

UNITED SECURITY BANCSHARES
Form 10-Q
August 08, 2006

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 JUNE 30, 2006.**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____ .**
Commission file number: 000-32987

UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA

91-2112732

(State or other jurisdiction of incorporation or organization)

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

1525 East Shaw Ave., Fresno, California

93710

(Address of principal executive offices)

(Zip Code)

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

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

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

Yes No

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

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 July 31, 2006: 11,375,449

TABLE OF CONTENTS

Page

Facing Page

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets

Consolidated Statements of Income and Comprehensive Income

Consolidated Statements of Changes in Shareholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Results of Operations

Financial Condition

Liquidity and Asset/Liability Management

Regulatory Matters

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity and Market Risk

Item 4. Controls and Procedures

PART II. Other Information

Item 1. Legal Proceedings

Item 1A. Risk Factors

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

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits

Signatures

Certifications

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets
June 30, 2006 (unaudited) and December 31, 2005

<i>(in thousands except shares)</i>	June 30, 2006	December 31, 2005
Assets		
Cash and due from banks	\$ 30,833	\$ 27,915
Federal funds sold and securities purchased under agreements to resell	5,600	35,115
Cash and cash equivalents	36,433	63,030
Interest-bearing deposits in other banks	7,772	7,656
Investment securities available for sale	91,237	95,236
Loans and leases	483,039	417,910
Unearned fees	(1,143)	(753)
Allowance for credit losses	(8,039)	(7,748)
Net loans	473,857	409,409
Accrued interest receivable	4,127	3,394
Premises and equipment - net	12,463	11,028
Other real estate owned	4,351	4,356
Intangible assets	2,532	2,801
Goodwill	750	750
Cash surrender value of life insurance	13,187	13,529
Investment in limited partnership	3,784	3,963
Deferred income taxes	5,639	5,194
Other assets	8,139	8,513
Total assets	\$ 664,271	\$ 628,859
Liabilities & Shareholders Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 144,736	\$ 153,113
Interest bearing	416,370	393,347
Total deposits	561,106	546,460
Federal funds purchased	17,100	0
Accrued interest payable	1,676	1,875
Accounts payable and other liabilities	5,490	6,046
Junior subordinated debentures	15,464	15,464
Total liabilities	600,836	569,845
Shareholders Equity		
Common stock, no par value 20,000,000 shares authorized, 11,361,913 and 11,361,118 issued and outstanding, in 2006 and 2005, respectively	22,019	22,084
Retained earnings	43,107	38,682
Accumulated other comprehensive loss	(1,691)	(1,752)
Total shareholders equity	63,435	59,014
Total liabilities and shareholders equity	\$ 664,271	\$ 628,859

See notes to consolidated financial statements

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

	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
<i>(In thousands except shares and EPS)</i>				
Interest Income:				
Loans, including fees	\$ 10,421	\$ 8,094	\$ 19,675	\$ 15,952
Investment securities AFS taxable	802	1,072	1,642	2,145
Investment securities AFS nontaxable	27	27	54	54
Federal funds sold and securities purchased under agreements to resell	79	109	429	186
Interest on deposits in other banks	80	77	161	152
Total interest income	11,409	9,379	21,961	18,489
Interest Expense:				
Interest on deposits	2,880	2,033	5,326	3,712
Interest on other borrowings	431	270	724	548
Total interest expense	3,311	2,303	6,050	4,260
Net Interest Income Before Provision for Credit Losses	8,098	7,076	15,911	14,229
Provision for Credit Losses	123	247	363	498
Net Interest Income	7,975	6,829	15,548	13,731
Noninterest Income:				
Customer service fees	964	1,132	2,000	2,248
Gain on sale of other real estate owned	12	294	27	306
Proceeds from life insurance	477	0	477	0
Loss on swap ineffectiveness	(147)	0	(147)	0
Gain on sale of investment in correspondent bank stock	0	0	1,877	0
Shared appreciation income	0	18	0	50
Other	288	319	567	482
Total noninterest income	1,594	1,763	4,801	3,086
Noninterest Expense:				
Salaries and employee benefits	2,374	1,923	4,810	3,905
Occupancy expense	614	561	1,203	1,109
Data processing	145	167	277	325
Professional fees	207	199	420	470
Director fees	56	52	110	103
Amortization of intangibles	135	135	269	269
Correspondent bank service charges	51	92	100	182
Writedown on investment	0	662	0	662
Loss on California tax credit partnership	110	114	220	228
Other	1,344	608	2,175	1,276
Total noninterest expense	5,036	4,513	9,584	8,529
Income Before Taxes on Income	4,533	4,079	10,765	8,288
Provision for Taxes on Income	1,471	1,490	3,839	3,035
Net Income	\$ 3,062	\$ 2,589	\$ 6,926	\$ 5,253
Other comprehensive income, net of tax:				
Unrealized gain (loss) on available for sale securities and interest rate swap net of income tax expense (benefit) of \$125, \$434, \$41 and \$(181)	188	651	62	(271)
Comprehensive Income	\$ 3,250	\$ 3,240	\$ 6,988	\$ 4,982

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Net Income per common share				
Basic	\$ 0.27	\$ 0.23	\$ 0.61	\$ 0.46
Diluted	\$ 0.27	\$ 0.23	\$ 0.60	\$ 0.46
Shares on which net income per common shares were based				
Basic	11,367,629	11,369,816	11,368,679	11,370,850
Diluted	11,502,106	11,443,991	11,496,469	11,443,940

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders Equity
Periods Ended June 30, 2006

<i>(In thousands except shares)</i>	Common stock	Common stock	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Total
	Number of Shares	Amount				
Balance January 1, 2005	11,367,588	\$ 22,322	\$ 31,879	\$ (67)	\$ (898)	\$ 53,236
Director/Employee stock options exercised	6,000	53				53
Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$226)					(339)	(339)
Net changes in unrealized loss on interest rate swaps (net of income tax of \$45)					67	67
Dividends on common stock (\$0.18 per share)			(2,046)			(2,046)
Repurchase and cancellation of common shares	(12,088)	(151)				(151)
Release of unearned ESOP shares	7,692	8		67		75
Net Income			5,253			5,253
Balance June 30, 2005 (Unaudited)	11,369,192	22,235	33,086	0	(1,170)	56,151
Director/Employee stock options exercised	6,000	66				66
Tax benefit of stock options exercised		10				10
Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$484)					(725)	(725)
Net changes in unrealized loss on interest rate swaps (net of income tax of \$16)					143	143
Dividends on common stock (\$0.19 per share)			(2,159)			(2,159)
Repurchase and cancellation of common shares	(14,074)	(227)				(227)
Net Income			5,755			5,755
Balance December 31, 2005	11,361,118	22,084	38,682	0	(1,752)	59,014
Director/Employee stock options exercised	14,000	123				123
Tax benefit of stock options exercised		7				7
Net changes in unrealized loss on available for sale securities (net of income tax benefit of \$247)					(371)	(371)
Net changes in unrealized loss on interest rate swaps (net of income tax of \$288)					432	432
Dividends on common stock (\$0.26 per share)			(2,501)			(2,501)
Repurchase and cancellation of common shares	(13,205)	(305)				(305)
Stock-based compensation expense		110				110
Net Income			6,926			6,926
Balance June 30, 2006 (Unaudited)	11,361,913	\$ 22,019	\$ 43,107	\$ 0	\$ (1,691)	\$ 63,435

See notes to consolidated financial statements

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

<i>(In thousands)</i>	Six Months Ended June 30,	
	2006	2005
Cash Flows From Operating Activities:		
Net income	\$ 6,926	\$ 5,253
Adjustments to reconcile net earnings to cash provided by operating activities:		
Provision for credit losses	363	498
Depreciation and amortization	802	730
Amortization of investment securities	(20)	(33)
Increase in accrued interest receivable	(733)	(196)
(Decrease) increase in accrued interest payable	(199)	437
Increase (decrease) in unearned fees	390	(264)
(Decrease) increase in income taxes payable	(322)	56
Excess tax benefits from stock-based payment arrangements	(1)	0
Stock-based compensation expense	110	0
Increase in accounts payable and accrued liabilities	(156)	(622)
Gain on sale of correspondent bank stock	(1,877)	0
Gain on sale of other real estate owned	(27)	(306)
Write-down of other investments	0	662
Gain on sale of fixed assets	(1)	(4)
Loss on swap ineffectiveness	147	0
Income from life insurance proceeds	(477)	0
Decrease (increase) in surrender value of life insurance	342	(220)
Loss on limited partnership interest	220	228
Net decrease (increase) in other assets	202	(2,326)
Net cash provided by operating activities	5,689	3,893
Cash Flows From Investing Activities:		
Net increase in interest-bearing deposits with banks	(116)	(111)
Net redemption (purchase) of FHLB/FRB and other bank stock	51	(267)
Purchases of available-for-sale securities	0	(4,430)
Maturities and calls of available-for-sale securities	3,402	4,002
Net increase in loans	(65,655)	(10,596)
Cash proceeds from sale of correspondent bank stock	2,607	0
Cash proceeds from sales of leased assets	187	29
Proceeds from sales of other real estate owned	20	1,875
Capital expenditures for premises and equipment	(1,961)	(584)
Cash proceeds from sales of premises and equipment	1	19
Net cash used in investing activities	(61,464)	(10,063)
Cash Flows From Financing Activities:		
Net increase in demand deposit and savings accounts	5,278	1,854
Net decrease in certificates of deposit	9,369	6,731
Net increase in federal funds purchased	17,100	0
Director/Employee stock options exercised	123	53
Excess tax benefits from stock-based payment arrangements	1	0
Repurchase and retirement of common stock	(305)	(151)
Repayment of ESOP borrowings	0	(75)
Payment of dividends on common stock	(2,388)	(1,933)
Net cash provided by financing activities	29,178	6,479
Net (decrease) increase in cash and cash equivalents	(26,597)	309
Cash and cash equivalents at beginning of period	63,030	56,406
Cash and cash equivalents at end of period	\$ 36,433	\$ 56,715

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 (the Fund). United Security Bancshares Capital Trust I (the Trust) was deconsolidated effective March 2004 pursuant to FIN46, (collectively the Company or USB). Intercompany accounts and transactions have been eliminated in consolidation.

On March 28, 2006, the Company announced a 2-for-1 stock split of the Company's no-par common stock payable May 1, 2006 effected in the form of a 100% stock dividend. All periods presented in this 10-Q have been restated to reflect the effect of the stock split (see Note 8).

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

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 Annual Report on Form 10-K for the year ended December 31, 2005. Effective January 1, 2006, the Company has adopted SFAS No. 123R, Accounting for Share-Based Payments for recording and measurement of its shared-based payments as disclosed in Note 9 below. 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 2005 financial statements to conform to the classifications used in 2006.

New Accounting Standard:

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109*. FIN 48 clarifies SFAS No. 109, *Accounting for Income Taxes*, to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of the Interpretation, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term *more likely than not* means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

The scope of FIN 48 is broad and includes *all* tax positions accounted for in accordance with SFAS No. 109. Additionally, besides business enterprises, FIN 48 applies to not-for-profit organizations, pass-through entities, and entities whose tax liability is subject to 100 percent credit for dividends paid (such as real estate investment trusts).

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 should be reported as an adjustment to retained earnings at the beginning of the period in which the Interpretation is adopted. The Company has not yet determined what impact FIN 48 will have on the Company's financial statements.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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 June 30, 2006 and December 31, 2005:

(In thousands) June 30, 2006:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	\$ 78,837	\$ 43	\$ (2,340)	\$ 76,540
U.S. Government agency Collateralized mortgage obligations	19	0	(1)	18
Obligations of state and political subdivisions	2,226	63	(4)	2,285
Other investment securities	13,000	0	(606)	12,394
	<u>\$ 94,082</u>	<u>\$ 106</u>	<u>\$ (2,951)</u>	<u>\$ 91,237</u>
December 31, 2005:				
U.S. Government agencies	\$ 82,215	\$ 110	\$ (2,002)	\$ 80,323
U.S. Government agency collateralized mortgage obligations	22	0	(1)	21
Obligations of state and political subdivisions	2,226	95	(1)	2,320
Other investment securities	13,000	0	(428)	12,572
	<u>\$ 97,463</u>	<u>\$ 205</u>	<u>\$ (2,432)</u>	<u>\$ 95,236</u>

Included in other investment securities at both June 30, 2006 and December 31, 2005, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.7 million at June 30, 2006 and \$4.9 million at December 31, 2005. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

There were no realized gains or losses on sales or calls of available-for-sale securities during the six months ended June 30, 2006 or June 30, 2005.

Securities that have been temporarily impaired less than 12 months at June 30, 2006 are comprised of four U.S. government agency securities and four municipal agency securities with a total weighted average life of 2.6 years. As of June 30, 2006, there were nineteen U.S. government agency securities, one collateralized mortgage obligation, and two other investment securities with a total weighted average life of 2.3 years that have been temporarily impaired for twelve months or more.

The following summarizes temporarily impaired investment securities at June 30, 2006:

(In thousands) Securities available for sale:	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
U.S. Government agencies	\$ 3,003	\$ (45)	\$ 70,465	\$ (2,295)	\$ 73,468	\$ (2,340)
U.S. Government agency collateralized mortgage Obligations	0	0	13	(1)	13	(1)
Obligations of state and political subdivisions	369	(4)	0	0	369	(4)
Other investment securities	0	0	12,394	(606)	12,394	(606)
Total impaired securities	<u>\$ 3,372</u>	<u>\$ (49)</u>	<u>\$ 82,872</u>	<u>\$ (2,902)</u>	<u>\$ 86,244</u>	<u>\$ (2,951)</u>

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Because the decline in market value is attributable to changes in market rates of interest rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2006.

At June 30, 2006 and December 31, 2005, available-for-sale securities with an amortized cost of approximately \$79.9 million and \$69.3 million (fair value of \$77.7 million and \$67.8 million) were pledged as collateral for public funds, treasury tax and loan balances, and repurchase agreements.

3. Loans and Leases

Loans include the following:

<i>(In thousands)</i>	June 30, 2006	% of Loans	December 31, 2005	% of Loans
Commercial and industrial	\$ 136,649	28.3%	\$ 113,263	27.1%
Real estate mortgage	108,219	22.4%	89,503	21.4%
Real estate construction	170,316	35.3%	162,873	38.9%
Agricultural	37,319	7.7%	24,935	6.0%
Installment/other	19,192	4.0%	15,002	3.6%
Lease financing	11,344	2.3%	12,334	3.0%
Total Gross Loans	\$ 483,039	100.0%	\$ 417,910	100.0%

There were no loans over 90 days past due and still accruing interest at June 30, 2006 or December 31, 2005. Nonaccrual loans totaled \$7.6 million and \$13.9 million at June 30, 2006 and December 31, 2005, respectively.

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

<i>(In thousands)</i>	June 30, 2006	December 31, 2005	June 30, 2005
Balance, beginning of year	\$ 7,748	\$ 7,251	\$ 7,251
Provision charged to operations	363	1,140	498
Losses charged to allowance	(168)	(773)	(308)
Recoveries on loans previously charged off	63	165	50
Reclassification of off-balance sheet reserve	33	(35)	12
Balance at end-of-period	\$ 8,039	\$ 7,748	\$ 7,503

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 \$509,000 at June 30, 2006 has been reclassified to other liabilities. Significant changes in these estimates might be required in the event of a downturn in the economy and/or the real estate markets in the San Joaquin Valley, and the greater Oakhurst and East Madera County areas.

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

<i>(in thousands)</i>	June 30, 2006	December 31, 2005	June 30, 2005
Total impaired loans at period-end	\$ 7,359	\$ 12,851	\$ 19,304
Impaired loans which have specific allowance	5,930	10,564	11,383

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Total specific allowance on impaired loans	4,084	4,125	3,405
Total impaired loans which as a result of write-downs or the fair value of the collateral, did not have a specific allowance	1,429	2,287	7,921
<i>(in thousands)</i>	QTD	6/30/06	YTD - 12/31/05
	QTD	6/30/05	
Average recorded investment in impaired loans during period	\$ 10,896	\$ 15,936	\$ 16,883
Income recognized on impaired loans during period	35	34	0

4 Supplemental Cash Flow Disclosures

<i>(In thousands)</i>	Six Months Ended June 30,	
	2006	2005
Cash paid during the period for:		
Interest	\$ 6,249	\$ 3,823
Income Taxes	4,201	3,034
Noncash investing activities:		
Dividends declared not paid	\$ 1,250	\$ 1,023

5 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:

<i>(In thousands except earnings per share data)</i>	Quarter Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income available to common shareholders	\$ 3,062	\$ 2,589	\$ 6,926	\$ 5,253
Weighted average shares issued	11,368	11,370	11,369	11,371
Add: dilutive effect of stock options	134	74	127	73
Weighted average shares outstanding adjusted for potential dilution	11,502	11,444	11,496	11,444
Basic earnings per share	\$ 0.27	\$ 0.23	\$ 0.61	\$ 0.46
Diluted earnings per share	\$ 0.27	\$ 0.23	\$ 0.60	\$ 0.46

All periods presented have been restated for 2-for-1 stock split approved March 28, 2006, that was paid on May 1, 2006 effected in the form of a 100% stock dividend.

6. 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 has a remaining notional value of \$15.6 million, matures in September 2008, and has a duration of approximately 12 months. As of June 30, 2006, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately 2.25 years. As of June 30, 2006, the loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$16,000 (net of tax benefit of \$11,000). During the six months ended June 30, 2006, \$234,000 was reclassified from other accumulated comprehensive income into expense, and is reflected as a reduction in other noninterest income.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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

7. Common Stock Repurchase Plan

(The following information in Note 7 has not been restated for the 2-for-1 stock split effective May 1, 2006).

On February 25, 2004, the Company announced a 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 previous 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 stock repurchase plan. During the year ended December 31, 2005, 13,081 shares were repurchased at a total cost of \$377,000 and an average price per share of \$28.92.

During the six months ended June 30, 2006, 13,205 shares were repurchased at a total cost of \$305,000 and an average per share price of \$23.08.

8. Stock Split

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

9. Stock Based Compensation

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

The Company has adopted SFAS No. 123 R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the six months ended June 30, 2006 includes: a) compensation cost for all share-based awards granted prior to, but not yet vested as of January 1, 2006 and b) compensation cost for all share-based awards granted subsequent to January 1, 2006. Compensation cost was determined using proforma disclosure information previously calculated under SFAS No. 123. Pursuant to the modified-prospective-transition method, the results for prior periods have not been restated.

Included in salaries and employee benefits for the six months ending June 30, 2006 is \$110,000 of share-based compensation. The related tax benefit, recorded in the provision for income taxes, totaled \$2,000.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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

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

There were 172,000 total shares granted, including 161,000 incentive stock options and 11,000 non-qualified stock options (140,000 total exercisable, including 138,000 incentive stock options and 2,000 non-qualified stock options) remaining under the 1995 Plan as of December 31, 2005. Under the 2005 Plan, 70,000 shares had been granted (60,000 incentive stock options and 10,000 nonqualified stock options) as of December 31, 2005. The underlying terms of the 2005 and 1995 stock option plan options are identical, and thus have not been separately disclosed for this 2006 FAS 123R disclosure.

A summary of the Bank's options as of January 1, 2006 and changes during the six months ending June 30, 2006 is presented below (restated to reflect 2-for-1 stock split).

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$ 000 s)	Weighted Average Remaining Contractual Term (years)
Options outstanding January 1, 2006	242,000	\$ 9.16		5.1
Granted during the year	103,500	18.12		13.1
Exercised during the year	(14,000)	8.75		
<hr/>				
Options outstanding June 30, 2006	331,500	\$ 11.97	\$ 3,122	6.2
<hr/>				
Options exercisable at June 30, 2006	142,000	\$ 6.39	\$ 2,130	1.9

As of June 30, 2006 there was \$495,000 of total unrecognized compensation expense related to nonvested stock options. This cost is expected to be recognized over a weighted average period of approximately 3.1 years. The Company received \$123,000 in cash proceeds on options exercised during the six months ended June 30, 2006. Tax benefits realized on those options exercised totaled \$7,000.

	June 30, 2006	June 30, 2005
Weighted average grant-date fair value of stock options granted	\$ 4.01	\$ 2.22
Total fair value of stock options vested	\$ 29,170	\$ 15,000
Total intrinsic value of stock options exercised	\$ 147,190	\$ 22,490

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

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

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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

	Six Months Ended	
	June 30, 2006	June 30, 2005
Risk Free Interest Rate	4.58%	5.03%
Expected Dividend Yield	2.69%	2.94%
Expected Life in Years	6.50 Years	6.31 Years
Expected Price Volatility	18.38%	14.30%

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

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

<i>(In thousands except earnings per share)</i>	Quarter Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	\$ 2,589	\$ 5,253
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7)	(8)
Pro forma net income	\$ 2,582	\$ 5,245
Earnings per share:		
Basic as reported	\$ 0.23	\$ 0.46
Basic pro forma	\$ 0.23	\$ 0.46
Diluted as reported	\$ 0.23	\$ 0.46
Diluted pro forma	\$ 0.23	\$ 0.46

10. Taxes Loss Contingency

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

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit, and counsel has provided the FTB with documentation supporting the Company's position. The FTB concluded its audit during January 2006. At that time the FTB submitted a closing letter to the Company, which included proposed assessments related to the tax benefits taken for the REIT during 2002. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income resulting from the reversal of tax benefits taken during 2002 would be approximately \$755,000, excluding any possible penalties and interest. The Company cannot reasonably determine at this time what the ultimate outcome of the audit will be, although the FTB appears unwilling to accept the Company's position. The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (*City National v. Franchise Tax Board*). Based upon discussions with legal counsel, it is management's understanding that the FTB is unwilling to resolve or concede any issues in the audit pending the final outcome of the *City National* case which contains all of the issues related to the Company's audit with the FTB. The case is ongoing and may take several years to complete. As a result, the Company has not recognized any liability with respect to the FTB's assessment as of June 30, 2006.

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, 2005.

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

The Company currently has ten banking branches, which provide financial services in Fresno, Madera, and Kern counties.

Trends Affecting Results of Operations and Financial Position

The following table summarizes the quarterly 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 6/30/06	YTD Average 12/31/05	YTD Average 6/30/05
Loans and Leases	78.49 %	72.50 %	75.10 %
Investment securities available for sale	16.67%	19.81%	20.94%
Interest-bearing deposits in other banks	1.37%	1.36%	1.38%
Federal funds sold	3.47%	6.33%	2.58%
Total earning assets	100.00%	100.00%	100.00%
NOW accounts	11.96%	12.14%	12.67%
Money market accounts	31.00%	28.63%	26.96%
Savings accounts	8.41%	8.45%	8.41%
Time deposits	44.12%	46.78%	47.57%
Other borrowings	0.83%	0.32%	0.65%
Subordinated debentures	3.68%	3.68%	3.74%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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

The Company has continued its business development efforts throughout its market area, and as a result, realized increases in average loans during the first half of 2006. On average, the Company experienced increases of \$34.4 million in loans and \$5.5 million in average federal funds sold, while other interest earning assets, including investment securities, declined during the period, as compared to the first half of 2005. The Company experienced growth in all loan categories except lease financing, with growth being strongest in commercial and industrial loans, commercial real estate loans real estate, and agricultural loans. Deposit growth totaled \$14.6 million during the six months ended June 30, 2006, with much of that growth in NOW, money market accounts, and time deposits over \$100,000, as depositors were attracted to those deposit categories by higher yields.

With continued increases in market rates of interest experienced since mid-2004, the Company has realized substantial increases in net interest margins throughout 2005, continuing into the first half of 2006. The Company anticipates continued rate increases through possibly August of 2006 with some stabilization of interest rates after that time. The Company's net interest margin was 5.69% for the six months ended June 30, 2006, as compared to 5.26% for the year ended December 31, 2005, and 5.29% for the six months ended June 30, 2005. With approximately 61% of the loan portfolio in floating rate instruments at June 30, 2006, benefits of rising rates continue to be realized almost immediately on loan yields. Loans yielded 8.97% during the six months ended June 30, 2006 as compared to 8.21% for the year ended December 31, 2005, and 7.89% for the six months ended June 30, 2005. The Company continues to experience pricing pressures on deposits, as lagging deposit rates played catch-up during 2005 and into the first six months of 2006. The Company's average cost of funds was 2.90% for the six months ended June 30, 2006 as compared to 2.30% for the year ended December 31, 2005, and 2.08% for the six months ended June 30, 2005. With at least one additional rate increase expected during the last half of 2006, the Company anticipates strong net interest margins during most of 2006.

Noninterest income was enhanced during the quarter ended June 30, 2006 as the result of death-benefit proceeds of \$477,000 from the Company's bank-owned life insurance. Additionally, during the first quarter of 2006, the Company realized a nonrecurring \$1.9 million gain on the sale of an investment in correspondent bank stock. Customer service fees declined during both the quarter ended and the six months ended June 30, 2006 as compared to the same periods during 2005. This decline was primarily the result of temporary decreases in ATM income as the Company changed service providers for a portion of its ATM network, combined with minor decreases in overdraft and business analysis fees. It is not anticipated that the decline in ATM fee income is permanent, and the Company anticipates attaining close to previous fee income levels during the third quarter of 2006. During the quarter ended June 30, 2006, the Company realized a loss totaling \$147,000 on the ineffective portion of its interest rate swap agreement pursuant to SFAS No. 133 (See Note 6 to the Company's consolidated financial statements).

The Company has increased efforts to hire and retain qualified staff as part of its strategic growth strategy. As a result, the Company has experienced increased salary expense during the six months ended June 30, 2006, including nearly \$97,000 in recruitment fees. Additional noninterest expenses were incurred during the first six months of 2006 as the result of \$930,000 in costs associated with an OREO property the Company is in the process of liquidating. The sale of the OREO property is expected to be completed during the third quarter of 2006.

The Company has maintained a strong yet conservative balance sheet, with strong loan growth and sound deposit growth. While total assets have grown nearly \$35.4 million between December 31, 2005 and June 30, 2006, the loan portfolio has grown even faster with growth of \$65.1 million during the first six months of 2006. Even with the increased loan growth average loan portfolio comprised approximately 79% of overall earning assets during the period. In total, average core deposits, including NOW accounts, money market accounts, and savings accounts, continue to increase and comprise a greater percentage of total interest-bearing liabilities for the six months ended June 30, 2006 as compared to the averages for the previous periods. Time deposits continue to decline as a percentage of total average interest-bearing liabilities, and represents 44.1% of interest-bearing liabilities for the six months ended June 30, 2006 as compared to 46.8% for the year ended December 31, 2005, and 47.6% of interest-bearing liabilities for the six months ended June 30, 2005. As a result of increased loan growth, federal funds borrowings have increased during the period, and totaled \$17.1 million at June 30, 2006.

The Company continues to emphasize relationship banking and core deposit growth, and has focused greater attention on its market area of Fresno, Madera, and Kern Counties. The San Joaquin Valley and other California markets continue to benefit from construction lending and commercial loan demand from small and medium size businesses. On average, loans have increased nearly \$34.4 million between six-month periods ended June 30, 2005 and June 30, 2006, and total loans at period-end have increased \$65.1 million between December 31, 2005 and June 30, 2006. Growth continues primarily in commercial and industrial loans, and commercial real estate loans with increases of \$23.4 million, and \$18.7 million in those two categories between December 31, 2005 and June 30, 2006. Additional but modest growth was also experienced in agricultural loans, as well as construction loans during the first half of 2006. In the future, the Company will maintain an emphasis on its core lending strengths of commercial real estate and construction lending, as well as small business financing, while expanding opportunities in agricultural, installment, and other loan categories when possible.

The Company continually evaluates its strategic business plan as economic and market factors change in its market area. Growth and increasing market share will be of primary importance during the remainder of 2006 and beyond. The Company will continue to develop new business in its Convention Center Branch opened in Downtown Fresno during April 2004, as well in the two Kern County branches acquired during April 2004 as the result of the merger with Taft National Bank. During the third quarter of 2005, the Company relocated its East Shaw branch, as well as the Construction and Consumer Loans Departments, located in Fresno, to a new location in north Fresno, which will enhance its business presence in that rapidly growing area. During August 2005, the Company hired a Chief Banking Officer who is responsible for business development efforts within the Company's market area. The Company is currently developing a new banking program with a major bank in Mexico, which is directed at the Central Valley's growing Hispanic community. This new program, called Promesa Latina, is scheduled to begin during the third quarter of 2006 and will allow customers to perform a variety of banking services, including money transfers to Mexico. Market rates of interest will also be an important factor in the Company's ongoing strategic planning process, as interest rates are expected to continue to rise in the upcoming months.

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 2006 as the Company seeks additional opportunities within its market areas, particularly as a result of the recently acquired operations in Kern County.

Results of Operations

For the six months ended June 30, 2006, the Company reported net income of \$6.9 million or \$0.61 per share (\$0.60 diluted) as compared to \$5.3 million or \$0.46 per share (\$0.46 diluted) for the six months ended June 30, 2005. The Company's return on average assets was 2.20% for the six-month-period ended June 30, 2006 as compared to 1.73% for the six-month-period ended June 30, 2005. The Bank's return on average equity was 22.34% for the six months ended June 30, 2006 as compared to 19.25% for the same six-month period of 2005.

Net Interest Income

Net interest income before provision for credit losses totaled \$15.9 million for the six months ended June 30, 2006, representing an increase of \$1.7 million or 11.8% when compared to the \$14.2 million reported for the same six months of the previous year. The increase in net interest income between 2005 and 2006 is primarily the result of increased volumes in, and yields on, interest-earning assets, which more than offset increases in the Company's cost of interest-bearing liabilities.

The Bank's net interest margin, as shown in Table 1, increased to 5.69% at June 30, 2006 from 5.29% at June 30, 2005, an increase of 40 basis points (100 basis points = 1%) between the two periods. Average market rates of interest increased significantly between the six-month periods ended June 30, 2005 and 2006. The prime rate averaged 7.66% for the six months ended June 30, 2006 as compared to 5.68% for the comparative six months of 2005.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Table 1. Distribution of Average Assets, Liabilities and Shareholders' Equity:
Interest rates and Interest Differentials
Six Months Ended June 30, 2006 and 2005

(dollars in thousands)	2006			2005		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Assets:						
Interest-earning assets:						
Loans and leases (1)	\$ 442,271	\$ 19,675	8.97%	\$ 407,871	\$ 15,952	7.89%
Investment Securities taxable	91,695	1,642	3.61%	111,493	2,145	3.89%
Investment Securities nontaxable (2)	2,226	54	4.89%	2,243	54	4.85%
Interest-bearing deposits in other banks	7,710	161	4.21%	7,481	152	4.09%
Federal funds sold and reverse repos	19,553	429	4.42%	14,011	186	2.68%
Total interest-earning assets	563,455	\$ 21,961	7.86%	543,099	\$ 18,489	6.87%
Allowance for credit losses	(7,960)			(7,426)		
Noninterest-bearing assets:						
Cash and due from banks	26,913			29,556		
Premises and equipment, net	11,470			8,825		
Accrued interest receivable	3,383			2,559		
Other real estate owned	4,355			1,045		
Other assets	34,290			34,337		
Total average assets	\$ 635,906			\$ 611,995		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
NOW accounts	\$ 50,322	\$ 126	0.50%	\$ 52,326	\$ 109	0.42%
Money market accounts	130,394	1,520	2.35%	111,350	991	1.79%
Savings accounts	35,364	94	0.54%	34,724	81	0.47%
Time deposits	185,631	3,586	3.90%	196,516	2,531	2.60%
Other borrowings	3,491	91	5.26%	2,692	44	3.30%
Junior subordinated debentures	15,464	633	8.25%	15,464	504	6.57%
Total interest-bearing liabilities	420,666	\$ 6,050	2.90%	413,072	\$ 4,260	2.08%
Noninterest-bearing liabilities:						
Noninterest-bearing checking	145,044			138,139		
Accrued interest payable	1,861			1,110		
Other liabilities	5,803			4,658		
Total Liabilities	573,374			556,979		
Total shareholders' equity	62,532			55,016		
Total average liabilities and shareholders' equity	\$ 635,906			\$ 611,995		
Interest income as a percentage of average earning assets						
			7.86%			6.87%
Interest expense as a percentage of average earning assets						
			2.17%			1.58%
Net interest margin						
			5.69%			5.29%

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

- (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 \$1,674,000 and \$1,828,000 for the six months ended June 30, 2006 and 2005, respectively.
- (2) Applicable nontaxable securities yields have not been calculated on a tax-equivalent basis because they are not material to the Company's results of operations.

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.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Table 2. Rate and Volume Analysis

<i>(In thousands)</i>	Increase (decrease) in the six months ended June 30, 2006 compared to June 30, 2005		
	Total	Rate	Volume
Increase (decrease) in interest income:			
Loans and leases	\$ 3,723	\$ 943	\$ 2,780
Investment securities available for sale	(503)	(422)	(81)
Interest-bearing deposits in other banks	9	4	5
Federal funds sold and securities purchased under agreements to resell	243	65	178
Total interest income	3,472	590	2,882
Increase (decrease) in interest expense:			
Interest-bearing demand accounts	546	283	263
Savings accounts	13	10	3
Time deposits	1,056	991	65
Other borrowings	47	15	32
Subordinated debentures	128	128	0
Total interest expense	1,790	1,427	363
Increase (decrease) in net interest income	\$ 1,682	\$ (837)	\$ 2,519

For the six months ended June 30, 2006, total interest income increased approximately \$3.5 million or 18.8% as compared to the six-month period ended June 30, 2005. Earning asset volumes increased primarily in loans and federal funds sold, while volumes decreased moderately in investment securities.

For the six months ended June 30, 2006, total interest expense increased approximately \$1.8 million or 42.0% as compared to the six-month period ended June 30, 2005. Between those two periods, average interest-bearing liabilities increased by \$7.6 million, while the average rates paid on those liabilities increased by 82 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 six months ending June 30, 2006, the provision to the allowance for credit losses amounted to \$363,000 as compared to \$498,000 for the six months ended June 30, 2005. The amount provided to the allowance for credit losses during the first six months brought the allowance to 1.67% of net outstanding loan balances at June 30, 2006, as compared to 1.86% of net outstanding loan balances at December 31, 2005, and 1.84% at June 30, 2005. The allowance as a percentage of net outstanding loans declined during the six months of 2006 as the result of an improvement in the overall level of nonperforming assets during the period.

Noninterest Income

Table 3. Changes in Noninterest Income

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2006 as compared to the six months ended June 30, 2005:

<i>(In thousands)</i>	2006	2005	Amount of Change	Percent Change
Customer service fees	\$ 2,000	\$ 2,248	\$ (248)	-11.03%
Gain on sale of OREO	27	306	(279)	-91.18%
Proceeds from life insurance	477	0	477	
Loss on swap ineffectiveness	(147)	0	(147)	
Gain on sale of investment	1,877	0	1,877	
Shared appreciation income	0	50	(50)	-100.00%

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Other	567	482	85	17.63%
Total noninterest income	\$ 4,801	\$ 3,086	\$ 1,715	55.57%

Noninterest income for the six months ended June 30, 2006 increased \$1.7 million when compared to the same period last year. Customer service fees decreased \$248,000 between the two six-month periods presented, which is attributable, in part, to declines in ATM income, as well as overdraft charges and business analysis fees. Noninterest income was enhanced during the quarter ended June 30, 2006 as the result of death-benefit proceeds of \$477,000 from the Company's bank owned life insurance. Additionally, during the quarter ended June 30, 2006, the Company realized a loss totaling \$147,000 on the ineffective portion of its interest rate swap agreement pursuant to SFAS No. 133 (See Note 6 to the Company's consolidated financial statements). The \$1.9 million gain on sale of investment is the result of the sale of an equity investment in correspondent bank stock with Pacific Coast Bankers Bank (PCBB) recorded during January 2006.

Noninterest Expense

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2006 as compared to the six months ended June 30, 2005:

Table 4. Changes in Noninterest Expense

<i>(In thousands)</i>	2006	2005	Amount of Change	Percent Change
Salaries and employee benefits	\$ 4,810	\$ 3,905	\$ 905	23.20%
Occupancy expense	1,203	1,109	94	8.50%
Data processing	277	325	(48)	-14.63%
Professional fees	420	470	(50)	-10.79%
Directors fees	110	103	7	6.86%
Amortization of intangibles	269	269	0	0.00%
Correspondent bank service charges	100	182	(82)	-44.93%
Writedown on investment	0	662	(662)	-100.00%
Loss on California tax credit partnership	220	228	(8)	-3.53%
Other	2,175	1,276	899	70.34%
Total expense	\$ 9,584	\$ 8,529	\$ 1,055	12.36%

Increases in noninterest expense between the six months ended June 30, 2006 and 2005 are associated primarily with normal, anticipated growth of the Company, including additional staffing costs. Increases in other noninterest expense were primarily the result of additional expenses incurred on a single OREO property, which is in the process of liquidation. Expenses on OREO increased approximately \$882,000 between the two six-month periods ended June 30, 2005 and June 30, 2006. The \$662,000 writedown of investment incurred during 2005 was related to the Company's investment in Title Company, which was written down during the second quarter of 2005.

Pursuant to the adoption of SFAS No. 123R during the first quarter of 2006, the Company recognized stock-based compensation expense of \$64,000 for the quarter ended June 30, 2006, and a total of \$110,000 for the six months ended June 30, 2006. This expense is included in noninterest expense under salaries and employee benefits. The Company expects stock-based compensation expense to be about \$64,000 per quarter during the remaining two quarters of 2006. Under the current pool of stock options, stock-based compensation expense will decline to approximately \$43,000 per quarter during 2007, then to \$26,000 per quarter for 2008, and decline after that through 2010. If new stock options are issued, or existing options fail to vest due, for example, to forfeiture, actual stock-based compensation expense in future periods will change.

Income Taxes

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

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit, and counsel has provided the FTB with documentation supporting the Company's position. The FTB concluded its audit during January 2006. At that time the FTB submitted a closing letter to the Company, which included proposed assessments related to the tax benefits taken for the REIT during 2002. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. If the FTB were to prevail against the Company in its defense of tax benefits taken during 2002, the negative effect to net income resulting from the reversal of tax benefits taken during 2002 would be approximately \$755,000, excluding any possible penalties and interest.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

The Company cannot reasonably determine at this time what the ultimate outcome of the audit will be, although the FTB appears unwilling to accept the Company's position. The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (*City National v. Franchise Tax Board*). Based upon discussions with legal counsel, it is management's understanding that the FTB is unwilling to resolve or concede any issues in the audit pending the final outcome of the *City National* case which contains all of the issues related to the Company's audit with the FTB. The case is ongoing and may take several years to complete. As a result, the Company has not recognized any liability with respect to the FTB's assessment as of June 30, 2006.

Financial Condition

Total assets increased \$35.4 million or 5.63% to a balance of \$664.3 million at June 30, 2006, from the balance of \$628.9 million at December 31, 2005, and increased \$41.2 million 6.62% from the balance of \$623.0 million at June 30, 2005. Total deposits of \$561.1 million at June 30, 2006 increased \$14.6 million or 2.68% from the balance reported at December 31, 2005, and increased \$24.4 million from the balance of \$536.7 million reported at June 30, 2005. Between December 31, 2005 and June 30, 2006, loan growth totaled \$65.1 million while securities and other short-term investments decreased \$30.6 million as these funds were utilized to fund loan growth.

Earning assets averaged approximately \$563.5 million during the six months ended June 30, 2006, as compared to \$543.1 million for the same six-month period of 2005. Average interest-bearing liabilities increased to \$420.7 million for the six months ended June 30, 2006, as compared to \$413.1 million for the comparative six-month period of 2005.

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 \$483.0 million at June 30, 2006, an increase of \$65.1 million or 15.6% when compared to the balance of \$417.9 million at December 31, 2005, and an increase of \$74.7 million or 18.1% when compared to the balance of \$409.0 million reported at June 30, 2005. Loans on average increased 8.4% between the six-month periods ended June 30, 2005 and June 30, 2006, with loans averaging \$442.3 million for the six months ended June 30, 2006, as compared to \$407.9 million for the same six-month period of 2005.

During the first six months of 2006, increases were experienced primarily in commercial and industrial loans, as well as commercial real estate loans, with moderate increases in agricultural loans and construction loans. The following table sets forth the amounts of loans outstanding by category at June 30, 2006 and December 31, 2005, the category percentages as of those dates, and the net change between the two periods presented.

Table 5. Loans

<i>(In thousands)</i>	June 30, 2006		December 31, 2005		Net Change	% Change
	Dollar Amount	% of Loans	Dollar Amount	% of Loans		
Commercial and industrial	\$ 136,649	28.3%	\$ 113,263	27.1%	\$ 23,386	20.65%
Real estate mortgage	108,219	22.4%	89,503	21.4%	18,716	20.91%
Real estate construction	170,316	35.3%	162,873	38.9%	7,443	4.57%
Agricultural	37,319	7.7%	24,935	6.0%	12,384	49.67%
Installment/other	19,192	4.0%	15,002	3.6%	4,190	27.93%
Lease financing	11,344	2.3%	12,334	3.0%	(990)	-8.03%
Total Gross Loans	\$ 483,039	100.0%	\$ 417,910	100.0%	\$ 65,129	15.58%

The overall average yield on the loan portfolio was 8.97% for the six months ended June 30, 2006 as compared to 7.89% for the six months ended June 30, 2005, and increased between the two periods primarily as the result of an increase in market rates of interest which positively impacted loan yields. At June 30, 2006, 60.9% of the Company's loan portfolio consisted of floating rate instruments, as compared to 58.1% of the portfolio at December 31, 2005, with the majority of those tied to the prime rate.

Deposits

Total deposits increased during the period to a balance of \$561.1 million at June 30, 2006 representing an increase of \$14.6 million or 2.68% from the balance of \$546.5 million reported at December 31, 2005, and an increase of \$15.8 million or 2.91% from the balance reported at June 30, 2005. During the first six months of 2006, increases were experienced in interest-bearing checking accounts, savings accounts, and time deposits of \$100,000 or more. During the same period time deposits of less than \$100,000 declined by \$7.3 million, and noninterest-bearing deposits decreased by \$8.4 million or 5.47%.

The following table sets forth the amounts of deposits outstanding by category at June 30, 2006 and December 31, 2005, and the net change between the two periods presented.

Table 6. Deposits

<i>(In thousands)</i>	June 30, 2006	December 31, 2005	Net Change	Percentage Change
Noninterest bearing deposits	\$ 144,736	\$ 153,113	\$ (8,377)	-5.47%
Interest bearing deposits:				
NOW and money market accounts	186,215	175,852	10,363	5.89%
Savings accounts	36,881	33,590	3,291	9.80%
Time deposits:				
Under \$100,000	45,949	53,254	(7,305)	-13.72%
\$100,000 and over	147,325	130,651	16,674	12.76%
Total interest bearing deposits	416,370	393,347	23,023	5.85%
Total deposits	\$ 561,106	\$ 546,460	\$ 14,646	2.68%

The Company's deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits. Interest-bearing deposits consist of time certificates, NOW and money market accounts and savings deposits. Total interest-bearing deposits increased \$23.0 million or 5.85% between December 31, 2005 and June 30, 2006, while noninterest-bearing deposits decreased \$8.4 million or 5.47% 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 73.4% and 75.7% of the total deposit portfolio at June 30, 2006 and December 31, 2005, respectively.

On a year-to-date average (refer to Table 1), the Company experienced an increase of \$13.7 million or 2.57% in total deposits between the six-month periods ended June 30, 2005 and June 30, 2006. Between these two periods, average interest-bearing deposits increased \$6.8 million or 1.72%, while total noninterest-bearing checking increased \$6.9 million or 5.0% on a year-to-date average basis.

Short-Term Borrowings

The Company had collateralized and uncollateralized lines of credit aggregating \$275.5 million, as well as FHLB lines of credit totaling \$25.2 million at June 30, 2006. 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 June 30, 2006, the Company had advances of \$17.1 million on an uncollateralized Federal Funds line of credit. The Company had collateralized and uncollateralized lines of credit aggregating \$248.7 million, as well as FHLB lines of credit totaling \$10.7 million at December 31, 2005.

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 Interagency Policy Statement on the Allowance for Loan and Lease Losses (Statement) issued jointly by banking regulators during July 2001. The Statement outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was also released at this time which represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators. The Company segments the loan and lease portfolio into eleven (11) segments, primarily by loan class and type, that have homogeneity and commonality of purpose and terms for analysis under SFAS No. 5. Those loans, which are determined to be impaired under SFAS No. 114, are not subject to the general reserve analysis under SFAS No. 5, and evaluated individually for specific impairment.

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

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

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

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

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

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 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. During the first six months of 2006, there were no changes in estimation methods or assumptions that affected the methodology for assessing the adequacy of the allowance for credit losses.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly/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 June 30, 2006 and 2005, the Company's recorded investment in loans for which impairment has been recognized totaled \$7.4 million and \$19.3 million, respectively. Included in total impaired loans at June 30, 2006, are \$5.9 million of impaired loans for which the related specific allowance is \$4.1 million, as well as \$1.5 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. Total impaired loans at June 30, 2005 included \$11.4 million of impaired loans for which the related specific allowance is \$3.4 million, as well as \$7.9 million of impaired loans that, as a result of write-downs or the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$10.9 million during the first six months of 2006 and \$17.1 million during the first six months of 2005. In most cases, the Bank 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 six months ended June 30, 2006, and year ended December 31, 2005, the Company recognized \$35,000 and \$34,000, respectively, in income on such loans. For the six months ended June 30, 2005 the Company recognized no income on such loans.

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

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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>	June 30, 2006	June 30, 2005
Total loans outstanding at end of period before deducting allowances for credit losses	\$ 481,896	\$ 408,203
Average net loans outstanding during period	442,271	407,871
Balance of allowance at beginning of period	7,748	7,251
Loans charged off:		
Real estate	0	0
Commercial and industrial	(2)	(115)
Lease financing	(149)	(143)
Installment and other	(17)	(50)
Total loans charged off	(168)	(308)
Recoveries of loans previously charged off:		
Real estate	0	0
Commercial and industrial	42	24
Lease financing	1	2
Installment and other	20	24
Total loan recoveries	63	50
Net loans charged off	(105)	(258)
Provision charged to operating expense	363	498
Reclassification of off-balance sheet reserve	33	12
Balance of allowance for credit losses at end of period	\$ 8,039	\$ 7,503
Net loan charge-offs to total average loans (annualized)	0.05%	0.13%
Net loan charge-offs to loans at end of period (annualized)	0.04%	0.13%
Allowance for credit losses to total loans at end of period	1.67%	1.84%
Net loan charge-offs to allowance for credit losses (annualized)	2.63%	6.93%
Net loan charge-offs to provision for credit losses (annualized)	28.93%	51.81%

At both June 30, 2006 and 2005, \$509,000 and \$495,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, carried separately in other liabilities. Management believes that the 1.67% credit loss allowance at June 30, 2006 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that the economic conditions which may adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio.

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>	June 30, 2006	December 31, 2005
Nonaccrual Loans	\$ 7,624	\$ 13,930
Restructured Loans	4,924	0
Total nonperforming loans	12,548	13,930
Other real estate owned	4,351	4,356
Total nonperforming assets	\$ 16,899	\$ 18,286
Loans past due 90 days or more, still accruing	\$ 2	\$ 0
Nonperforming loans to total gross loans	2.60%	3.33%
Nonperforming assets to total gross loans	3.50%	4.38%

Nonaccrual loans have declined between December 31, 2005 and June 30, 2006 as the result of a transfer of a single lending relationship from nonaccrual status to accrual status during the first quarter of 2006. The \$4.9 million loan was restructured during the first quarter of 2006 has been reclassified as such for reporting purposes.

The Company purchased a schedule of payments collateralized by Surety Bonds and lease payments in September 2001 that have a current balance owing of \$5.5 million plus interest. The leases have been nonperforming since June of 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 2005 Annual Report on Form 10-K*). The impaired lease portfolio is on non-accrual status and has a specific allowance allocation of \$3.8 million and \$3.5 million allocated at June 30, 2006 and December 31, 2005, and a net carrying value of \$1.7 million and \$2.0 million at June 30, 2006 and December 31, 2005, respectively. 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 \$3.8 million calculated for the impaired lease portfolio at June 30, 2006 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 June 30, 2006 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

Liquidity and Asset/Liability Management

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

Liquidity 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.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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 60.9% of the Company's loan portfolio at June 30, 2006. This does not preclude the Company from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Company has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Company has the ability to utilize an asset management approach and, either control asset growth or, fund further growth with maturities or sales of investment securities.

The Company's liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell (reverse repos) and investment securities, is maintained at a level deemed sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At June 30, 2006, the Bank had 71.3% of total assets in the loan portfolio and a loan to deposit ratio of 85.9%. Liquid assets at June 30, 2006 include cash and cash equivalents totaling \$36.4 million as compared to \$63.0 million at December 31, 2005. 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 \$300.1 million at June 30, 2006.

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 six months ended June 30, 2006, dividends paid by the Bank to the parent company totaled \$5.0 million dollars.

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 June 30, 2006 and the minimum capital requirements for both under the regulatory guidelines discussed above:

Table 9. Capital Ratios

	Company Actual Capital Ratios	Bank Actual Capital Ratios	Minimum Capital Ratios
Total risk-based capital ratio	13.52%	12.92%	10.00%
Tier 1 capital to risk-weighted assets	12.42%	11.82%	6.00%
Leverage ratio	11.68%	11.10%	5.00%

As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at June 30, 2006. 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 six months of 2006, the Company has received \$5.0 million in cash dividends from the Bank, from which the Company paid \$2.4 million in dividends to shareholders.

Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. At June 30, 2006 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 June 30, 2006 from those presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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

Under the interest rate swap agreement, the Company receives a fixed rate and pays a variable rate based on 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. The amortizing hedge has a remaining notional value of \$15.6 million, matures in September 2008, and has a duration of approximately 12 months. As of June 30, 2006, the maximum length of time over which the Company is hedging its exposure to the variability of future cash flows is approximately 2.25 years. As of June 30, 2006, the loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$16,000 (net of tax benefit of \$11,000). During the six months ended June 30, 2006, \$234,000 was reclassified from other accumulated other comprehensive income into expense, and is reflected as a reduction in other noninterest income.

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

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 June 30, 2006, the resultant projected impact on net interest income falls within policy limits set by the Board of Directors for all rate scenarios run.

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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 June 30, 2006 and December 31, 2005 (\$ in thousands). Fair value estimates are subjective in nature and involve uncertainties and significant judgment and, therefore, cannot be determined with absolute precision. Assumptions have been made as to the appropriate discount rates, prepayment speeds, expected cash flows and other variables. Changes in these assumptions significantly affect the estimates and as such, the obtained fair value may not be indicative of the value negotiated in the actual sale or liquidation of such financial instruments, nor comparable to that reported by other financial institutions. In addition, fair value estimates are based on existing financial instruments without attempting to estimate future business.

Change in Rates	June 30, 2006			December 31, 2005		
	Estimated MV of Equity	Change in MV of Equity \$	Change in MV of Equity %	Estimated MV of Equity	Change in MV of Equity \$	Change in MV of Equity %
+ 200 BP	\$ 85,319	\$ 934	1.11%	\$ 76,643	\$ (519)	-0.67%
+ 100 BP	85,833	1,148	1.72%	76,202	(960)	-1.24%
0 BP	84,385	0	0.00%	77,162	0	0.00%
- 100 BP	83,606	(779)	-0.92%	72,918	(4,244)	-5.50%
- 200 BP	81,759	(2,626)	-3.11%	70,587	(6,576)	-8.52%

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, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective on a timely manner to alert them to material information relating to the Company which is required to be included in the Company's periodic Securities and Exchange Commission filings.

(b) Changes in Internal Controls over Financial Reporting: During the quarter ended June 30, 2006, the Company did not make any significant changes in, nor take any corrective actions regarding, its internal controls over financial reporting or other factors that could significantly affect these controls.

The Corporation 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 Corporation 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 in the Company's risk factors during the second quarter of 2006.**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(All amounts in the following table and discussion have been adjusted to reflect the 2-for-1 stock split effective May 1, 2006):

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
04/01/06 to 04/30/06	0		0	350,314
05/01/06 to 05/31/06	9,090	\$ 23.40	9,094	341,220
06/01/06 to 06/30/06	4,031	\$ 22.52	4,031	337,189
Total second quarter 2006	13,121	\$ 23.13	13,121	

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 553,000 shares (adjusted for 2-1 stock split May 2006) of the Company's common stock on the open market or in privately negotiated transactions. As with the first plan, the duration of the new program is open-ended and the timing of purchases will depend on market conditions.

Concurrent with the approval of the new repurchase plan, the Board terminated the 2001 repurchase plan and canceled the remaining 64,577 shares yet to be purchased under the earlier plan.

Item 3. Not applicable**Item 4.** Not applicable**Item 5.** Not applicable**Item 6.** Exhibits:

(a) Exhibits:

- 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

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.

Date: August 8, 2006

United Security Bancshares

/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