UNITED SECURITY BANCSHARES
Form 10-K/A
May 25, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

Amendment No. 3

ý	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004.**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **FOR THE TRANSITION PERIOD FROM TO .**

Commission file number: 000-32987

UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA (State or other jurisdiction of incorporation or organization)	**91-2112732** (I.R.S. Employer Identification No.)
1525 East Shaw Ave., Fresno, California (Address of principal executive offices)	**93710** (Zip Code)

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

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

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

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 ý No o

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ý No o

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, 2004: **$88,898,832**

Shares outstanding as of February 28, 2005: **5,685,724**

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Definitive Proxy Statement for the 2005 Meeting of Shareholders is incorporated by reference into Part III.	Part III, Items 10, 11, 12 and 13

UNITED SECURITY BANCSHARES

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EXPLANATORY NOTE

This Amendment No. 3 to the Company s Annual Report on Form 10-K is solely for the purpose of re-filing the entire 2004 10-K as a result of a typographical error in Exhibit 31.2 filed with the original 2004 10-K filed on March 15, 2005 (Original Report).

All changes submitted with Amendment No. 2 are re-filed in this Amendment No. 3, including Management s Report on Internal Control Over Financial Reporting , and the Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting in Item 9A, which were initially omitted from Registrant s original 2004 Form 10-K report as permitted by the Order under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1 issued by the Securities and Exchange Commission (SEC) on November 30, 2004.

This Amendment No. 3 does not reflect events occurring after the filing of the Original Report or modify or update the disclosures therein in any way other than as described above.

PART 1

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

Item 1 - Business

General

United Security Bancshares (the Company) is a California corporation incorporated during March of 2001and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company s stock is listed on NASDAQ under the symbol UBFO . United Security Bank (the Bank) is a wholly-owned bank subsidiary of the Company and was formed in 1987. United Security Bancshares Capital Trust I (the Trust) is also a wholly-owned subsidiary of the Company and was formed during June of 2001 as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. At present, the Company does not engage in any material business activities other than ownership of the Bank. References to the Company are references to United Security Bancshares, Inc. (including the Bank), except for periods prior to June 12, 2001, in which case, references to the Company are references to the Bank.

United Security Bank

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

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

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

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

During October of 1997, the Bank completed the purchase from Bank of America of two of its branches located in Firebaugh and Coalinga, both located in Fresno County. The acquisition brought the total branches operated by the Bank to eight at that time and the total assets to approximately $238 million. The premium paid by the Bank totaled approximately $3.0 million and the amount of

deposits totaled approximately $44.4 million. The transaction included the receipt of cash balances of approximately $1.0 million and the purchase of premises and equipment totaling approximately $600,000.

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

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

At December 31, 2004, the Company operated ten bank branches and one construction lending office; with seven branches in Fresno County, two branches in Kern County, and one branch in Madera County. The Bank operates three branches (including its main office) and one construction lending office in Fresno and one branch each, in Oakhurst, Caruthers, San Joaquin, Firebaugh, Coalinga, Bakersfield, and Taft. In addition, the Company and Bank have administrative headquarters at 1525 East Shaw Avenue, Fresno, California, 93710.

At December 31, 2004, the consolidated Company had approximately $611.7 million in total assets, $390.3 million in net loans, $536.7 million in deposits, and $53.2 million in shareholders equity.

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

Bank Services

As a state-chartered commercial bank, United Security Bank offers a full range of commercial banking services primarily to the business and professional community and individuals located in Fresno, Madera, and Kern Counties.

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

The Bank also engages in a full complement of lending activities, including real estate mortgage, commercial and industrial, real estate construction, as well as agricultural, lease financing, and consumer loans, with particular emphasis on short and medium-term obligations. The Bank s loan portfolio is not concentrated in any one industry, although approximately 70% of the Bank s loans are secured by real estate. A loan may be secured (in whole or in part) by real estate even though the purpose of the loan is not to facilitate the purchase or development of real estate. At December 31, 2004, the Bank had loans (net of unearned fees) outstanding of $397.6 million, which represented approximately 74 % of the Bank s total deposits and approximately 65 % of its total assets.

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

In the normal course of business, the Bank makes various loan commitments and incurs certain contingent liabilities. At December 31, 2004 and 2003, loan commitments of the Bank aggregated $179.6 million and $140.3 million, respectively. Of the $179.6 million in loan commitments outstanding at December 31, 2004, $77.3 million or 43 % were for loans with maturities of one year or less. Due to the nature of the business of the Bank s customers, there are no seasonal patterns or absolute predictability to the utilization of unused loan commitments; therefore the Bank is unable to forecast the extent to which these commitments will be exercised within the current year. The Bank does not believe that any such utilization will constitute a material liquidity demand.

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

Competition and Market Share

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

The Company s primary market area is located in Fresno, Madera, and Kern Counties, in which approximately 27 FDIC-insured financial institutions compete for business. The following table sets forth information regarding deposit market share and ranking by county as of June 30, 2004, which is the most current information available.

	Rank	**Share**
Fresno County	7th	5.42%
Madera County	8th	5.16%
Kern County	15th	1.06%
Total of Fresno, Madera, Kern Counties	7th	3.92%

Supervision and Regulation

The Company

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

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

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

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

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

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

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

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

The Bank

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

Insurance Act. As a consequence of the extensive regulation of commercial banking activities in California and the United States, the Bank s business is particularly susceptible to changes in California and federal legislation and regulation, which may have the effect of increasing the cost of doing business, limiting permissible activities or increasing competition.

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

Effect of Governmental Policies and Recent Legislation

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

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

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

Recent Legislation and Other Changes

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

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

The Sarbanes-Oxley Act amends the Securities Exchange Act of 1934 to prohibit a registered public accounting firm from performing specified nonaudit services contemporaneously with a mandatory audit. The Sarbanes-Oxley Act also vests the audit committee of an issuer with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It requires each committee member to be a member of the board of directors of the issuer, and to be otherwise independent. The Sarbanes-Oxley

Act further requires the chief executive officer and chief financial officer of an issuer to make certain certifications as to each annual or quarterly report filed with the SEC.

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

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

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

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

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

The FRB on October 31, 2002 approved a final Regulation W that comprehensively implements sections 23A and 23B of the Federal Reserve Act. Sections 23A and 23B and Regulation W restrict loans by a depository institution to its affiliates, asset purchases by a depository institution from its affiliates, and other transactions between a depository institution and its affiliates. Regulation W unifies in one public document the Board s interpretations of sections 23A and 23B. Regulation W will have an effective date of April 1, 2003.

In December of 2001 and January of 2002, the Office of the Comptroller of the Currency, FRB and the FDIC adopted final rules governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies and financial holding companies. The final rules became effective on April 1, 2002. The new capital requirements apply symmetrically to equity investments made by banks and their holding companies in nonfinancial companies under the legal authorities specified in the final rules. Among others, these include the merchant banking authority granted by the Gramm-Leach-Bliley Act and the authority to invest in small business investment companies (SBICs) granted by the Small Business Investment Act. Covered equity investments will be subject to a series of marginal Tier 1 capital charges, with the size of the charge increasing as the organization s level of concentration in equity investments increases. The highest marginal charge specified in the final rules requires a 25 percent deduction from Tier 1 capital for covered investments that aggregate more than 25 percent of an organization s Tier 1 capital. Equity investments through SBICs will be exempt from the new charges to the extent such investments, in the aggregate, do not exceed 15 percent of the banking organization s Tier 1 capital. The new charges would not apply to individual investments made by banking organizations prior to March 13, 2000. Grandfathered investments made by state banks under section 24(f) of the Federal Deposit Insurance Act also are exempted from coverage.

The terrorist attacks in September 2001, have impacted the financial services industry and led to federal legislation that attempts to address certain issues involving financial institutions. On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001.

Part of the USA Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (IMLA). IMLA authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies, and/or other financial institutions. These measures may include enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions.

Among its other provisions, IMLA requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish due diligence policies, procedures and controls with respect to its private banking accounts and correspondent banking accounts involving foreign individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, IMLA contains a provision encouraging cooperation among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. IMLA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours. IMLA also amends the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution s anti-money laundering activities when reviewing an application under these acts.

IMLA became effective July 23, 2002. Additional regulations establish minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, to prohibit the anonymous use of concentration accounts, and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program.

The Federal Reserve Board and the Secretary of the Treasury in January 2001 jointly adopted a final rule governing merchant banking investments made by financial holding companies. The rule implements provisions of the Gramm-Leach-Bliley Act discussed below that permit financial holding companies to make investments as part of a bona fide securities underwriting or merchant or investment banking activity. The rule provides that a financial holding company may not, without Federal Reserve Board approval, directly or indirectly acquire any additional shares, assets or ownership interests or make any additional capital contribution to any company the shares, assets or ownership interests of which are held by the financial holding company subject to the rule if the aggregate carrying value of all merchant banking investments held by the financial holding company exceeds:

30 percent of the Tier 1 capital of the financial holding company, or

after excluding interests in private equity funds, 20 percent of the Tier 1 capital of the financial holding company.

A separate final rule will establish the capital charge of merchant banking investments for the financial holding company.

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

Employees

At December 31, 2004, the Company employed 122 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

Available Information

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

Item 2 - Properties

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

The Company occupies the banking premises of approximately 3,600 square feet for its East Shaw branch at 1041 E. Shaw Avenue, Fresno, California, under a lease extension expiring February 28, 2005. The lease has been renewed until August 2005, with additional extensions available to August 31, 2011.

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

The Company leases the Caruthers bank branch located at 13356 South Henderson, Caruthers, California, which consists of approximately 5,000 square feet of floor space. The branch was acquired from Wells Fargo Bank in February 1997 under a lease which expires January 19, 2006 with extensions to January 19, 2021.

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

The Company owns the Firebaugh bank branch located at 1067 O Street, Firebaugh, California which was purchased from Bank of America during October 1997 for a total consideration of $211,500. The premises are comprised of approximately 4,666 square feet of office space situated on land totaling approximately one-third of an acre.

The Company owns the Coalinga bank branch located at 145 East Durian, Coalinga, California which was also purchased from Bank of America during October 1997. The total price paid for the premises was $268,000 for an office building with 6,184 square feet of interior floor space situated on approximately 0.45 acres of land.

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

The Company leases the Taft branch office premises located at 523 Cascade Place, Taft, California. The branch facilities consist of approximately 9,200 square feet of office space, and the lease expires in November 2007. The Taft branch facilities were acquired during April 2004 as the result of the merger with Taft National Bank.

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

The Company owns its administrative headquarters located at 1525 East Shaw Avenue, Fresno, California. The building consists of approximately 10,000 square feet of interior floor space.

The Company owns property at 2126 Inyo Street, Fresno, California, which it is currently developing to be its new administrative headquarters. The facility consists of approximately 21,400 square feet. A portion of the premises will be subleased to a third-party under a lease term of approximately seven years. It is anticipated that the Company will occupy the premises during the later part of 2005.

Item 3 - Legal Proceedings

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

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

No matters were submitted to a vote of shareholders during the fourth quarter of 2004.

PART II

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

Trading History

The Company became a NASDAQ National Market listed company on May 31, 2001 and trades under the symbol UBFO. The Company s common stock was previously quoted on the OTCBB (over-the-counter bulletin board), a quotation service for securities not listed or traded on NASDAQ or a national securities exchange. Volumes traded are shown below.

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

The following table sets forth the high and low closing sales prices by quarter for the Company s common stock, for the years ended December 31, 2004 and 2003.

	Closing Prices				
Quarter		**High**		**Low**	**Volume**
4th Quarter 2004	$	25.75	$	21.89	260,200
3rd Quarter 2004	$	23.44	$	20.25	225,400
2nd Quarter 2004	$	26.05	$	20.69	634,900
1st Quarter 2004	$	28.50	$	23.61	257,700
4th Quarter 2003	$	27.45	$	24.35	173,900
3rd Quarter 2003	$	26.59	$	20.82	294,000
2nd Quarter 2003	$	26.60	$	19.67	515,500
1st Quarter 2003	$	20.00	$	16.30	132,000

At January 31, 2005, there were approximately 724 record holders of common stock of the Company. This does not reflect the number of persons or entities who hold their stock in nominee or street name through various brokerage firms.

Dividends

The Company s shareholders are entitled to cash dividends when and as declared by the Company s Board of Directors out of funds legally available therefore. Dividends paid to shareholders by the Company are subject to restrictions set forth in California General Corporation Law, which provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal the amount of the proposed distribution. As a bank holding company without significant assets other than its equity position in the

Bank, the Company s ability to pay dividends to its shareholders depends primarily upon dividends it receives from the Bank. Such dividends paid by the Bank to the Company are subject to certain limitations. See Management s Discussion and Analysis of Financial and Results of Operations Regulatory Matters .

The Company paid cash dividends to shareholders of $ 0.145 per share on January 21, 2004, and $0.16 per share on April 21, 2004, July 21, 2004 and October 20, 2004. During the previous year, the Company paid cash dividends to shareholders of $ 0.13 per share on January 22, 2003, and $0.145 per share on April 23, 2003, July 23, 2003 and October 22, 2003.

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

Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth securities authorized for issuance under equity compensation plans as for December 31, 2004.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (column a)	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	108,000	$ 16.05	100,000
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	108,000	$ 16.05	100,000

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

Purchases of Equity Securities by Affiliates and Associated Purchasers

Period	Total Number Of Shares Purchased	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs
10/1/04 to 10/31/04	0	N/A	0	190,062
11/09/2004 to 11/29/2004	1,007	$ 23.69	1,007	189,055
12/03/2004	775	$ 24.91	775	188,280
Total fourth quarter 2004	1,782	$ 24.22	1,782	

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 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 had been repurchased under that plan as of December 31, 2003, at a total cost of $3.7 million.

Then, on February 25, 2004 the Company announced another stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares 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 yet to be purchased under the earlier plan.

Item 6 - Selected Financial Data

The following table sets forth certain selected financial data for the Bank for each of the years in the five-year periods ended December 31, 2004 and should be read in conjunction with the more detailed information and financial statements contained elsewhere herein (in thousands except per share data and ratios).

				December 31,				
(in thousands except per share data and ratios)		**2004**		**2003**		**2002**		**2001**		**2000**

(in thousands except per share data and ratios)		**2004**		**2003**		**2002**		**2001**		**2000**
Summary of Year-to-Date Earnings:										
Interest income and loan fees	$	30,748	$	26,927	$	28,716	$	30,063	$	28,941
Interest expense		6,433		7,260		11,516		13,411		11,544
Net interest income		24,315		19,667		17,200		16,652		17,397
Provision for credit losses		1,145		1,713		1,963		1,733		1,580
Net interest income after Provision for credit losses		23,170		17,954		15,237		14,919		15,817
Noninterest income		4,868		6,271		5,368		4,277		2,538
Noninterest expense		14,667		11,855		10,860		9,818		8,648
Income before taxes on income		13,371		12,370		9,745		9,378		9,707
Taxes on income		4,966		4,664		2,912		3,185		3,450
Net Income	$	8,405	$	7,706	$	6,833	$	6,193	$	6,257
Per Share Data:										
Net Income Basic	$	1.49	$	1.41	$	1.27	$	1.14	$	1.16
Net Income Diluted	$	1.48	$	1.40	$	1.25	$	1.11	$	1.12
Average shares outstanding - Basic		5,630,256		5,459,926		5,400,751		5,443,734		5,374,734
Average shares outstanding - Diluted		5,667,243		5,511,670		5,487,038		5,563,855		5,587,292
Cash dividends paid	$	0.63	$	0.57	$	0.51	$	0.45	$	0.36
Financial Position at Period-end:										
Total assets	$	611,696	$	506,588	$	519,316	$	450,928	$	356,832
Total net loans and leases		390,334		338,716		343,042		331,163		256,802
Total deposits		536,672		440,444		423,987		368,651		271,862
Total shareholders equity		53,236		45,036		40,561		36,059		33,749
Book value per share	$	9.39	$	8.17	$	7.50	$	6.68	$	6.23
Selected Financial Ratios:										
Return on average assets		1.52%		1.51%		1.37%		1.55%		1.95%
Return on average shareholders equity		16.81%		17.80%		17.64%		17.25%		20.05%
Average shareholders equity to average assets		9.01%		8.48%		7.76%		9.00%		9.71%
Allowance for credit losses as a percentage of total nonperforming loans		42.51%		32.58%		36.00%		34.23%		134.27%
Net charge-offs to average loans		0.12%		0.34%		0.25%		0.35%		0.19%
Allowance for credit losses as a percentage of period-end loans		1.82%		1.76%		1.59%		1.33%		1.45%
Dividend payout ratio		43.16%		40.07%		40.94%		40.09%		32.14%

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

<u>Overview</u>

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, but are not limited to, those described in Management s Discussion and Analysis of Financial Condition and Results of Operations. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

The Company

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

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

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

As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and took no such benefit in the 4th quarter. The Company has recorded no state tax liability for 2002. United Security Bancshares and its financial advisors believe that the Company s position has merit and the Company will pursue its tax claims and defend its use of these entities and transactions. The Company cannot predict at this time what the ultimate outcome will be.

Effective April 23, 2004, the Company announced the completion of a merger with Taft National Bank headquartered in Taft, California. Taft National Bank (Taft) was merged into United Security Bank and Taft s two branches will operate as branches of United Security Bank. The total consideration paid to Taft shareholders was 241,447 shares of the Company s Common Stock valued at just over approximately $6 million. As a

result of the merger, the Company acquired $15.4 million in cash and short-term investments, $23.3 million in loans, and $48.2 million in deposits. This transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities. The consolidated statement of income includes the operations of Taft from the date of the acquisition to December 31, 2004.

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

Trends Affecting Results of Operations and Financial Position

The Company s overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact results of operations, but also the composition of the Company s balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets

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with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth.

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

	YTD Average 12/31/04	YTD Average 12/31/03	YTD Average 12/31/02
Loans	75.12%	75.39%	76.08%
Investment securities	18.58%	19.88%	19.24%
Interest-bearing deposits in other banks	1.57%	1.81%	0.67%
Federal funds sold	4.73%	2.92%	4.01%
Total earning assets	100.00%	100.00%	100.00%
NOW accounts	11.54%	8.25%	7.22%
Money market accounts	23.85%	20.08%	16.03%
Savings accounts	7.65%	6.34%	5.32%
Time deposits	52.77%	57.79%	58.60%
Other borrowings	0.22%	3.53%	8.86%
Trust Preferred Securities	3.97%	4.01%	3.97%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

The Company has modified its business plan over the past several years to better position itself for strategic growth in the future, while reducing potential risk levels. This is in response to the relative size and complexity of the Company, as well as economic and other market factors that may affect future operations and anticipated growth.

After experiencing significant growth during 2001 and 2002, the Company reduced overall asset growth in 2003 while focusing efforts on strengthening the balance sheet to improve asset quality and enhance liquidity. During 2003, loan growth was curtailed in out-of-market-area participations, and certain liabilities including FHLB borrowings totaling $35 million, were paid off. As a result, loans declined during 2003 by approximately $3.3 million and excess funds obtained from deposit growth were used to pay down borrowings or were invested in short-term overnight investments to enhance liquidity.

During 2004, the Company increased its business development efforts, and as a result, realized increases in both loans and deposits during the year. Exclusive of loans and deposit acquired from Taft National Bank, the Company experienced increases of $30.2 million in loans, and $50.4 million in deposits between December 31, 2003 and December 31, 2004. The majority of the loan growth was in construction loans, although increases were also experienced in agricultural and installment loans. Deposit growth, exclusive of deposits acquired in the Taft merger were primarily in noninterest-bearing checking, which helped enhance the Company s core deposit base.

With increases in market rates of interest experienced during the second half of 2004, the Company has realized increased net interest margins, and should continue to experience increases into 2005. With nearly 68% of the loan portfolio in floating rate instruments, benefits of rising rates were realized almost immediately on loan yields during the later half of 2004. Deposit rates lagged during the third quarter of 2004, but deposit-pricing pressures increased during the fourth quarter of 2004 and have continued into 2005. With additional rate increases anticipated during 2005, the Company should continue to realize strong net interest margins during the upcoming year.

The Company continues to emphasize relationship banking and core deposit growth, and has continued to focus greater attention on its market area of Fresno and Madera Counties, as well as its new markets in Kern County. The San Joaquin Valley and other California markets continue to benefit from construction lending and commercial loan demand from small and medium size businesses. During 2004, loan growth totaled more than $53.0 million, with $39.6 million or $74.7% of that growth occurring in real estate construction loans. Growth also occurred in agricultural and installment loans during 2004, as the Company has sought to diversify the loan portfolio as opportunities arise. In the future, the Company will continue to emphasize its core lending strengths of commercial real estate and construction lending, as well as small business financing, while expanding opportunities in agricultural, installment, and other loan categories when possible.

Deposit growth totaled $96.2 million during 2004, as compared to $16.5 million during 2003, with $50.4 million of that 2004 deposit growth resulting from the Taft National Bank merger. During the past several years, substantial increases have been experienced in the Company s core deposit base, including noninterest-bearing checking accounts, as well as NOW and money market accounts. Time deposits have declined over the past three years, as the Company continues to emphasize core deposit growth as part of it s relationship banking strategy. Over the past several years, the Company has been able to control the level of time deposits to some degree with pricing strategies, and will continue to use pricing strategies to control the overall level of time deposits as part of its growth and liquidity planning process.

The Company will continue to evaluate its business plan as economic and market factors change in its market area. Growth and increased market share will be of primary importance during 2005 as the Company seeks additional opportunities within its market areas, particularly as a result of the recently acquired operations in Kern County.

Application of Critical Accounting Policies

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

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

Allowance for Credit Losses

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

If the loan portfolio were to increase by 10% proportionally throughout all loan classifications, the additional estimated provision to the allowance that would be required, based on the percentage allocations utilized at December 31, 2004, would be approximately $407,000 pretax ($240,000 net of tax). This includes an additional $125,000 ($74,000 net of tax) for criticized loans (those classified as special mention or worse and excluding those considered impaired under SFAS No. 114), and an additional $283,000 ($167,000 net of tax) for the remainder of the loan portfolio that is performing.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally on the straight-line method over the estimated useful lives of the assets. The expected useful lives of certain assets including technological

related hardware and software could be subject to change due to technological advances or new standards among computer, or other related equipment. Such equipment generally has a short depreciable life, and therefore changes in the useful lives of such equipment would not have a material impact on the net income of the Company.

Other Real Estate Owned

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

Goodwill

Business combinations involving the Company s acquisition of the equity interests or net assets of another enterprise or the assumption of net liabilities in an acquisition of branches constituting a business may give rise to goodwill. The acquisition of Taft National Bank during April 2004 gave rise to goodwill totaling approximately $750,000. Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed in transactions accounted for under the purchase method of accounting. The value of goodwill is ultimately derived from the Company s ability to generate net earnings after the acquisition. A decline in net earnings could be indicative of a decline in the fair value of goodwill and result in impairment. For that reason, goodwill is assessed for impairment at a reporting unit level at least annually. While the Company believes all assumptions utilized in its assessment of goodwill for impairment are reasonable and appropriate, changes in earnings, the effective tax rate, historical earnings multiples and the cost of capital could all cause different results for the calculation of the present value of future cash flows.

Income Taxes

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

On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and took no such benefit in the 4th quarter. The Company continues to review the information available from the FTB and its financial advisors and believe 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 what the ultimate outcome will be; however, management believes it is not probable that these benefits will be reversed for the year ended December 31, 2002. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income would be approximately $624,000, excluding any possible penalties and interest.

Stock-Based Compensation

For all years presented in the Consolidated Financial Statements, the Company accounted for stock options under the provisions APB No. 25. Accordingly, no compensation expense related to the issuance of stock options is reflected in the income statements. Pro forma disclosures of the impact of compensation expense (and related tax benefit) associated with stock options are included in Note 1 in the Notes to the Consolidated Financial Statements. The pro forma amounts are calculated on the estimated fair value of the options at the date of the grant, based on assumptions made during the year of the grant. Those assumptions are outlined in Note 10. Stock Options in the Company s Notes to Financial Statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS 123(R)), Share-Based Payment , which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using Accounting Principles Board Opinion No. 25 and requires that such transactions be accounted for using a fair value-based method. The Company will adopt the requirements of SFAS No. 123R using the modified-prospective method during the second quarter of 2005. SFAS No. 123R will require the Company to recognize as compensation expense, the fair value of

stock options granted to employees and Directors of the Company beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date. The estimated additional pretax compensation expense to be recognized during 2005 is approximately $41,000.

Revenue recognition

The Company s primary sources of revenue are interest income from loans and investment securities. Interest income is generally recorded on an accrual basis, unless the collection of such income is not reasonably assured or cannot be reasonably estimated. Pursuant to SFAS No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases , nonrefundable fees and costs associated with originating or acquiring loans are recognized as a yield adjustment to the related loans by amortizing them into income over the term of the loan using a method which approximates the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

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

Results of Operations

For the year ended December 31, 2004, the Company reported net income of $8.4 million or $1.49 per share ($1.48 diluted) as compared to $7.7 million or $1.41 per share ($1.40 diluted) for the year ended December 31, 2003, and $6.8 million or $1.27 per share ($1.25 diluted) for the year ended December 31, 2002. Net income for 2004 increased $699,000 from the previous year primarily as the result of increased yield and volume in earning assets combined with a substantial decrease in the cost of interest-bearing liabilities. Increases in market rates of interest during the second half of the year improved yields on earning assets, and the Company s net interest margin.

The Company s return on average assets was 1.52 % for the year ended December 31, 2004 as compared to 1.51 % and 1.37 % for the same twelve-month periods of 2003 and 2002, respectively. The Company s return on average equity was 16.81% for the year ended December 31, 2004 as compared to 17.80 % and 17.64 % for the same twelve-month periods of 2003 and 2002, respectively.

Net Interest Income

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

Net interest income before provision for credit losses totaled $24.3 million for the year ended December 31, 2004 as compared to $19.7 million for the year ended December 31, 2003, and $17.2 million for the year ended December 31, 2002. This represents an increase of $4.6 million or 23.6 % between the years ended December 31, 2003 and 2004, as compared to an increase of $2.5 million or 14.3% between 2002 and 2003. The increase in net interest income between 2003 and 2004 is primarily the result of substantial growth in net average earning assets, combined with a decline in the cost of average interest-bearing liabilities, which was enhanced by an increase in average market rates of interest between those two twelve-month periods. The increase in net interest income between 2002 and 2003 is primarily the result of growth in net average earning assets, combined with a decline in average interest-bearing liabilities, which more than offset the decline in average market rates of interest between those two twelve-month periods.

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

Interest rates and interest differentials

Years Ended December 31, 2004, 2003, and 2002

	2004			2003			2002		
(Dollars in thousands)	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**
Assets:									
Interest-earning assets:									
Loans (1)	$ 374,748	$ 26,558	7.09%	$ 353,562	$ 23,134	6.54%	$ 347,192	$ 24,521	7.06%
Investment Securities taxable	90,473	3,442	3.80%	90,608	3,169	3.50%	84,904	3,617	4.26%
Investment Securities nontaxable (2)	2,242	123	5.49%	2,613	132	5.05%	2,889	139	4.81%
Interest on deposits in other banks	7,845	310	3.95%	8,496	345	4.06%	3,048	138	4.53%
Federal funds sold and reverse repos	23,616	315	1.33%	13,714	147	1.07%	18,322	301	1.64%
Total interest-earning assets	498,924	$ 30,748	6.16%	468,993	$ 26,927	5.74%	456,355	$ 28,716	6.29%
Allowance for possible loan losses	(7,013)			(5,375)			(5,372)		
Noninterest-bearing assets:									
Cash and due from banks	24,141			18,449			17,728		
Premises and equipment, net	6,608			3,960			2,839		
Accrued interest receivable	2,141			2,226			2,891		
Other real estate owned	2,417			4,348			9,186		
Other assets	27,507			17,690			15,580		
Total average assets	$ 554,725			$ 510,291			$ 499,207		
Liabilities and Shareholders Equity:									
Interest-bearing liabilities:									
NOW accounts	$ 44,585	$ 171	0.38%	$ 30,840	$ 146	0.47%	$ 27,275	$ 208	0.76%
Money market accounts	92,159	1,298	1.41%	75,111	1,103	1.47%	60,573	1,131	1.87%
Savings accounts	29,548	136	0.46%	23,705	124	0.52%	20,106	165	0.82%
Time deposits	203,839	3,983	1.95%	216,127	4,563	2.11%	221,387	7,686	3.47%
Other borrowings	858	23	2.68%	13,206	540	4.09%	33,476	1,427	4.26%
Trust Preferred securities	15,349	822	5.36%	15,000	784	5.23%	15,000	899	5.99%
Total interest-bearing liabilities	386,338	$							