |

**5. Short-term Borrowings/Other Borrowings**

At September 30, 2008, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$286.6 million, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$32.8 million. At September 30, 2008, the Company had total outstanding balances of \$28.0 million drawn against its FHLB line of credit. The weighted average cost of borrowings outstanding at September 30, 2008 was 2.63%. The \$28.0 million in FHLB borrowings outstanding at September 30, 2008 are summarized in the table below.

FHLB term borrowings at September 30, 2008 (in 000's):

| Term   | Balance at 9/30/08 | Fixed Rate | Maturity |
|--------|--------------------|------------|----------|
| 1 year | \$ 7,000           | 2.51%      | 2/11/09  |

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|        |           |       |         |
|--------|-----------|-------|---------|
| 2 year | 10,000    | 4.92% | 3/30/09 |
| 2 year | 11,000    | 2.67% | 2/11/10 |
|        | \$ 28,000 | 3.43% |         |

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. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time.

## 6. *Supplemental Cash Flow Disclosures*

| <i>(In thousands)</i>                                    | Nine Months Ended September 30, |           |
|--|---------------------------------|-----------|
|  | 2008                            | 2007      |
| <b>Cash paid during the period for:</b>                  |                                 |           |
| Interest   | \$ 12,918                       | \$ 15,393 |
| Income Taxes   | 1,610                           | 5,556     |
| <b>Noncash investing activities:</b>                     |                                 |           |
| Dividends declared not paid                              | \$ 0                            | \$ 1,490  |
| Loans transferred to foreclosed assets                   | \$ 2,803                        | 0         |
| <b>Supplemental disclosures related to acquisitions:</b> |                                 |           |
| Deposits   |                                 | \$ 69,600 |
| Other liabilities  |                                 | 286       |
| Securities available for sale                            |                                 | (7,414)   |
| Loans, net of allowance for loan losses                  |                                 | (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  |

## 7. *Common Stock Dividend*

On September 23, 2008, the Company’s Board of Directors declared a one-percent (1%) stock dividend on the Company’s outstanding common stock. Based upon the number of outstanding common shares on the record date of October 10, 2008, an additional 117,732 shares were issued to shareholders on October 22, 2008. Because the stock dividend was considered a “small stock dividend”, approximately \$1.8 million was transferred from retained earnings to common stock based upon the \$15.65 closing price of the Company’s common stock on the declaration date of September 23, 2008. Fractional shares were paid in cash, with a cash-in-lieu of payment of approximately \$4,000. Other than for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively from September 30, 2008 for financial reporting purposes. For purposes of earnings per share calculations, the Company’s weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

## 8. *Net Income per Common 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:

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| <i>(In thousands except earnings per share data)</i>                | Quarter Ended Sept 30, |          | Nine Months Ended Sept 30, |           |
|---|------------------------|----------|----------------------------|-----------|
|   | 2008                   | 2007     | 2008                       | 2007      |
| Net income available to common shareholders                         | \$ (1,342)             | \$ 3,657 | \$ 3,228                   | \$ 10,568 |
| Weighted average shares issued                                      | 11,916                 | 12,050   | 11,939                     | 12,058    |
| Add: dilutive effect of stock options                               | 0                      | 21       | 5                          | 44        |
| Weighted average shares outstanding adjusted for potential dilution | 11,916                 | 12,071   | 11,944                     | 12,102    |
| Basic earnings per share  | \$ (0.11)              | \$ 0.30  | \$ 0.27                    | \$ 0.88   |
| Diluted earnings per share  | \$ (0.11)              | \$ 0.30  | \$ 0.27                    | \$ 0.87   |
| Anti-dilutive shares excluded from earnings per share calculation   | 116                    | 109      | 110                        | 57        |

The Company's average weighted shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders of record on October 10, 2008.

#### **9. *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 for 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 is 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 matured in September 2008. During the nine months ended September 30, 2008, \$5,000 was reclassified from other accumulated comprehensive income into expense, and is reflected as a reduction in interest income. The Company recorded pretax hedge gains related to swap ineffectiveness of approximately \$9,100 during the nine months ended September 30, 2008. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

#### **10. *Common Stock Repurchase Plan***

Since August 2001, the Company's Board of Directors has approved three separate consecutive plans to repurchase, as conditions warrant, up to approximately 5% of the Company's common stock on the open market or in privately negotiated transactions. The duration of the stock repurchase programs has been open-ended and the timing of purchases depends on market conditions. As each new stock repurchase plan was approved, the previous plan was cancelled.

On May 16, 2007, the Board of Directors approved the third and most recent 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 previous 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 previous 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.

During the nine months ended September 30, 2008, 66,086 shares were repurchased at a total cost of \$1.0 million and an average per share price of \$15.23.

## II. *Stock Based Compensation*

All share-based payments to employees, including grants of employee stock options, are 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 nine months ended September 30, 2008 and 2007 is \$91,000 and \$140,000 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 quarter.

A summary of the Company's options as of January 1, 2008 and changes during the nine months ended September 30, 2008 is presented below.

|   | 2005<br>Plan | Weighted<br>Average<br>Exercise<br>Price | 1995<br>Plan | Weighted<br>Average<br>Exercise<br>Price |
|---|--------------|--|--------------|--|
| Options outstanding January 1, 2008       | 176,500      | \$ 17.14                                 | 36,000       | \$ 11.21                                 |
| Exercised during the period               | 0            | —  | (8,000)      | 8.75                                     |
| Forfeited during the period               | 0            | —  | (12,000)     | 11.53                                    |
| 1% common stock dividend                  | 1,765        | (0.17)                                   | 160          | (0.12)                                   |
| Options outstanding September 30, 2008    | 178,265      | \$ 16.97                                 | 16,160       | \$ 12.08                                 |
| Options exercisable at September 30, 2008 | 83,224       | \$ 16.50                                 | 14,140       | \$ 12.08                                 |

As of September 30, 2008 and 2007, there was \$133,000 and \$270,000, 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 0.75 years and 1.25 years, respectively. The Company received \$70,000 and \$510,000 in cash proceeds on options exercised during the nine months ended September 30, 2008 and 2007, respectively. No tax benefits were realized on stock options exercised during the nine months ended September 30, 2008 or 2007, because all options exercised during the periods were incentive stock options.

|   | Period Ended<br>September 30,<br>2008 | Period Ended<br>September 30,<br>2007 |
|---|---------------------------------------|---------------------------------------|
| Weighted average grant-date fair value of stock options granted | n/a                                   | \$ 4.51                               |
| Total fair value of stock options vested                        | \$ 171,676                            | \$ 167,028                            |
| Total intrinsic value of stock options exercised                | \$ 55,000                             | \$ 1,517,000                          |

The Company 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 vested as of January 1, 2006 or granted after January 1, 2006, and valued in accordance with FAS 123R, the Company 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 Company 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.



|                           | September 30, 2008 | September 30, 2007 |
|---------------------------|--------------------|--------------------|
| Risk Free Interest Rate   | —                  | 4.53%              |
| Expected Dividend Yield   | —                  | 2.47%              |
| Expected Life in Years    | —                  | 6.50 Years         |
| Expected Price Volatility | —                  | 20.63%             |

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 about 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 Company's recorded stock-based compensation expense could have been materially different from that previously reported by the Company. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. The Company's current expected forfeiture rate is zero. If the Company's actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different.

## 12. *Taxes – FIN48*

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 quarters since that time 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, and the nine months ended September 30, 2008, the Company recorded an additional \$87,000 and \$43,000, respectively in interest liability pursuant to the provisions of FIN48. The Company had approximately \$522,000 accrued for the payment of interest and penalties at September 30, 2008. 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):

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|   |    |       |
|---|----|-------|
| Balance at January 1, 2008                  | \$ | 1,385 |
| Additions for tax provisions of prior years |    | 43    |
| Balance at September 30, 2008               | \$ | 1,428 |

### 13. *Fair Value Adjustments - Junior Subordinated Debt/Trust Preferred Securities*

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 issued under the Company’s wholly-owned trust, USB Capital Trust I. The junior subordinated debt issued under USB Capital Trust I was ultimately redeemed during July 2007, and USB Capital Trust I was dissolved. The Company also elected the fair value option pursuant to SFAS No. 159 for subsequent junior subordinated debt issued under USB Capital Trust II formed during July 2007. The rate paid on the junior subordinated debt issued under USB Capital Trust II is 3-month LIBOR plus 129 basis points, and is adjusted quarterly.

At September 30, 2008 the Company performed a fair value measurement analysis on its junior subordinated debt pursuant to SFAS No. 157 using a valuation model approach that had been utilized in previous periods because of the absence of quoted market prices. Because the trust preferred markets became effectively inactive during the first quarter of 2008 due to increasing credit concerns in the capital markets, management used unobservable pricing spreads to 3-month LIBOR in the fair value determination of its junior subordinated debt. Management utilized a similar market spread from 3-month LIBOR to that used for the fourth quarter of 2007 when observable data were more available. Management believes this market spread is still relatively indicative of those used by market participants, although for purposes of the fair value analysis performed for September 30, 2008, that spread was increased by 20 basis points. The Company believes that when financial markets again normalize, market credit spreads will be slightly higher than they have been in the past, although it is difficult to determine by how much at this time.

The fair value calculation performed at September 30, 2008 resulted in a pretax loss adjustment of \$37,000 for the quarter ended September 30, 2008, and a cumulative pretax gain adjustment \$464,000 for the nine months ended September 30, 2008. The cumulative gain adjustment is primarily the result of a 65 basis point decline in the 3-month LIBOR base rate between December 31, 2007 and September 30, 2008, combined with a 20 basis point increase in the market spread from LIBOR used in the analysis. At September 30, 2008, the total cumulative fair value gain recorded on the balance sheet for was \$2.8 million. Upon initial adoption of SFAS No. 159, fair value adjustments were reflected in retained earnings. Fair value gains and losses subsequent to initial adoption of SFAS No. 159 are reflected as a component of noninterest income.

### 14. *Fair Value Measurements—Adoption of SFAS No. 157*

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 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.

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 reporting entity 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 reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

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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 and interest rate swaps are performed on a recurring basis, while others, such as impairment of loans, 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 and non-recurring basis as of September 30, 2008 (in 000's):

| Description of Assets                    | Sept 30, 2008     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|-------------------|--|---|---|
| AFS Securities                           | \$ 96,324         | \$ 13,221  | \$ 83,103                                     |   |
| Investment in Bank equity securities     | 164               | 164  |   |   |
| Impaired Loans (non-recurring)           | 19,381            |  | 3,156   | \$ 16,225                                 |
| Core deposit intangibles (non-recurring) | 1,406             |  |   | 1,406                                     |
| <b>Total</b>                             | <b>\$ 117,275</b> | <b>\$ 13,385</b>   | <b>\$ 86,259</b>                              | <b>\$ 17,631</b>                          |

| Description of Liabilities | Sept 30, 2008    | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|----------------------------|------------------|--|---|---|
| Junior subordinated debt   | \$ 12,783        |  |   | \$ 12,783                                 |
| <b>Total</b>               | <b>\$ 12,783</b> | <b>\$ 0</b>  | <b>\$ 0</b>                                   | <b>\$ 12,783</b>                          |

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

| Description of Assets          | December 31, 2007 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------------|-------------------|--|---|---|
| AFS Securities                 | \$ 89,415         | \$ 89,415  |   |   |
| Interest Rate Swap             | (12)              |  | \$ (12)                                       |   |
| Impaired Loans (non-recurring) | 6,298             |  | 4,185   | \$ 2,113                                  |
| <b>Total</b>                   | <b>\$ 95,701</b>  | <b>\$ 89,415</b>   | <b>\$ 4,173</b>                               | <b>\$ 2,113</b>                           |

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

Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a spread forward from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded in other comprehensive income as the securities are available for sale.

Investment in Bank equity securities is classified as available for sale and is valued based upon open-market price quotes obtained from an active stock exchange. Changes in fair market value are recorded in other comprehensive income.

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 \$55,000 and \$203,000 for the nine months ended September 30, 2008, and year ended December 31, 2007, respectively. 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.

The fair value of the junior subordinated debt was determined based upon a valuation discounted cash flows model 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. For the nine month period ended September 30, 2008, management utilized a similar market spread from 3-month LIBOR to that used for the fourth quarter of 2007 when observable data were more available. The Company believes this adjustment is significant enough to the fair value determination of the junior subordinated debt as to make them Level 3 inputs as of March 31, 2008, June 30, 2008, and September 30, 2008. The junior subordinated debt was classified as Level 2 as of December 31, 2007.

The nonrecurring fair value measurements performed during the quarter ended March 31, 2008 resulted in a pretax fair value impairment adjustment of \$624,000 (\$364,000 net of tax) to the core deposit intangible asset. The adjustment is reflected as a component of noninterest expense for the quarter ended March 31, 2008 and the nine months ended September 30, 2008.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on a recurring and non-recurring basis during the periods ended September 30, 2008 and 2007 (in 000's):

|   | 9/30/2008                    |         | 9/30/2007                                     |       |
|---|------------------------------|---------|---|-------|
|   | Impaired<br>Loans<br>and CDI |         | Impaired<br>Loans<br>Business<br>Combinations |       |
| Reconciliation of Assets:                                   |                              |         |   |       |
| Beginning balance   | \$                           | 2,211   | \$  | 1,521 |
| Total gains included in earnings (or changes in net assets) |                              | (1,891) |   | (203) |
| Transfers in and/or out of Level 3                          |                              | 17,311  |   | 111   |
| Ending balance  | \$                           | 17,631  | \$  | 1,429 |
|   | \$                           | (338)   | \$  | (203) |
|   |                              |         | \$  | 9,910 |

The amount of total gains 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

|  | 9/30/2008          | 9/30/2007                |
|--|--------------------|--------------------------|
|  | Junior<br>Sub Debt | Business<br>Combinations |
| Reconciliation of Liabilities:   |                    |                          |
| Beginning balance  | \$ 0               | \$ 0                     |
| Total gains included in earnings (or changes in net assets)  | (464)              | (3,215)                  |
| Transfers in and/or out of Level 3   | 13,247             | 69,600                   |
| Ending balance   | \$ 12,783          | \$ 66,385                |
| The amount of total gains for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date | \$ (464)           | \$ (3,215)               |

During the quarter ended March 31, 2008, the Company reclassified approximately \$12.8 million in junior subordinated debt from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. The fair value of junior subordinated debt was again considered a Level 3 input at September 30, 2008. This re-class was primarily the result of continued credit market and liquidity deterioration in which credit markets for trust preferred securities became effectively inactive during the period.

#### 15. *Impairment Loss – Core Deposit Intangible*

The Company conducts periodic impairment analysis on its intangible assets and goodwill. Impairment analysis is performed at least annually or more often as conditions require.

During the first quarter of 2008, the Company performed an impairment analysis of the goodwill and core deposit intangible assets associated with the Legacy Bank merger completed during February 2007. The original goodwill and core deposit intangible assets recorded as a result of the Legacy merger totaled \$8.8 million and \$3.0 million respectively. Goodwill is not amortized. The core deposit intangible asset is being amortized over an estimated life of approximately seven years. As a result, the Company recognized \$164,000 and \$63,000 in amortization expense during the first quarter of 2008 and 2007, respectively, bringing the net remaining carrying value of the Legacy core deposit intangible to \$2.3 million at March 31, 2008.

During the impairment analysis performed as of March 31, 2008, it was determined that the original deposits purchased from Legacy Bank during February 2007 had declined faster than originally anticipated when the core deposit intangible was calculated at the time of the merger. As a result of increased deposit runoff, particularly in interest-bearing and noninterest-bearing checking accounts, the estimated value of the Legacy core deposit intangible was determined to be \$1.6 million at March 31, 2008 rather than the pre-adjustment carrying value of \$2.3 million. As a result of the impairment analysis, the Company recorded a pre-tax impairment loss of \$624,000 (\$364,000 net of tax) reflected as a component of noninterest expense for the quarter ended March 31, and the nine months ended September 30, 2008. Pursuant to the impairment analysis conducted as of March 31, 2008, the Company determined that there was no impairment to the goodwill related to the Legacy merger. During the quarter ended September 30, 2008, the Company recorded \$90,000 of amortization expense related to the Legacy core deposit intangible asset bringing the net carrying value to \$1.4 million at September 30, 2008.



**Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

*Certain matters discussed or incorporated by reference in this Quarterly Report of Form 10-Q 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. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2007.*

The Company currently has eleven banking branches, which provide financial services in Fresno, Madera, Kern, and Santa Clara counties in the state of California.

***Trends Affecting Results of Operations and Financial Position***

The following table summarizes the nine-month and 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<br>9/30/08 | YTD Average<br>12/31/07 | YTD Average<br>9/30/07 |
|--|------------------------|-------------------------|------------------------|
| Loans and Leases                         | 84.28%                 | 85.00%                  | 84.45%                 |
| Investment securities available for sale | 14.58%                 | 13.46%                  | 13.74%                 |
| Interest-bearing deposits in other banks | 1.04%                  | 1.02%                   | 1.15%                  |
| Federal funds sold                       | 0.10%                  | 0.52%                   | 0.66%                  |
| Total earning assets                     | 100.00%                | 100.00%                 | 100.00%                |
| NOW accounts                             | 8.04%                  | 8.82%                   | 9.01%                  |
| Money market accounts                    | 23.47%                 | 25.99%                  | 27.08%                 |
| Savings accounts                         | 7.62%                  | 8.79%                   | 9.14%                  |
| Time deposits                            | 45.74%                 | 50.05%                  | 48.44%                 |
| Other borrowings                         | 12.78%                 | 3.40%                   | 3.19%                  |
| Subordinated debentures                  | 2.35%                  | 2.95%                   | 3.14%                  |
| Total interest-bearing liabilities       | 100.00%                | 100.00%                 | 100.00%                |

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.

Continued weakness in the real estate markets and the general economy have impacted the Company's operations during 2008 although, the Company continues its business development and expansion efforts throughout a diverse market area.

With market rates of interest declining 100 basis points during the fourth quarter of 2007, and another 225 basis points during the first nine months of 2008, the Company has experienced continued declines in its net interest margin. The Company's net interest margin was 4.44% for the nine months ended September 30, 2008, as compared to 5.35% for the year ended December 31, 2007, and 5.50% for the nine months ended September 30, 2007. With approximately 64% of the loan portfolio in floating rate instruments at September 30, 2008, the effects of market rates continue to be realized almost immediately on loan yields. Loans yielded 7.04% during the nine months ended September 30, 2008, as compared to 9.07% for the year ended December 31, 2007, and 9.28% for the nine months ended September 30, 2007. With a significant increase in nonaccrual loans during the first nine months of 2008, the Company reversed approximately \$755,000 in interest income during the period, reducing the loan yield by approximately 17 basis points during the first nine months of 2008. Loan yield was enhanced during 2007, as a nonperforming loan was paid off during the first quarter of 2007, providing an additional \$825,000 in previously unrecognized interest income that would not have otherwise been recognized during 2007, and an enhancement to loan yield of approximately 19 basis points for the nine months ended September 30, 2007 and 14 basis points for the year ended December 31, 2007. With market rates of interest declining so rapidly during the past four quarters, deposit repricing has been slow to follow loan repricing, as deposit rate changes tend to lag the market, while floating-rate loans reprice immediately. While deposit rates have declined, 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 2.95% for the nine months ended September 30, 2008 as compared to 3.91% for the year ended December 31, 2007, and 3.90% for the nine months ended September 30, 2007.

Total noninterest income of \$5.6 million reported for the nine months ended September 30, 2008 decreased \$1.9 million or 25.3% as compared to the nine months ended September 30, 2007, primarily as the result of changes in SFAS No. 159 fair market value adjustments between the two nine-month periods on the Company's junior subordinated debt. Noninterest income continues to be driven by customer service fees, which totaled \$3.6 million for the nine months ended September 30, 2008, representing an increase of \$51,000 or 1.5% over the \$3.5 million in customer service fees reported for the nine months ended September 30, 2007. Customer service fees represented 63.0% and 46.4% of total noninterest income for the nine-month periods ended September 30, 2008 and 2007, respectively.

Noninterest expense increased approximately \$1.0 million or 6.4% between the nine-month periods ended September 30, 2007 and September 30, 2008. An impairment loss on the Company's core deposit intangible asset related to the Legacy Bank merger totaled \$624,000 or 61.4% of the increase in noninterest expense experienced during the first nine months of 2008. Other components of the increase experienced during 2008 were employee salary and benefit costs, including additional employee costs associated with the new financial services department, increased occupancy expense, and increased expenses related to other real estate owned through foreclosure. Professional fees declined \$192,000 or 15.4% between the nine-month periods ended September 30, 2007 and September 30, 2008 as the result of reductions in corporate legal fees between the two periods.

On September 23, 2008, the Company's Board of Directors declared a one-percent (1%) stock dividend on the Company's outstanding common stock. The stock dividend for the third quarter of 2008 replaces the normal quarterly cash dividend and reflects a similar value. Although the Company's capital position remains strong, the change in the dividend from cash to stock was employed as a precaution against uncertainties in the 1-4 family residential real estate market and the potential impact on the Company's construction and related land and lot loan portfolio. The Company believes, given the current uncertainties in the economy and unprecedented declines in real estate valuations in our markets, it is prudent to retain capital in this environment, and better position the Company for future growth opportunities. Based upon the number of outstanding common shares on the record date of October 10, 2008, an additional 117,732 shares were issued to shareholders on October 22, 2008. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

The Company has maintained a strong, yet conservative balance sheet during the nine months ended September 30, 2008 with only minor increases in loans during the period. Total assets increased approximately \$16.3 million during the nine months ended September 30, 2008, with increases of \$19.1 million in investment securities and interest-bearing deposits in other banks offsetting decreases in cash and due from banks. With increased average loan volume during 2008, average loans comprised approximately 84% of overall average earning assets during the nine months ended September 30, 2008.

Nonperforming assets increased during the quarter ended September 30, 2008 as real estate markets continue to suffer from the mortgage crisis which began during mid-2007. Nonaccrual loans increased \$11.1 million from the balance reported at June 30, 2008, and increased \$33.5 million from the balance reported at December 31, 2007, to a balance of \$55.1 million at September 30, 2008. This increase in nonaccrual loans during the quarter was almost exclusively in construction loans. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans increased \$33.0 million during the nine months ended September 30, 2008 and increased \$12.9 million during the third quarter of 2008 to a balance of \$53.7 million at September 30, 2008. Other real estate owned through foreclosure increased \$1.1 million between December 31, 2007 and September 30, 2008, as five properties were moved through foreclosure proceedings when all other means of collection failed. One of those foreclosed properties totaling \$1.6 million was subsequently sold during the second quarter of 2008. As a result of these events, nonperforming assets as a percentage of total assets increased from 3.66% at December 31, 2007 to 7.96% at September 30, 2008.

Management continues to monitor economic conditions in the real estate market for signs of further deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Increased charge-offs and additional loan loss provisions made during the nine months ended September 30, 2008 impacted earnings during the third quarter of 2008, but the provisions made to the allowance for credit losses, totaling \$265,000, \$548,000, and \$6.4 million during the first, second, and third quarters of 2008, respectively, are adequate to cover inherent losses in the loan portfolio. Loan and lease charge-offs totaling \$1.5 million during the quarter ended September 30, 2008 included the charge-off of a single unsecured commercial loan relationship totaling \$1.2 million.

Deposits decreased by \$32.3 million during the nine months ended September 30, 2008, as brokered deposits of \$100,000 or more matured and were replaced with less costly borrowings from the Company's FHLB lines of credit or from the Federal Reserve Discount Window. 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 nine months ended September 30, 2008, as brokered time deposits have been allowed to run off as they matured during 2008.

The Company has increasingly utilized its overnight borrowing and other term credit lines, with borrowings totaling \$86.8 million at September 30, 2008 as compared to \$32.3 million at December 31, 2007. The Company increased its use of FHLB term credit lines during the first nine months of 2008, with one-to-two year fixed-rate borrowings totaling \$28.0 million at September 30, 2008, as compared to \$10.0 million in a single two year fixed rate note at December 31, 2007. The average rate of those term borrowings was 3.43% at September 30, 2008 as compared to 4.92% at December 31, 2007, representing a cost reduction of 149 basis points during the first nine months of 2008. Overnight borrowings have increased significantly during 2008, as maturing brokered deposits were replaced with less expensive overnight borrowings through the Federal Reserve Discount window. Although the Company has realized significant interest expense reductions by utilizing these overnight borrowings lines, the use of such lines are monitored closely to ensure sound balance sheet management in light of the current economic and credit environment.

The cost of the Company's subordinated debentures issued by USB Capital Trust II has declined as market rates of interest have fallen during the nine months ended September 30, 2008. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 4.14% at September 30, 2008, representing a rate reduction of 247 basis points between December 31, 2007 and September 30, 2008. As a result of interest rate changes experienced during the first nine months of 2008 in relation to market spreads for junior subordinated debentures, the Company recorded an additional \$464,000 pretax fair value gain on its junior subordinated debt bring the total cumulative gain recorded on the debt to \$2.8 million at September 30, 2008.

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 Campbell, in Santa Clara County. The San Joaquin Valley and other California markets have shown weaker demand for construction lending and commercial lending from small and medium size businesses, as commercial and residential real estate markets declined during 2007 and throughout the first nine months of 2008. The first nine months of 2008 have presented significant challenges for the banking industry with tightening credit markets, weakening real estate markets, and increased loan losses adversely affecting the industry.

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 banking industry is currently experiencing continued pressure on net margins as well as asset quality resulting from conditions 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 be an important factor in the Company's ongoing strategic planning process.

## **Results of Operations**

For the nine months ended September 30, 2008, the Company reported net income of \$3.2 million or \$0.27 per share (\$0.27 diluted) as compared to \$10.6 million or \$0.88 per share (\$0.87 diluted) for the nine months ended September 30, 2007. For the quarter ended September 30, 2008, the Company reported a net loss of \$1.3 million or \$0.11 per share as compared to net income of \$3.7 million or \$0.30 per share (\$0.30 diluted) for the quarter ended September 30, 2007. The net loss reported during the third quarter of 2008 was primarily the result of additional provisions for loan losses totaling \$6.4 million made during the period.

The Company's return on average assets was 0.56% for the nine-month period ended September 30, 2008 as compared to 1.87% for the nine-month period ended September 30, 2007. The Bank's return on average equity was 5.18% for the nine months ended September 30, 2008 as compared to 17.43% for the same nine-month period of 2007.

### *Net Interest Income*

Net interest income before provision for credit losses totaled \$23.1 million for the nine months ended September 30, 2008, representing a decrease of \$4.6 million, or 16.7% when compared to the \$27.8 million reported for the same nine months of the previous year. The decrease in net interest income between 2007 and 2008 is primarily the result of decreased yields on interest-earning assets, which more than offset increases in volumes of earning assets, as well as decreases in the Company's cost of interest-bearing liabilities.

The Bank's net interest margin, as shown in Table 1, decreased to 4.44% at September 30, 2008 from 5.50% at September 30, 2007, a decrease of 106 basis point (100 basis points = 1%) between the two periods. Average market rates of interest have decreased significantly between the nine-month periods ended September 30, 2007 and 2008. The prime rate averaged 5.43% for the nine months ended September 30, 2008 as compared to 8.23% for the comparative nine months of 2007.

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

Interest rates and Interest Differentials

Nine Months Ended September 30, 2008 and 2007

| (dollars in thousands)                           | Average<br>Balance | 2008<br>Interest | Yield/<br>Rate | Average<br>Balance | 2007<br>Interest | Yield/<br>Rate |
|--|--------------------|------------------|----------------|--------------------|------------------|----------------|
| <b>Assets:</b>                                   |                    |                  |                |                    |                  |                |
| Interest-earning assets:                         |                    |                  |                |                    |                  |                |
| Loans and leases (1)                             | \$ 587,647         | \$ 30,960        | 7.04%          | \$ 569,730         | \$ 39,542        | 9.28%          |
| Investment Securities –<br>taxable               | 100,152            | 3,910            | 5.21%          | 90,466             | 2,882            | 4.26%          |
| Investment Securities –<br>nontaxable (2)        | 1,520              | 54               | 4.75%          | 2,227              | 81               | 4.86%          |
| Interest-bearing deposits in<br>other banks      | 7,262              | 169              | 3.11%          | 7,762              | 223              | 3.84%          |
| Federal funds sold and<br>reverse repos          | 730                | 18               | 3.29%          | 4,485              | 183              | 5.46%          |
| Total interest-earning assets                    | 697,311            | \$ 35,111        | 6.73%          | 674,670            | \$ 42,911        | 8.50%          |
| Allowance for credit losses                      | (11,079)           |                  |                | (9,648)            |                  |                |
| Noninterest-bearing assets:                      |                    |                  |                |                    |                  |                |
| Cash and due from banks                          | 20,926             |                  |                | 24,587             |                  |                |
| Premises and equipment,<br>net                   | 15,148             |                  |                | 15,950             |                  |                |
| Accrued interest receivable                      | 2,915              |                  |                | 4,187              |                  |                |
| Other real estate owned                          | 7,619              |                  |                | 1,953              |                  |                |
| Other assets                                     | 44,062             |                  |                | 42,411             |                  |                |
| Total average assets                             | \$ 776,902         |                  |                | \$ 754,110         |                  |                |
| <b>Liabilities and<br/>Shareholders' Equity:</b> |                    |                  |                |                    |                  |                |
| Interest-bearing liabilities:                    |                    |                  |                |                    |                  |                |
| NOW accounts                                     | \$ 43,594          | \$ 169           | 0.52%          | \$ 46,675          | \$ 221           | 0.63%          |

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|  |            |           |       |            |           |       |
|--|------------|-----------|-------|------------|-----------|-------|
| Money market accounts                                      | 127,252    | 2,307     | 2.42% | 140,337    | 3,271     | 3.12% |
| Savings accounts   | 41,299     | 386       | 1.25% | 47,384     | 691       | 1.95% |
| Time deposits  | 247,959    | 7,094     | 3.82% | 250,983    | 9,299     | 4.95% |
| Other borrowings   | 69,280     | 1,478     | 2.85% | 16,513     | 657       | 5.32% |
| Junior subordinated debentures                             | 12,742     | 536       | 5.62% | 16,272     | 984       | 8.09% |
| Total interest-bearing liabilities                         | 542,126    | \$ 11,970 | 2.95% | 518,164    | \$ 15,123 | 3.90% |
| Noninterest-bearing liabilities:                           |            |           |       |            |           |       |
| Noninterest-bearing checking                               | 143,413    |           |       | 145,471    |           |       |
| Accrued interest payable                                   | 1,224      |           |       | 2,238      |           |       |
| Other liabilities  | 6,868      |           |       | 7,185      |           |       |
| Total Liabilities  | 693,631    |           |       | 673,058    |           |       |
| Total shareholders' equity                                 | 83,271     |           |       | 81,052     |           |       |
| Total average liabilities and shareholders' equity         | \$ 776,902 |           |       | \$ 754,110 |           |       |
| Interest income as a percentage of average earning assets  |            |           | 6.73% |            |           | 8.50% |
| Interest expense as a percentage of average earning assets |            |           | 2.29% |            |           | 3.00% |
| Net interest margin  |            |           | 4.44% |            |           | 5.50% |



- (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 \$2,523,000 and \$2,285,000 for the nine months ended September 30, 2008 and 2007, 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.

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 periods indicated.

Table 2. Rate and Volume Analysis

| <i>(In thousands)</i>  | Increase (decrease) in the nine months ended<br>Sept 30, 2008 compared to Sept 30, 2007 |                   |               |
|--|---|-------------------|---------------|
|  | Total   | Rate              | Volume        |
| <b>Increase (decrease) in interest income:</b>                         |   |                   |               |
| Loans and leases   | \$ (8,582)  | \$ (9,804)        | \$ 1,222      |
| Investment securities available for sale                               | 1,001   | 690               | 311           |
| Interest-bearing deposits in other banks                               | (54)  | (43)              | (11)          |
| Federal funds sold and securities purchased under agreements to resell | (165)   | (53)              | (112)         |
| <b>Total interest income</b>   | <b>(7,800)</b>  | <b>(9,210)</b>    | <b>1,410</b>  |
| <b>Increase (decrease) in interest expense:</b>                        |   |                   |               |
| Interest-bearing demand accounts                                       | (1,016)   | (736)             | (280)         |
| Savings accounts   | (305)   | (225)             | (80)          |
| Time deposits  | (2,205)   | (2,096)           | (109)         |
| Other borrowings   | 821   | (430)             | 1,251         |
| Subordinated debentures  | (448)   | (262)             | (186)         |
| <b>Total interest expense</b>  | <b>(3,153)</b>  | <b>(3,749)</b>    | <b>596</b>    |
| <b>Increase (decrease) in net interest income</b>                      | <b>\$ (4,647)</b>   | <b>\$ (5,461)</b> | <b>\$ 814</b> |

For the nine months ended September 30, 2008, total interest income decreased approximately \$7.8 million, or 18.2% as compared to the nine-month period ended September 30, 2007. Earning asset volumes increased almost exclusively in loans, with minor increases experienced in investment securities.

For the nine months ended September 30, 2008, total interest expense decreased approximately \$3.2 million, or 20.8% as compared to the nine-month period ended September 30, 2007. Between those two periods, average interest-bearing liabilities increased by \$24.0 million, while the average rates paid on these liabilities decreased by 95 basis points.

Provisions for credit losses are determined on the basis of management's periodic 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 nine months ended September 30, 2008, the provision to the allowance for credit losses amounted to \$7.2 million as compared to \$2.4 million for the nine months ended September 30, 2007. The provision to the allowance for credit losses for the quarter ended September 30, 2008 totaled \$6.4 million as compared to \$2.0 million for the quarter ended September 30, 2007. The amount provided to the allowance for credit losses during the first nine months of 2008 brought the allowance to 2.66% of net outstanding loan balances at September 30, 2008, as compared to 1.83% of net outstanding loan balances at December 31, 2007, and 1.62% at September 30, 2007.

**Noninterest Income****Table 3. Changes in Noninterest Income**

The following table sets forth the amount and percentage changes in the categories presented for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007:

| <i>(In thousands)</i>                       | 2008            | 2007            | Amount of<br>Change | Percent<br>Change |
|---|-----------------|-----------------|---------------------|-------------------|
| Customer service fees                       | \$ 3,554        | \$ 3,503        | \$ 51               | 1.46%             |
| Gain on redemption of securities            | 24              | 0               | 24                  | —                 |
| Gain on sale of OREO                        | 67              | 35              | 32                  | 91.43%            |
| Proceeds from bank-owned life insurance     | 0               | 483             | (483)               | -100.00%          |
| Gain (loss) on swap ineffectiveness         | 9               | 44              | (35)                | -79.55%           |
| Gain on fair value of financial liabilities | 464             | 2,234           | (1,770)             | -79.23%           |
| Shared appreciation income                  | 265             | 34              | 231                 | 679.41%           |
| Other                                       | 1,261           | 1,221           | 40                  | 3.28%             |
| <b>Total noninterest income</b>             | <b>\$ 5,644</b> | <b>\$ 7,554</b> | <b>\$ (1,910)</b>   | <b>-25.28%</b>    |

Noninterest income for the nine months ended September 30, 2008 decreased \$1.9 million or 25.3% when compared to the same period of 2007. Net decreases in total noninterest income experienced during 2008 were the primarily the result of SFAS No. 157 fair value gain adjustments on the Company's junior subordinated debt totaling \$464,000 during the nine months ended September 30, 2008, which represents a decrease of \$1.8 million from the fair market value gains recognized during the nine months ended September 30, 2008. Customer service fees increased \$51,000 or 1.5% between the two nine-month periods presented, which is attributable in part to increases in revenues from the Company's newly acquired financial services department, as well as increases in NSF fees, which were partially offset by declines in ATM fees. Proceeds from bank-owned life insurance decreased \$483,000 between the nine months ended September 30, 2007 and September 30, 2008 as the result of an employee death-benefit payment received during 2007 that did not again occur during 2008.

**Noninterest Expense**

The following table sets forth the amount and percentage changes in the categories presented for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007:

**Table 4. Changes in Noninterest Expense**

| <i>(In thousands)</i>                      | 2008     | 2007     | Amount of<br>Change | Percent<br>Change |
|--|----------|----------|---------------------|-------------------|
| Salaries and employee benefits             | \$ 8,200 | \$ 7,972 | \$ 228              | 2.86%             |
| Occupancy expense                          | 2,977    | 2,662    | 315                 | 11.83%            |
| Data processing                            | 216      | 326      | (110)               | -33.74%           |
| Professional fees                          | 1,059    | 1,251    | (192)               | -15.35%           |
| Directors fees                             | 196      | 201      | (5)                 | -2.49%            |
| Amortization of intangibles                | 737      | 740      | (3)                 | -0.41%            |
| Correspondent bank service charges         | 329      | 343      | (14)                | -4.08%            |
| Impairment loss on core deposit intangible | 624      | 0        | 624                 | —                 |

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|   |           |           |          |        |
|---|-----------|-----------|----------|--------|
| Loss on California tax credit partnership | 324       | 324       | 0        | 0.00%  |
| Impairment loss on OREO                   | 31        | 0         | 31       | —      |
| OREO expense                              | 211       | 118       | 93       | 78.81% |
| Other                                     | 2,121     | 2,072     | 49       | 2.36%  |
| Total expense                             | \$ 17,025 | \$ 16,009 | \$ 1,016 | 6.35%  |

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Increases in noninterest expense between the nine months ended September 30, 2007 and 2008 are associated primarily with normal continued growth of the Company, including additional staffing costs, and costs associated, in part, with the new financial services department located in Fresno, California. During the first quarter of 2008, the Company recorded an impairment loss of \$624,000 on the core deposit intangible related to the Legacy Bank merger.

The Company recognized stock-based compensation expense of \$91,000 and \$140,000 for the nine months ended September 30, 2008 and 2007, respectively. This expense is included in noninterest expense under salaries and employee benefits. The Company expects stock-based compensation expense to be about \$29,000 per quarter during the remainder of 2008. Under the current pool of stock options, stock-based compensation expense will decline to approximately \$17,000 per quarter during 2009, then to \$8,000 per quarter for 2010, and decline after that through 2011. If new stock options are issued, or existing options fail to vest, for example, due to unexpected forfeitures, 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 since 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. Since the adoption of FIN48 on January 1, 2007, the Company has increased the unrecognized tax liability by an additional \$130,000 in interest, including \$87,000 during 2007 and \$43,000 during the first nine months of 2008, bringing the total recorded tax liability under FIN48 to \$1.4 million at September 30, 2008. 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 September 30, 2008, 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 \$16.3 million, or 2.11% to a balance of \$788.0 million at September 30, 2008, from the balance of \$771.7 million at December 31, 2007, and decreased \$15.0 million or 1.86% from the balance of \$803.0 million at September 30, 2007. Total deposits of \$602.3 million at September 30, 2008 decreased \$32.3 million, or 5.09% from the balance reported at December 31, 2007, and decreased \$67.2 million from the balance of \$669.5 million reported at September 30, 2007. Between December 31, 2007 and September 30, 2008, loans increased \$9.4 million, or 1.56% to a balance of \$607.6 million, while investment securities increased by \$7.0 million, or 7.73%, and interest-bearing deposits in other banks increased \$12.2 million or 419.11%.

Earning assets averaged approximately \$697.3 million during the nine months ended September 30, 2008, as compared to \$674.7 million for the same nine-month period of 2007. Average interest-bearing liabilities increased to \$542.1 million for the nine months ended September 30, 2008, as compared to \$518.2 million for the comparative nine-month period of 2007.

***Loans and Leases***

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 \$607.6 million at September 30, 2008, an increase of \$9.4 million or 1.56% when compared to the balance of \$598.2 million at December 31, 2007, and a decrease of \$18.4 million or 2.93% when compared to the balance of \$625.9 million reported at September 30, 2007. Loans on average increased \$17.9 million or 3.14% between the nine-month periods ended September 30, 2007 and September 30, 2008, with loans averaging \$587.6 million for the nine months ended September 30, 2008, as compared to \$569.7 million for the same nine-month period of 2007.

During the first nine months of 2008, increases were experienced in commercial and industrial loans, agricultural loans, and installment loans. During the first nine months of 2008, declines were experienced in construction loans and real estate mortgage loans, with the strongest decline experienced in real estate construction lending as a result of declines in new home sales within the Company's market area. The following table sets forth the amounts of loans outstanding by category at September 30, 2008 and December 31, 2007, the category percentages as of those dates, and the net change between the two periods presented.

**Table 5. Loans**

| <i>(In thousands)</i>      | September 30, 2008 |               | December 31, 2007 |               | Net Change      | % Change     |
|----------------------------|--------------------|---------------|-------------------|---------------|-----------------|--------------|
|                            | Dollar Amount      | % of Loans    | Dollar Amount     | % of Loans    |                 |              |
| Commercial and industrial  | \$ 229,352         | 37.7%         | \$ 204,385        | 34.2%         | \$ 24,967       | 12.22%       |
| Real estate – mortgage     | 132,085            | 21.7%         | 142,565           | 23.8%         | (10,480)        | -7.35%       |
| Real estate – construction | 160,630            | 26.5%         | 178,296           | 29.8%         | (17,666)        | -9.91%       |
| Agricultural               | 57,663             | 9.5%          | 46,055            | 7.7%          | 11,608          | 25.20%       |
| Installment/other          | 20,572             | 3.4%          | 18,171            | 3.0%          | 2,401           | 13.21%       |
| Lease financing            | 7,276              | 1.2%          | 8,748             | 1.5%          | (1,472)         | -16.82%      |
| <b>Total Gross Loans</b>   | <b>\$ 607,578</b>  | <b>100.0%</b> | <b>\$ 598,220</b> | <b>100.0%</b> | <b>\$ 9,358</b> | <b>1.56%</b> |

The overall average yield on the loan portfolio was 7.04% for the nine months ended September 30, 2008, as compared to 9.28% for the nine months ended September 30, 2007, and decreased between the two periods primarily as the result of a decline in average market rates of interest between the two periods. Loan yields declined, in part, as the result of the reversal of approximately \$755,000 in interest income on nonaccrual loans during the nine months

ended September 30, 2008, which reduced loan yield by approximately 0.17% during the period. The loan yield realized during the first nine months of 2007 was enhanced to some degree as the result of a nonperforming loan that was paid off during the quarter, providing an additional \$825,000 in previously unrecognized interest income, and an increase in loan yield for the first nine months of 2007 of approximately 0.19%. At September 30, 2008, 63.8% of the Company's loan portfolio consisted of floating rate instruments, as compared to 62.2% of the portfolio at December 31, 2007, with the majority of those tied to the prime rate.



**Deposits**

Total deposits decreased during the period to a balance of \$602.3 million at September 30, 2008 representing a decrease of \$32.3 million, or 5.09% from the balance of \$634.6 million reported at December 31, 2007, and a decrease of \$67.2 million, or 10.04% from the balance reported at September 30, 2007. During the first nine months of 2008, decreases were experienced primarily in time deposits of \$100,000 or more, with only minor declines in savings accounts. Increases were experienced in noninterest-bearing deposits, NOW and money market accounts, savings accounts, and time deposits of less than \$100,000. The decline of \$93.0 million in time deposits of \$100,000 or more experienced during the first nine months of 2008 was primarily in brokered deposits, as maturing brokered deposits were replaced with less expensive overnight and short-term borrowings.

The following table sets forth the amounts of deposits outstanding by category at September 30, 2008 and December 31, 2007, and the net change between the two periods presented.

**Table 6. Deposits**

| <i>(In thousands)</i>           | September 30,<br>2008 | December 31,<br>2007 | Net<br>Change | Percentage<br>Change |
|---------------------------------|-----------------------|----------------------|---------------|----------------------|
| Noninterest bearing deposits    | \$ 154,186            | \$ 139,066           | \$ 15,120     | 10.87%               |
| Interest bearing deposits:      |                       |                      |               |                      |
| NOW and money market accounts   | 181,912               | 153,717              | 28,195        | 18.34%               |
| Savings accounts                | 39,010                | 40,012               | (1,002)       | -2.50%               |
| Time deposits:                  |                       |                      |               |                      |
| Under \$100,000                 | 70,654                | 52,297               | 18,357        | 35.10%               |
| \$100,000 and over              | 156,523               | 249,525              | (93,002)      | -37.27%              |
| Total interest bearing deposits | 448,099               | 495,551              | (47,452)      | -9.58%               |
| Total deposits                  | \$ 602,285            | \$ 634,617           | \$ (32,332)   | -5.09%               |

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 decreased \$47.5 million, or 9.58% between December 31, 2007 and September 30, 2008, while noninterest-bearing deposits increased \$15.1 million, or 10.87% between the same two periods presented.

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 Company's principal sources of funding and liquidity. These core deposits amounted to 69.5% and 59.9% of the total deposit portfolio at September 30, 2008 and December 31, 2007, respectively. Brokered deposits totaled \$83.7 million at September 30, 2008 as compared to \$139.3 million at December 31, 2007 and \$122.9 million at September 30, 2007. The Company has allowed approximately \$55.6 million in brokered deposits to runoff as they matured during the nine months ended September 30, 2008, and has utilized more cost-effective overnight borrowing lines through Federal Reserve Discount Window.

On a year-to-date average (refer to Table 1), the Company experienced a decrease of \$27.3 million or 4.33% in total deposits between the nine-month periods ended September 30, 2007 and September 30, 2008. Between these two periods, average interest-bearing deposits decreased \$25.3 million or 5.21%, while total noninterest-bearing checking decreased \$2.1 million or 1.41% on a year-to-date average basis.

**Short-Term Borrowings**

The Company had collateralized and uncollateralized lines of credit aggregating \$286.6 million, as well as FHLB lines of credit totaling \$32.8 million at September 30, 2008. 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. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time. At September 30, 2008, the Company had \$28.0 million borrowed against its FHLB lines of credit. The \$28.0 million in FHLB borrowings outstanding at September 30, 2008 consists of a various FHLB term-advances (summarized in table below.) The Company had collateralized and uncollateralized lines of credit aggregating \$386.7 million, as well as FHLB lines of credit totaling \$22.0 million at December 31, 2007.

FHLB term borrowings at September 30, 2008 (in 000's):

| Term   | Balance at 9/30/08 | Rate  | Maturity |
|--------|--------------------|-------|----------|
| 1 year | \$ 7,000           | 2.51% | 2/11/09  |
| 2 year | 10,000             | 4.92% | 3/30/09  |
| 2 year | 11,000             | 2.67% | 2/11/10  |
|        | \$ 28,000          | 3.43% |          |

***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 conclusion that a loan may become uncollectible, either in part or in whole is judgmental and subject to economic, environmental, and other conditions which cannot be predicted with certainty. When determining the adequacy of the allowance for credit losses, the Company follows, in accordance with GAAP, the guidelines set forth in the Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued by banking regulators during December 2006. The Statement is a revision of the previous guidance released in July 2001, and 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, and updates previous guidance that describes the responsibilities of the board of directors, management, and bank examiners regarding the allowance for credit losses. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was released during July 2001, and 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 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 identified as impaired, or for problem graded loans which may require reserves in excess of the formula allowance,
- 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. 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. At September 30, 2008 problem graded or "classified" loans totaled \$105.1 million or 17.3% of gross loans as compared to \$51.8 million or 8.7% of gross loans at December 31, 2008.

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.

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 concentrations, and other business conditions.

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at September 30, 2008 and December 31, 2007.

| (in 000's)   | Balance<br>September 30, 2008 | Balance<br>December 31, 2007 |
|--|-------------------------------|------------------------------|
| Specific allowance – impaired loans                      | \$ 7,953                      | \$ 4,452                     |
| Formula allowance – special mention and classified loans | 3,860                         | \$ 2,459                     |
| Total allowance for special mention and classified loans | 11,813                        | 6,911                        |
| Formula allowance for pass loans                         | 3,973                         | 3,990                        |
| Unallocated allowance                                    | 320                           | 0                            |
| Total allowance  | \$ 16,106                     | \$ 10,901                    |

Impaired loans increased approximately \$33.0 million between December 31, 2007 and September 30, 2008, and increased approximately \$12.9 million during the quarter ended September 30, 2008. The specific allowance related to impaired loans increased \$3.5 million and \$3.8 million for the nine months and quarter ended September 30, 2008, respectively. The formula allowance related to loans that are not impaired (including special mention and substandard) increased approximately \$1.4 million between December 31, 2007 and September 30, 2008, and increased \$900,000 during the quarter ended September 30, 2008. Increases for the nine months ended September 30, 2008 were the result of increases in the volume of substandard and special mention loans, as well as minor increases in adjusting factors for current economic trends and conditions, and trends in delinquent and nonaccrual loans. Even though the level of "pass" loans decreased during the nine months ended September 30, 2008, the related formula allowance has remained level over that period as a result of an increase in commercial and industrial loans which have a higher percentage loss allocation, as well as factor allocation increases due to current economic conditions.

At September 30, 2008, the Company segregated approximately \$26.6 million of the total \$46.8 million in substandard classified loans for purposes of the quarterly analysis of the adequacy of the allowance for credit losses under SFAS No. 5. Many of these loans had been downgraded to substandard because the borrowers had other direct or indirect lending relationships which were classified as substandard or impaired. The \$26.6 million in substandard loans consists of ten borrowing relationships, which although classified as substandard, the Company believes are performing and therefore do not warrant the same loss factors as other substandard loans in the portfolio. The adequacy of the allowance for credit losses related to this \$26.6 million pool of substandard loans was based upon current payment history, loan-to-value ratios, future anticipated performance, and other various factors. The formula allowance for credit losses related to these substandard loans totaled \$1.2 million at September 30, 2008. This formula reserve is included in the formula allowance for special mention and classified loans totaling \$2.9 million in the table above.

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 concentrations, and 10) other business conditions. Other than for the segregation of approximately \$26.6 million in substandard loans at September 30, 2008 discussed above, there were no changes in estimation methods or assumptions that affected the methodology for assessing the adequacy of the allowance for credit losses during the nine months ended September 30, 2008.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly/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.

Impaired loans are calculated under SFAS No. 114, and 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.

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 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.

At September 30, 2008 and 2007, the Company's recorded investment in loans for which impairment has been identified totaled \$53.7 million and \$23.1 million, respectively. Included in total impaired loans at September 30, 2008, are \$27.3 million of impaired loans for which the related specific allowance is \$8.0 million, as well as \$26.4 million of impaired loans that as a result of write-downs or the sufficiency of the fair value of the collateral, did not have a specific allowance. Total impaired loans at September 30, 2007 included \$12.9 million of impaired loans for which the related specific allowance is \$5.2 million, as well as \$10.2 million of impaired loans that, as a result of write-downs or the sufficiency of the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$32.8 million during the first nine months of 2008 and \$14.7 million during the first nine months of 2007. 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 nine months ended September 30, 2008 and 2007, the Company recognized no income on such loans.

As with nonaccrual loans, the greatest increase in impaired loans during the nine months ended September 30, 2008 has been in real estate construction loans, with that loan category comprising more than 74% of total impaired loans at September 30, 2008. Although construction loans are generally collateral dependent and the related collateral is considered adequate to cover the loan's carrying value in many cases, the specific reserve related to impaired construction loans has increased approximately \$3.5 million since December 31, 2007 as property valuations have declined. Specific collateral related to impaired loans is reviewed for current appraisal information, economic trends within geographic markets, loan-to-value ratios, and other factors that may impact the value of the loan collateral. Adjustments are made to collateral values as needed for these factors. Of total impaired loans, approximately \$46.5 million or 86.6% are secured by real estate, and \$43.2 million of total impaired loans are for the purpose of residential construction, residential and commercial acquisition and development, and land development. Residential construction loans are made for the purpose of building residential 1-4 single family homes. Residential and commercial acquisition and development loans are made for the purpose of purchasing land, and developing that land if required, and to develop real estate or commercial construction projects on those properties. Land development loans are made for the purpose of converting raw land into construction-ready building sites. The following table summarizes the components of impaired loans and their related specific reserves at September 30, 2008 and December 31, 2007.

| (in 000's)                 | Balance<br>Sept 30, 2008 | Reserve<br>Sept 30, 2008 | Balance<br>December 31,<br>2007 | Reserve<br>December 31,<br>2007 |
|----------------------------|--------------------------|--------------------------|---------------------------------|---------------------------------|
| Commercial and industrial  | \$ 7,831                 | \$ 294                   | \$ 7,617                        | \$ 339                          |
| Real estate - mortgage     | 600                      | 0                        | 0                               | 0                               |
| Real estate - construction | 39,799                   | 4,133                    | 7,474                           | 598                             |
| Agricultural               | 0                        | 0                        | 0                               | 0                               |
| Installment/other          | 0                        | 0                        | 0                               | 0                               |
| Lease financing            | 5,425                    | 3,526                    | 5,536                           | 3,516                           |
| <b>Total</b>               | <b>\$ 53,655</b>         | <b>\$ 7,953</b>          | <b>\$ 20,627</b>                | <b>\$ 4,453</b>                 |

Of the \$39.8 million in impaired construction loans shown above, approximately \$18.6 million or 46.8% are for residential construction, \$10.9 million or 27.3% are for residential acquisition and development, and another \$10.3 million or 25.9% are for land development. Of the \$7.8 million in impaired commercial and industrial loans, nearly \$2.7 million or 34.4% are for land development. Geographically, the \$43.2 million in impaired loans made for the purpose of residential construction, residential and commercial acquisition and development, and land development, are disbursed throughout a wide area of California, with approximately 40.3% of those loans within Fresno, Madera, Kern, and Santa Clara Counties. The following table summarizes the impaired loan balances by county of loans made for the purpose of residential construction, residential and commercial acquisition and development, and land development as of September 30, 2008.

| County:        | Impaired        |            |
|----------------|-----------------|------------|
|                | Balance (000's) | Percentage |
| Fresno         | \$ 12,779       | 29.56%     |
| Madera         | 259             | 0.60%      |
| Kern           | 140             | 0.32%      |
| Santa Clara    | 4,240           | 9.81%      |
| Alpine         | 7,973           | 18.44%     |
| Los Angeles    | 1,435           | 3.32%      |
| Merced         | 2,524           | 5.84%      |
| Monterey       | 7,781           | 18.00%     |
| Tulare         | 5,503           | 12.73%     |
| Other counties | 600             | 1.39%      |



|                                |    |        |         |
|--------------------------------|----|--------|---------|
| Total R.E. related<br>impaired | \$ | 43,234 | 100.00% |
|--------------------------------|----|--------|---------|

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, 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, another 225 basis points during the first nine months of 2008, and then another 50 basis points during October 2008, indications are that the economy will continue to suffer 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 showed signs of slowing during the past several quarters, and current GDP projections for the next year have softened significantly. 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 more stable economically during the past several years than other areas of the state and the nation, which have experienced more volatile economic trends, including significant softening of residential real estate markets. Although the local area residential housing markets have softened to a large degree, they continue to perform better than other parts of the state, which should bode well for sustained, but slower 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.

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

Table 7. Allowance for Credit Losses - Summary of Activity (unaudited)

| <i>(In thousands)</i>  | September 30,<br>2008 | September 30,<br>2007 |
|--|-----------------------|-----------------------|
| Total loans outstanding at end of period before deducting allowances for credit losses | \$ 606,212            | \$ 624,091            |
| Average net loans outstanding during period  | 587,647               | 569,730               |
| Balance of allowance at beginning of period  | 10,901                | 8,365                 |
| Loans charged off:   |                       |                       |
| Real estate  | (473)                 | 0                     |
| Commercial and industrial  | (1,105)               | (1,793)               |
| Lease financing  | (273)                 | (8)                   |
| Installment and other  | (255)                 | (115)                 |
| Total loans charged off  | (2,106)               | (1,916)               |
| Recoveries of loans previously charged off:  |                       |                       |
| Real estate  | 0                     | 0                     |
| Commercial and industrial  | 72                    | 27                    |
| Lease financing  | 13                    | 0                     |
| Installment and other  | 11                    | 17                    |
| Total loan recoveries  | 96                    | 44                    |
| Net loans charged off  | (2,010)               | (1,872)               |
| Provision charged to operating expense   | 7,215                 | 2,360                 |
| Reserve acquired in business combination   | 0                     | 1,268                 |
| Balance of allowance for credit losses at end of period                                | \$ 16,106             | \$ 10,121             |
| Net loan charge-offs to total average loans (annualized)                               | 0.46%                 | 0.44%                 |
| Net loan charge-offs to loans at end of period (annualized)                            | 0.44%                 | 0.40%                 |
| Allowance for credit losses to total loans at end of period                            | 2.66%                 | 1.62%                 |
| Net loan charge-offs to allowance for credit losses (annualized)                       | 16.67%                | 24.73%                |
| Net loan charge-offs to provision for credit losses (annualized)                       | 27.86%                | 79.32%                |

At September 30, 2008 and 2007, \$384,000 and \$609,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, carried separately in other liabilities. Management believes that the 2.66% credit loss allowance at September 30, 2008 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.

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 ability 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.



Table 8. Nonperforming Assets

| <i>(In thousands)</i>                          | September 30,<br>2008 | December 31,<br>2007 |
|--|-----------------------|----------------------|
| Nonaccrual Loans                               | \$ 55,116             | \$ 21,583            |
| Restructured Loans                             | 0                     | 23                   |
| Total nonperforming loans                      | 55,116                | 21,606               |
| Other real estate owned                        | 7,728                 | 6,666                |
| Total nonperforming assets                     | \$ 62,844             | \$ 28,272            |
| Loans past due 90 days or more, still accruing | \$ 894                | \$ 189               |
| Nonperforming loans to total gross loans       | 9.07%                 | 3.61%                |
| Nonperforming assets to total gross loans      | 10.34%                | 4.73%                |

Non-performing assets have increased between December 31, 2007 and September 30, 2008 as declines in real estate markets and related sectors experienced since the later part of 2007 resulting from lending problems continue to impact credit markets and the general economy during 2008. Nonaccrual loans increased \$33.5 million between December 31, 2007 and September 30, 2008, with construction loans comprising approximately 71% of total nonaccrual loans at September 30, 2008, and commercial and industrial loans comprising another 16%. The following table summarizes the nonaccrual totals by loan category for the periods shown.

|                              | Balance<br>Sept 30,<br>2008 | Balance<br>June 30,<br>2008 | Balance<br>December<br>31, 2007 | Change<br>from<br>June 30,<br>2008 | Change<br>from<br>December<br>31, 2007 |
|------------------------------|-----------------------------|-----------------------------|---------------------------------|------------------------------------|--|
| Nonaccrual Loans (in 000's): |                             |                             |                                 |                                    |  |
| Commercial and industrial    | \$ 8,766                    | \$ 7,849                    | \$ 6,372                        | \$ 917                             | \$ 2,394                               |
| Real estate - mortgage       | 1,747                       | 1,027                       | 428                             | 720                                | 1,319                                  |
| Real estate - construction   | 39,088                      | 29,571                      | 7,548                           | 9,517                              | 31,540                                 |
| Agricultural                 | 0                           | 0                           | 1,684                           | 0                                  | (1,684)                                |
| Installment/other            | 20                          | 12                          | 3                               | 8                                  | 17                                     |
| Lease financing              | 5,495                       | 5,590                       | 5,548                           | (95)                               | (53)                                   |
| Total Nonaccrual Loans       | \$ 55,116                   | \$ 44,049                   | \$ 21,583                       | \$ 11,067                          | \$ 33,533                              |

Increases in nonaccrual construction loans are the result of a significant slowdown in new housing starts and the resultant depreciation in land, and both partially completed and completed construction projects. As with impaired loans, a large percentage of nonaccrual loans were made for the purpose of residential construction, residential and commercial acquisition and development, and land development. The following table summarizes nonaccrual balances by purpose at September 30, 2008.

| <i>(in 000's)</i>                                      | September 30,<br>2008 |
|--|-----------------------|
| Residential construction                               | \$ 17,935             |
| Residential and commercial acquisition and development | 11,013                |
| Land development                                       | 13,678                |
| Other purposes   | 12,490                |
|  | \$ 55,116             |

Total nonaccrual  
loans

During the nine months ended September 30, 2008, five loans totaling approximately \$2.8 million were transferred from nonaccrual status to other real estate owned. Non-performing assets totaled 10.34% of total loans at September 30, 2008 as compared to 4.73% of total loans at December 31, 2007.

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 2002 (see “*Asset Quality and Allowance for Credit Losses*” section of *Management’s Discussion and Analysis of Financial Condition and Results of Operations* contained in the Company’s 2007 Annual Report on Form 10-K). The impaired lease portfolio is on non-accrual status and has a specific allowance allocation of \$3.5 million allocated at both September 30, 2008 and December 31, 2007, and a net carrying value of \$1.9 million at both September 30, 2008 and December 31, 2007. The specific allowance was determined based on an estimate of expected future cash flows.

The Company believes that under generally accepted accounting principles a total loss of principal is not probable, and the specific allowance of \$3.5 million calculated for the impaired lease portfolio at September 30, 2008 under SFAS No. 114 is in accordance with generally accepted accounting principles.

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, or those otherwise included in the impaired loan totals, there were no loans at September 30, 2008 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.

#### **Asset/Liability Management – Liquidity and Cash Flow**

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 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.

The Company continues to emphasize liability management as part of its overall asset/liability 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 63.8% of the Company’s loan portfolio at September 30, 2008. 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. Additional liquidity requirements may be funded with overnight or term borrowing arrangements with various correspondent banks, FHLB and the Federal Reserve Bank. 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 September 30, 2008, the Bank had 74.9% of total assets in the loan portfolio and a loan to deposit ratio of 100.7%, as compared to 75.9% of total assets in the loan portfolio and a loan to deposit ratio of 94.0% at December 31, 2007. Liquid assets at September 30, 2008 include cash and cash equivalents totaling \$17.9 million as compared to \$25.3 million at December 31, 2007. Other sources of liquidity include collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$319.4 million at September 30, 2008.

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 the nine months ended September 30, 2008, cash dividends paid by the Bank to the parent company totaled \$4.3 million dollars.

*Cash Flow*

Cash and cash equivalents have declined during the two nine-month periods ended September 30, 2007 and 2008 with period-end balances as follows (*from Consolidated Statements of Cash Flows – in 000's*):

|                    | Balance   |
|--------------------|-----------|
| December 31, 2006  | \$ 43,068 |
| September 30, 2007 | \$ 28,881 |
| December 31, 2007  | \$ 25,300 |
| September 30, 2008 | \$ 17,872 |

Cash and cash equivalents decreased \$7.4 million during the nine months ended September 30, 2008, as compared to a decrease of \$14.2 million during the nine months ended September 30, 2007.

The Company has maintained positive cash flows from operations, which amounted to \$10.9 million, and \$14.8 million for the nine months ended September 30, 2008, and September 30, 2007, respectively. The Company experienced net cash outflows from investing activities totaling \$35.0 million during the nine months ended September 30, 2008, as purchases of investment securities and net loan growth exceeded net loan payoffs and maturities of investment securities during the period. The Company experienced net cash outflows from investing activities totaling \$53.2 million during the nine months ended September 30, 2007 as loan growth exceeded net maturities of investment securities and other sources from investing activities during that nine-month period.

Net cash flows from financing activities, including deposit growth and borrowings, have traditionally provided funding sources for loan growth, and as a result of increases in total deposits and other borrowed funds during the first nine months of 2008, the Company experienced net cash inflows totaling \$16.7. The Company has the ability to decrease loan growth, increase deposits and borrowings, or a combination of both to manage balance sheet liquidity.

**Regulatory Matters***Capital Adequacy*

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. 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.

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. Insured institutions are required to maintain a 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.

The following table sets forth the Company's and the Bank's actual capital positions at September 30, 2008 and the minimum capital requirements for both under the regulatory guidelines discussed above:





Table 9. Capital Ratios

|  | Company<br>Actual<br>Capital Ratios | Bank<br>Actual<br>Capital Ratios | Minimum<br>Capital Ratios |
|--|-------------------------------------|----------------------------------|---------------------------|
| Total risk-based capital ratio         | 12.56%                              | 12.17%                           | 10.00%                    |
| Tier 1 capital to risk-weighted assets | 11.30%                              | 10.91%                           | 6.00%                     |
| Leverage ratio                         | 10.42%                              | 10.06%                           | 5.00%                     |

As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at September 30, 2008. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

### *Dividends*

The primary source of funds with which dividends will be paid to shareholders is from cash dividends received by the Company from the Bank. During the first nine months of 2008, the Company has received \$4.3 million in cash dividends from the Bank, from which the Company paid \$4.6 million in dividends to shareholders.

### *Reserve Balances*

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. At September 30, 2008 the Bank's qualifying balance with the Federal Reserve was approximately \$25,000 consisting of balances held with the Federal Reserve.

## **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

### *Interest Rate Sensitivity and Market Risk*

There have been no material changes in the Company's quantitative and qualitative disclosures about market risk as of September 30, 2008 from those presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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. The interest rate swap agreement matured on September 30, 2008.

Under the interest rate swap agreement, the Company received a fixed rate and pays a variable rate based on a spread from 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. During the nine months ended September 30, 2008, \$5,000 was reclassified from other accumulated other comprehensive income into expense, and is reflected as a reduction in interest income. In addition, the Company recorded a pretax hedge gain related to swap ineffectiveness of

approximately \$9,000 during the nine months ended September 30, 2008. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

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 September 30, 2008, the resultant projected impact on net interest income falls within policy limits set by the Board of Directors for all rate scenarios run.

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 September 30, 2008 and December 31, 2007 (\$ 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 | September 30, 2008     |                           |                          | December 31, 2007      |                           |                          |
|-----------------|------------------------|---------------------------|--------------------------|------------------------|---------------------------|--------------------------|
|                 | 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        | \$ 93,432              | \$ 5,548                  | 6.31%                    | \$ 105,596             | \$ 3,028                  | 2.95%                    |
| + 100 BP        | 91,946                 | 4,062                     | 4.62%                    | 105,207                | 2,639                     | 2.57%                    |
| 0 BP            | 87,884                 | 0                         | 0.00%                    | 102,568                | 0                         | 0.00%                    |
| - 100 BP        | 81,778                 | (6,106)                   | -6.95%                   | 97,410                 | (5,158)                   | -5.03%                   |
| - 200 BP        | 74,940                 | (12,944)                  | -14.73%                  | 91,212                 | (11,356)                  | -11.07%                  |

#### Item 4. 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 on that evaluation and the identification of the material weaknesses in the Company's internal control over financial reporting as described below under "Changes in Internal Control over Financial Reporting", the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were not effective at September 30, 2008 .

(b) Changes in Internal Controls over Financial Reporting,

Our Internal Control over Financial Reporting related to the allowance for loan losses and the completeness and accuracy of the provision for loan losses contained deficiencies that represent material weaknesses. Specifically the Company did not:

- Maintain sufficient policies and procedures to ensure that line personnel perform an analysis adequate to risk classify the current loan portfolio.
- Effectively have an adequate number of qualified and trained personnel in our credit administration to sufficiently identify problem loans timely.
- Maintain policies and procedures to ensure that SFAS 114 *Accounting by Creditors for Impairment of a Loan* documentation is prepared timely, accurately and subject to supervisory review.

These material weaknesses contributed in part to a delay in the preparation of the Company's financial statements and Form 10-Q as of September 30, 2008 and a material change in the provision for loan losses and the allowance for loan losses between the amounts reflected in our earnings release on October 16, 2008 and the amounts we have reported in this Form 10-Q.-Q as of September 30, 2008.

#### REMEDIATION OF MATERIAL WEAKNESSES

The Company determined the following preliminary steps necessary to address the aforementioned material weaknesses, including:

- 1)Ensuring via review by qualified senior management that management's assessment of loans requiring impairment analysis in accordance with SFAS 114 is supported by comprehensive documentation;
- 2)Training of lending and credit personnel to ensure that loans are appropriately classified and that problem loans are identified and communicated to Credit Administration on a timely basis; and
- 3)Documenting of processes and procedures, along with appropriate training, to ensure that the accounting policies, conform to GAAP and are consistently applied prospectively.

We began to execute the remediation plans identified above in the third quarter of 2008, and we believe our controls and procedures will continue to improve as a result of the further implementation of these actions. The Company cannot be assured that these remediation efforts will be successful or that further measures will not be necessary to remediate the material weaknesses.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## **PART II. Other Information**

### **Item 1.** Not applicable

**Item 1A.** There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. However, readers should consider the following additional risk factors:

#### ***U.S. and international financial markets and economic conditions could adversely affect the Company's liquidity, results of operations and financial condition***

Capital markets and economic conditions continue to be adversely affected worldwide and the resulting disruption has been particularly strong in the financial sector. The Company remains well capitalized and has not suffered any significant liquidity issues as a result of these recent events; however, the cost and availability of funds may be adversely affected by illiquid credit markets and the demand for our products and services may decline as our borrowers and customers realize the impact of an economic slowdown and recession. In addition, the severity and duration of these adverse conditions is unknown and may increase our exposure to credit risk and adversely affect the ability of borrowers to perform under the terms of their lending arrangements with us. Accordingly, continued unrest in the U.S. and international markets and economy may adversely affect our liquidity, financial condition, results of operations and profitability.

#### ***A prolonged economic downturn, especially one affecting our geographic market areas, could reduce our customer base, our level of deposits and demand for financial products, such as loans.***

We are in uncertain economic times, including uncertainty with respect to financial markets that have been volatile as a result of sub-prime mortgage related and other matters. The Company's success depends in large part upon the growth in population, income levels, deposits and housing trends in our geographic market areas. If the communities in which we operate do not grow, or if prevailing economic conditions locally or nationally are unfavorable, our business may experience difficulty. A prolonged economic downturn would likely contribute to the deterioration of the credit quality of the Company's loan portfolio and reduce the level of customer deposits, which in turn would hurt our business. If the current economic downturn in the economy as a whole, or in our geographic market areas, continues for a prolonged period, borrowers may be less likely to repay their loans as scheduled or at all. Moreover, the value of real estate or other collateral that may secure our loans could be adversely affected. A prolonged economic downturn could, therefore, result in losses that could materially and adversely affect our business.

#### ***There can be no assurance that actions of the U.S. Government, Federal Reserve and other governmental and regulatory bodies for the purpose of stabilizing the financial markets will achieve the intended effect***

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, President Bush signed the EESA into law. Pursuant to the EESA, the U.S. Treasury has the authority to utilize up to \$700 billion to purchase distressed assets from financial institutions or infuse capital into financial institutions for the purpose of stabilizing the financial markets. The Federal Government, Federal Reserve and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. There can be no assurance as to what impact such actions will have on the financial markets, including the extreme levels of volatility currently being experienced. Such continued volatility could materially and adversely affect our business, financial condition and results of operations, or the trading price of our common stock.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

#### *Purchases of Equity Securities by Affiliates and Associated Purchasers*

| Period                          | Total Number<br>Of Shares<br>Purchased | Weighted<br>Average<br>Price Paid<br>Per Share | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plan<br>or Program | Maximum Number<br>of Shares That May<br>Yet be Purchased<br>Under the Plans<br>or Programs |
|---------------------------------|--|--|--|--|
| 07/01/08 to 07/31/08            | 903                                    | \$ 14.96                                       | 903  | 199,225  |
| 08/01/08 to 08/31/08            | 887                                    | \$ 15.23                                       | 887  | 198,338  |
| 09/01/08 to 09/30/08            | 96                                     | \$ 15.05                                       | 96   | 198,242  |
| <b>Total third quarter 2008</b> | <b>1,886</b>                           | <b>\$ 15.09</b>                                | <b>1,886</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.

During the nine months ended September 30, 2008, 66,086 shares were repurchased at a total cost of \$1.0 million at an average per share price of \$15.23.

**Item 3.** Not applicable

**Item 4.** . Not applicable

**Item 5.** Not applicable

**Item 6.** Exhibits:

(a)

Exhibits:

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Computation of Earnings per Share\*

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

\* Data required by Statement of Financial Accounting Standards No. 128, *Earnings per Share*, is provided in Note 7 to the consolidated financial statements in this report.

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**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

United Security  
Bancshares

Date: November 17, 2008

/S/ Dennis R. Woods  
Dennis R. Woods  
President and  
Chief Executive Officer

/S/ Kenneth L. Donahue  
Kenneth L. Donahue  
Senior Vice President and  
Chief Financial Officer