Community Bancorp
Form 10-K
March 16, 2006
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the fiscal year ended DECEMBER 31, 2005**

**or**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from ________ to ________.**

**Commission File No. 000-51044**

# COMMUNITY BANCORP

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Nevada** | **01-0668846** |
| **(State or other jurisdiction** | **(I.R.S. Employer** |
| **of incorporation or organization)** | **Identification No.)** |
| **400 S. 4th Street, Suite 215, Las Vegas, NV** | **89101** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**Registrant s telephone number: (702) 878-0700**

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

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, $0.001 par value per share**

**(Title of class)**

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ¨ No x

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of June 30, 2005, the aggregate market value of the common stock held by non-affiliates of the Company was: $169,972,384

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Indicate the number of shares outstanding of each issuer s classes of common stock, as of the latest practicable date. As of March 10, 2006, 7,383,753

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**DOCUMENTS INCORPORATED BY REFERENCE**

The information required in Part III, Items 10-14 is incorporated by reference to the registrant s proxy statement for the 2006 annual meeting of shareholders, which will be filed pursuant Regulation 14A.

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**COMMUNITY BANCORP**

**ANNUAL REPORT ON FORM 10-K**

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## FORWARD-LOOKING INFORMATION

Certain statements contained in this Annual Report on Form 10-K ( Report ), including, without limitation, statements containing the words believes, anticipates, intends, expects, and words of similar import, constitute forward-looking statements within the meaning of Section 27A the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such forward looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: general economic and business conditions in those areas in which we operate, demographic changes, competition, fluctuations in interest rates, changes in business strategy or development plans, changes in governmental regulation, credit quality, the availability of capital to fund the expansion of our business, economic, political and global changes arising from the war on terrorism, the conflict with Iraq and its aftermath, and other factors referenced in this Report, including in Item 1A. Risk Factors. When relying on forward-looking statements to make decisions with respect to our Company, investors and others are cautioned to consider these and other risks and uncertainties. We disclaim any obligation to update any such factors or to publicly announce the results of any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

This discussion should be read in conjunction with our financial statements, including the notes thereto, appearing elsewhere in this Report.

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# PART I

## ITEM 1. BUSINESS

### Community Bancorp

Community Bancorp is the bank holding company for Community Bank of Nevada, a Nevada state chartered bank headquartered in Las Vegas. We deliver an array of commercial bank products and services with an emphasis on customer relationships and personalized service. At December 31, 2005, we had total assets of $893 million, gross loans of $663 million, total deposits of $725 million and stockholders equity of $107 million. Measured by total assets, we are one of the largest publicly-traded Nevada community banks.

Our holding company was formed in 2002. As a result, Community Bank of Nevada became our wholly-owned subsidiary and the shareholders of Community Bank of Nevada became our shareholders. Community Bank of Nevada was organized in July 1995 by local community leaders and experienced bankers with the mission of providing superior community banking services to the greater Las Vegas area.

We focus on meeting the commercial banking needs associated with the population and economic growth of the greater Las Vegas area. Our customers are generally small- to medium-sized businesses (generally representing businesses with less than $50 million in annual revenues) that require highly personalized commercial banking products and services that we deliver with an emphasis on relationship banking. We believe that our customers prefer locally managed banking institutions that provide responsive, personalized service and customized products. A substantial portion of our business is with customers who have long-standing relationships with our officers or directors or who have been referred to us by existing customers.

Historically, we have focused our lending activities on commercial real estate loans, construction loans and land acquisition and development loans, which comprised 76% of our loan portfolio at December 31, 2005. While this continues to be a large part of our business, we see significant opportunities in growing our commercial and industrial, or C&I, loans, and Small Business Administration, or SBA, loans. On the deposit side, we have focused on attracting low cost core deposits, with particular emphasis on growing our non-interest bearing demand deposits.

Our most recent significant event is the acquisition of Bank of Commerce in August 2005, which contributed to the strength of our balance sheet for the year. At the time of acquisition, our total assets increased $170.7 million, total loans increased $104.1 million, and total deposits increased $118.2 million. In addition to loans and deposits, the acquisition increased our available for sale securities portfolio by $22.4 million, our premises and equipment by $4.6 million, and provided a tax receivable of $1.1 million. Also as part of the acquisition, we reported goodwill of $19.7 million and a core deposit intangible of $5.3 million at December 31, 2005. We also assumed short term borrowings of $6.0 million and long term debt of $3.5 million. For a discussion of the merger-related activity, please see Item 8. Financial Statements and Supplementary Data.

In the fourth quarter of 2004, we successfully completed our initial public offering (IPO) and concurrent listing of common stock on the NASDAQ National Market. In our offering, we raised $39.3 million, net of expenses, and certain selling shareholders received net proceeds of $16.5 million.

We have nine full service branches, seven located in Las Vegas and two located in Henderson. In 1995, the first office, now our Rainbow office, commenced operations. In 1997, the Maryland Parkway branch opened in central Las Vegas followed by the opening of the Summerlin branch in 1999. In 2000, the Green Valley branch opened, marking expansion into Henderson, Nevada. In 2002, we opened our City Centre branch in downtown Las Vegas. Our sixth branch at the intersection of Interstate 215 and Russell Road opened in July 2005. The acquisition of Bank of Commerce in August 2005 added an additional three branches: our Sahara, Decatur and Sunset offices. Our headquarters is located at our downtown branch at 400 South 4th Street, Las Vegas, Nevada 89101 and our telephone number is (702) 878-0700. We maintain a website at www.communitybanknv.com. None of the information on or hyperlinked from our website is incorporated herein.

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**Strategy**

We strive to be a high performing community bank holding company for the long-term benefit of our shareholders, customers and employees. The key elements of our strategy are to:

***Growth Strategies***

*Expand our franchise* through acquisition or the establishment of new branches or banks in markets that offer regional continuity, such as the greater Las Vegas area or similar high-growth markets in Arizona and California. We opened our sixth branch in the second half of 2005 in Las Vegas and acquired three additional branches in August 2005. Our strategic plan currently calls for one additional branch per year through 2008.

*Continue as a public company* with a common stock that is quoted and traded on a national stock market. In addition to providing access to growth capital, we believe a public currency provides flexibility in structuring acquisitions and will allow us to attract and retain qualified bankers through equity-based compensation. We have just completed our first full year as a public company.

*Expand our commercial lending portfolio* to diversify both our customer base and maturities of the loan portfolio, and to benefit from the low cost deposits associated with the professional, construction and service industries that are common commercial borrowers. During 2005, we successfully recruited a team of local commercial lenders which has given us a greater network and far greater capacity to attract commercial relationships.

*Increase our SBA production* from each of our three loan production offices in Las Vegas, Phoenix and San Diego. The SBA loans provide us an option to portfolio or to sell the guaranteed portion of loans in the secondary market. With the centralized underwriting in Las Vegas and strong personnel marketing the product in each of the three locations, both interest income and non-interest income are expected to increase as this division reaches a level of production similar to the commercial and commercial real estate areas.

*Continue to grow our commercial real estate lending* by maintaining the professional respect of the community s most successful developers and leverage our successful background and depth of network from our experienced lenders to expand market share. We have demonstrated a very successful revenue chain while generating interest and fees at each stage of the development life cycle including land acquisition and development, construction and permanent loans.

*Continue to grow our real estate lending activities* by providing competitive commercial real estate loans, construction loans, and land acquisition and development loans. Through our financing activities, including the additional capital provided by our IPO, we have the ability to originate larger loans to new and existing customers.

***Operating Strategies***

*Enhance our risk management functions* by proactively managing sound procedures and committing experienced human resources to this effort. We seek (i) to identify risks in all functions of our business, including credit, operations and asset and liability management, (ii) to evaluate such risks and their trends and (iii) to adopt strategies to manage such risks based upon our evaluations.

*Maintain high asset quality* by continuing to utilize rigorous loan underwriting standards and credit risk management practices.

*Continue to actively manage interest rate and market risks* by closely matching the volume and maturity of our rate sensitive assets to our interest sensitive liabilities in order to mitigate adverse effects of rapid changes in interest rates on either side of our balance sheet.

*Expand commercial and industrial, as well as small business relationships* which commonly are associated with deposits that are a lower cost funding source. With loan demand remaining high, a

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significant emphasis has been placed on the growth of core deposits. Loan growth that may exceed the expansion of core deposits will be supported with in-market certificates of deposit, borrowings and wholesale deposits.

*Diversify our revenue source* by selling more products to each of our client relationships. We actively account for the number of products that our clients purchase from us and the products that those clients purchase from other financial service providers. Our mission is to continually cross-sell as well as expand each relationship by number of products annually.

**Market Area**

Our primary market area is Clark County, Nevada. Clark County is one of the fastest growing areas in the United States. According to the Center for Business and Economic Research based at the University of Nevada, Las Vegas, or the CBER, between 2001 and 2005, Clark County s population grew by approximately 5% on an annual basis, from 1,485,855 persons to 1,796,380 persons. This growth has been driven by a variety of factors including a growth in the service economy associated with the hospitality and gaming industries, affordable housing, no income taxation, a growing base of senior or retirement communities and general recreational opportunities associated with a favorable climate.

The following highlights, more specifically, some of the economic opportunities that have driven the population growth in Clark County. According to CBER, between 2001 and 2005:

total gaming revenue in Clark County has risen to revenue of over $9.7 billion in 2005, as compared to revenue of approximately $7.6 billion in 2001;

visitor volume has increased from approximately 35 million visitors to Las Vegas in 2001 to 39 million in 2005; and

the number of hotel rooms in Clark County increased from approximately 127,000 in 2001 to approximately 133,000 in 2005.

Complementing the region s expanding economic opportunities has been the availability of relatively affordable housing. The attraction and retention of a quality labor force to service the economy depends in part on housing availability. According to CBER, housing permits related to new homes in Clark County have risen over the last five years, from 29,668 in 2001 to 38,400 in 2005. Although home prices have recently risen, management believes median housing prices in Nevada are still below the median price for homes in California, which is the source of three of every five new Nevada residents.

Contributing to the population growth in Clark County has been the recent influx of retirees and young families to the area. According to CBER, over 20,000 retirees have moved to Clark County since 2001, factoring into the 2003 total number of 243,500 retirees. In addition to retirees, many young families have moved to Clark County, driven by the rapid economic growth, as described above, in the greater Las Vegas area.

The Clark County school district is the fastest growing school district in the United States, according to the Nevada Department of Education. According to the Clark County School District 1998 Building Program, the Clark County School district has opened 14 new schools for the 2004-2005 school year alone. In 1998 Clark County voters approved a bond issue for an additional $3.5 billion to build a total of 88 new schools (50 elementary schools, 22 middle schools, and 16 high schools) to accommodate an anticipated 15,980 new students a year, a number that is expected to increase to 18,049 students per year over the next decade. To date, 69 of these schools have already been built.

In addition to schools, population growth has created a need for all types of retail services. For example, over the past seven years, a national pharmacy chain has built 30 drug stores in Clark County. Commercial stores, gas stations, storage units, restaurants and bars, and clothing stores are among the services that have

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followed the population growth. Three new hospitals have recently opened in Clark County. As a result, we expect to see an increase in medical support facilities and doctors offices, especially with the retiree population continuing to grow. Also, the increase of products and services at the retail level require additions to the wholesale, warehouse and transportation sectors.

We believe that the economic growth in Clark County, the population growth and the accompanying need for infrastructure presents the following significant opportunities:

*Deposit Growth Opportunities.* According to the FDIC, deposits in Clark County grew from $15 billion to $34 billion between June 2001 and June 2005, a compound annual growth rate of 22%.

*Loan Growth Opportunities.* Increased residential and commercial development as well as the infrastructure growth in Clark County has offered more and larger lending opportunities for us.

**Business Activities**

We provide banking services throughout our primary market area to small-to medium-sized businesses (generally representing businesses with annual revenues of less than $50 million). Many of these small- to medium-sized businesses provide goods and services, directly or indirectly, to the development of the infrastructure in and around the greater Las Vegas area that services the growing population. Our customers include developers, contractors, professionals, distribution and service businesses, local residential home builders and manufacturers. We also provide a broad range of banking services and products to individuals, including personal checking and savings accounts and other consumer banking products, including electronic banking.

Both lending personnel and the business development staff who have a primary emphasis on deposit growth utilize this program to determine pricing for products. Some of the applications are summarized below:

*Lending.* Senior management establishes a minimum return on equity hurdle rate for each particular loan type, which is influenced by the pricing of credit and the revenue derived from various deposits generated. We pay incentives to our lenders based on maximizing the relationship return on equity. We have found that the lenders have become far more conscientious about pricing credit, as well as their ability to secure low cost deposits. Additionally, our pricing model has placed added emphasis on risk and return. The credit risk rating influences the costs associated with the credit and therefore influences pricing when additional risk is assumed.

*Deposits.* We have a very active business development culture and have developed a specific incentive plan for deposit gathering. The pricing model takes into account the interest expense associated with a deposit relationship and, through transfer pricing, helps determine the profitability of a deposit relationship. Since non-interest bearing deposits have no interest expense associated with them, the return on equity is high for that product and thus, the payout incentive to the business development staff is high.

Management continues to emphasize the utilization of variable rate pricing for the majority of all loan commitments. Among the variety of credit products provided, only the permanent commercial real estate loan has competitive pressure to provide a fixed rate loan. We have remained competitive with a fixed rate product that adjusts every 36 months tied to an index of prime or LIBOR.

We originate a variety of loans, including commercial real estate loans, secured and unsecured C&I loans, residential real estate loans, SBA loans, and, to a lesser extent, consumer loans. In addition to direct loan origination, we also utilize our relationships within the banking industry to participate in loans that fit our criteria. The amount of our participation loans at December 31, 2005 constituted approximately 7.4% of our total loan portfolio. When we consider the purchase of an interest in a participation, we apply our existing policies and procedures to the credit. Proven cash flow and an independent secondary source of repayment remain as the critical measurements of credit risk.

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Once we have booked an interest in a purchased participation loan, we strive to apply the same monitoring and credit quality assessment as we do for credits that we originate. These monitoring and assessment procedures include review of information supplied by borrowers pursuant to loan agreements as well as both internal and external loan review of the credit. To date, we have not suffered any loss on a loan purchased from another originator. We expect that our own originations will continue to be the primary source of our loan growth.

Our customers are generally comprised of the following groups:

- real estate developers in need of land, construction and permanent financing for commercial and residential developments;
- small- to medium-sized businesses in need of secured and unsecured lines of credit or permanent C&I loans;
- professionals and service providers in need of operating facilities.

We manage our loan portfolio to provide for an adequate return, but also to provide a diversification of risk. Historically, we have maintained very high asset quality. Our lending activities are concentrated in four main categories, as described below.

*Commercial Real Estate Loans.* We have a strong focus in the origination of commercial real estate, or CRE, loans. Our CRE loans fall into three sub-categories raw land, construction and term loans on completed projects. Construction and acquisition and development lending currently constitutes approximately 36% of total commercial real estate loans at December 31, 2005. Raw land loans and term loans on completed projects constituted approximately 15% and 49%, respectively, of total CRE loans at December 31, 2005.

To manage our concentration of loans in commercial real estate and the inherently higher risk of construction lending (see Item 1A. Risk Factors and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Allowance for Loan Losses ), we seek diversification through maintaining a broad base of borrowers and by adjusting our exposure to property types based on overall strength in a particular sector, which includes a variety of factors such as vacancy trends. During the past several years, the retail segment of the market has been strong, with low vacancies, while other segments of the commercial real estate market have experienced weaker fundamentals. Currently, a large portion of our portfolio is in the retail sector. As of December 31, 2005, our CRE loan portfolio, including construction loans, was comprised of the following property types:

| Loan Type | $ Outstanding (In millions) | % of Loan Portfolio |
|---|---|---|
| Retail | $ 156 | 23% |
| Office | $ 131 | 20% |
| Industrial | $ 61 | 9% |
| Hotel/Casino | $ 21 | 3% |
| Restaurant/Bar | $ 11 | 2% |
| Other | $ 19 | 3% |
| Total | $ 399 | 60% |

We have historically maintained very strong credit quality. We generally underwrite loans with a minimum equity position of 25% (or a maximum loan to value of 75%) and a minimum debt coverage ratio of 1.25:1. We also seek to lend to developers who have already entered into leases for the subject property, however, we are willing to provide loans for speculative development but only if the borrower has the ability to service the debt independent of the anticipated success of the subject property and can demonstrate such ability to our satisfaction.

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We have also increased our focus on owner-occupied real estate. Consistent with our strategic plan to reduce our cost of funds, we have found this often includes many core business opportunities with professionals such as attorneys, engineers, architects, doctors and dentists. These types of businesses also provide reliable depository relationships.

We have been active in both the construction lending and permanent financing of our CRE portfolio. Construction and raw land loans are short term in nature and generally do not exceed 18 months. Permanent commitments are primarily restricted to no greater than 10 year maturities with rate adjustment periods every 36 months when fixed commitments exist.

*Commercial and Industrial Loans.* We offer a variety of commercial loan products including lines of credit for working capital, term loans for capital expenditures and commercial stand-by letters of credit. As of December 31, 2005, we had $126 million of C&I loans outstanding and C&I commitments of $68 million. Lines of credit typically have a 12-month commitment and will be secured by the trading asset that is being financed. In cases of larger commitments, a borrowing base certificate may be required to determine eligible collateral and advance parameters. Term loans seldom exceed 60 months, but in no case, exceed the depreciable life of the tangible asset being financed.

We are a Preferred Lender with the Small Business Administration, or SBA. Our strategic plan calls for a much greater production of SBA loans. We offer both SBA 7a and SBA 504 programs. Under the 7a program, loans up to $150,000 are guaranteed up to 85% by the SBA. Under current SBA guidelines, 7a loans in excess of $150,000 but not in excess of $2,000,000 are guaranteed up to 75% by the SBA. Generally, this guarantee may become invalid only if the loan does not meet the SBA documentation guidelines. Subject to balance sheet needs and premium yields, we anticipate strong growth in this product and a continued philosophy to increase non interest income by selling these assets. We will continue to service the loans for a fee.

In 2002, we introduced our Express Loan program. All commercial credits less than $250,000 are underwritten by this department. We utilize credit scoring software to assist us with the credit decision process. This has resulted in far greater efficiency. Borrowers realize a 24-hour turn around time on loan decisions and have been willing to pay a premium for this service.

*Residential Real Estate Loans.* The majority of new home construction in the greater Las Vegas area is conducted by the large national/regional home builders that have direct access to capital markets. We have selectively participated with some of the small local home builders that continue to have success with in-fill parcels that have demonstrated high demand. As of December 31, 2005, our residential real estate loan portfolio was comprised of $134 million in loans, including both acquisition and development loans and new home construction totaling $64 million. These commitments extend up to 18 months and include both acquisition and development loans and new home construction. We do not participate in permanent mortgage financing in this segment, rather we have elected to broker these loans for a fee.

*Consumer Lending.* We have used consumer credit as a complementary product to our primary product line. Our approach to consumer credit is as a value added product for our business customers. We offer competitively priced products with an emphasis in the marketing towards the business owner and the work force of that client. Our products include home equity credit lines, automobile loans, personal lines of credit and home improvement loans.

***Lending and Credit Policies***

The Board of Directors of Community Bank of Nevada establishes our lending policies. The three key principles of our lending policies are (1) debt service coverage, (2) risk rating system and pricing for risk and (3) managed concentration levels.

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*Debt Service Coverage.* Our risk management philosophy is to extend credit only when an applicant has proven cash flow to service the proposed debt. Additionally, it is generally necessary for the applicant to demonstrate an independent secondary source of repayment.

*Risk Rating System and Pricing for Risk.* We have a risk rating system of eight categories that clearly define the fundamentals for each risk rating. At the time of origination, the underwriter assigns a risk rating and then it is reviewed periodically by credit administration. We use this system to manage levels of risk, pricing and forward thinking strategy for future extensions of certain loan categories. We introduced a relationship pricing model in 2003, which integrates our risk rating system and promotes the origination of highly profitable loans.

*Managed Concentration Levels.* We have established minimum levels of return on equity that varies by product type and concentration levels. We actively manage our pricing model, so that we have control over our concentrations in certain types of credits, so that if we near a policy guideline, we can adjust the hurdle rates based on our perceived concentration risk.

If a credit falls outside of the guidelines set forth in our lending policies, the loan is not approved until it is reviewed by a higher level of credit approval authority. Credit approval authority has three levels, as listed below from lowest to highest level. Based on the historical strong emphasis on business development, the Board of Directors of Community Bank of Nevada has intentionally kept approval authorities low to assure a high degree of secondary review for a credit consideration. Management believes that the current authority levels provide satisfactory management and a reasonable percentage of secondary review. Any conditions placed on loans in the approval process must be satisfied before our credit administration will release loan documentation for execution. Our credit administration works entirely independent of loan production and has full responsibility for all loan disbursements.

*Individual Authorities.* Selected loan officers have approval authority up to $750,000 for secured loans and up to $150,000 for unsecured transactions. The Chief Executive Officer, the President and Chief Operating Officer, and the Chief Credit Officer have approval authority of up to $2,000,000 for secured loans and up to $750,000 for unsecured loans.

*Senior Loan Committee.* The Senior Loan Committee consists of the Chief Executive Officer, the President and Chief Operating Officer, Chief Credit Officer and the managers of Commercial Lending and Commercial Real Estate. It has approval authority up to $6,000,000 for secured loans and up to $1,500,000 for unsecured loans.

*Board Loan Committee.* The Board Loan Committee consists of all of the members of the Board of Directors of Community Bank of Nevada. It has approval authority up to our legal lending limits. For the Bank, our legal lending limit was approximately $20.9 million at December 31, 2005.

*Loan Grading and Loan Review.* We seek to quantify the risk in our lending portfolio by maintaining a loan grading system consisting of eight different categories (Grades 1-8). The grading system is used to determine, in part, the provision for loan losses. The first four grades in the system are considered satisfactory. The other four grades range from a Watch/Pass category to a Doubtful category. These four grades are further discussed below under the section subtitled Classified Assets.

The originating loan officer initially assigns a grade to each credit as part of the loan approval process. Such grade may be changed as a loan application moves through the approval process. In addition to any dollar limitations that may require higher credit approval authority, each loan over $500,000 that is graded Watch/Pass or worse requires prior approval of the Board of Directors of Community Bank of Nevada.

After funding, all loans of $250,000 or over are reviewed by the Executive Vice President/Credit Administrator who may assign a different grade to the credit. The grade on each individual loan is reviewed at least annually by the loan officer overseeing the credit. The Board of Directors of Community Bank of Nevada reviews monthly the aggregate amount of all loans graded as special mention, substandard or doubtful, and each individual loan over $200,000 that has a grade within such range. Additionally, changes in the grade for a loan may occur through any of the following means:

- random reviews of the loan portfolio conducted by loan administration;
- annual reviews conducted by an outside loan reviewer;
- bank regulatory examinations;
- monthly action plans submitted to loan administration by the responsible lending officers for each credit graded 5-8; or
- at the monthly credit risk managers meeting if a loan is exhibiting certain delinquency tendencies.

*Loan Delinquencies.* When a borrower fails to make a committed payment, we attempt to cure the deficiency by contacting the borrower to seek payment. Habitual delinquencies and loans delinquent 30 days or more are reviewed at the monthly credit risk managers meeting for possible changes in grading.

*Classified Assets.* Federal regulations require that each insured bank classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, examiners have authority to identify problem assets, and, if appropriate, classify them. We use grades 5-8 of our loan grading system to identify potential problem assets and consider substandard and doubtful grades. There were $4.7 million, $1.5 million, $3.1 million and $4.3 million in classified loans at December 31, 2005, 2004, 2003 and 2002, respectively.

The following describes grades 5-8 of our loan grading system:

- *Watch/Pass Grade 5.* Generally these are assets that display negative trends or other causes for concern. This grade is regarded as a transition category. We will either upgrade the credit if meaningful progress is evident within six months, or downgrade the credit to a more severe grade as appropriate.
- *Special Mention Grade 6.* These assets have potential weaknesses that may result in deterioration of the repayment prospects and, therefore, deserve the attention of management. Usually, these assets are long-term problems that are likely to remain and require management action plans. These loans exhibit an increasing reliance on collateral for repayment.
- *Substandard Grade 7.* These assets are inadequately protected by the current worth and paying capacity of the borrower or of the collateral pledged, if any. Although loss may not be imminent, if the weaknesses are not corrected, there is a good possibility that we will sustain some loss.
- *Doubtful Grade 8.* These assets have all the weaknesses inherent in an asset classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, condition and values, highly questionable and improbable. At the point where a loss is identified, all or that portion deemed a loss is immediately classified as Loss and charged off.

**Risk Management**

Our strategic plan continues to promote a growth rate commensurate with the rapid growth of southern Nevada. We are equally committed to maintaining internal controls to manage the risk associated with such growth. Our Risk Management Committee has defined our most significant risks and measures the trends from low to high. The committee has identified credit risk and operational risk as the two areas that could have the greatest impact on capital.

To mitigate and proactively manage these areas of risk, we have established sound procedures and committed experienced human resources to this effort.

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We have focused on enhancing three functions:

- Credit Administration continues to be enhanced by seasoned lenders (underwriting) and administrative staff (post-closing review). Credit Administration maintains all credit policies and procedures, loan documentation, disbursement of loan proceeds concentration analysis and to review the integrity of the credit risk rating system.

- Operations Support has the primary responsibility to manage the identified risks such as wires, check fraud, Bank Secrecy Act and identity theft. Additionally, they ensure we are compliant with all applicable laws and regulations.

- The Audit and Compliance department has also been expanded under the direction of the Audit Committee. Also, we have hired an Executive Vice President/Chief Risk Manager, as well as additional audit staff. This staff of professionals regularly examines all of the areas of known risk and reports the findings to Executive Management and the Audit Committee.

We believe that the established organization allows management to maintain an accurate understanding of risk levels at all times. With this level of understanding, strategic plans are developed with the necessary risk parameters to adequately protect our capital.

**Investment Activities**

Our investment strategy is designed to be complementary to and interactive with our other activities (i.e. cash position; borrowed funds; quality, maturity, stability and earnings of loans; nature and stability of deposits; capital and tax planning). The target percentage for our investment portfolio is between 10% and 25% of total assets. At December 31, 2005, our total investment portfolio was 10.6%. Our general objectives with respect to our investment portfolio are to:

- achieve an acceptable asset/liability gap position (based on our separate policy related to asset/liability management that provides guidance for how investments are to be used to manage asset/liability gaps);

- provide a suitable balance of quality and diversification to our assets;

- provide liquidity necessary to meet cyclical and long-term changes in the mix of assets and liabilities;

- provide a stable flow of dependable earnings;

- maintain collateral for pledging requirements;

- manage interest rate risk;

- comply with regulatory and accounting standards; and

- provide funds for local community needs.

Investment securities consist primarily of US government agency issues, municipal bonds and mortgage-backed securities. In addition, for bank liquidity purposes, we use Federal Funds Sold, which are temporary overnight sales of excess funds to correspondent banks.

All of our investment securities are classified as available for sale or held to maturity pursuant to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Available for sale securities are reported at fair value, with unrealized gains and losses excluded from earnings and instead reported as a separate component of stockholders equity. Held to maturity securities are those securities that we have both the intent and the ability to hold to maturity. These securities are carried at cost adjusted for amortization of premium and accretion of discount.

Our securities portfolio is managed in accordance with guidelines set by our Investment Policy. Specific day-to-day transactions affecting the securities portfolio are managed by our Chief Financial Officer. In

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accordance with our written Investment Policy, all executions also require the prior written approval of the Chief Executive Officer or President. These securities activities are reviewed monthly or more often, as needed, by our Investment Committee and are reported monthly to our Board of Directors.

Our Investment Policy addresses strategies, types and levels of allowable investments and is reviewed and approved annually by our Board of Directors. Our Investment Policy authorizes us to invest in a variety of investment securities, subject to various limitations. It also limits the amount we can invest in various types of securities, places limits on average life and duration of securities, and limits the securities dealers with whom we can conduct business.

**Concentrations/Customers**

No individual or single group of related accounts is considered material in relation to our assets or deposits or in relation to our overall business. However, approximately 80% of our loan portfolio at December 31, 2005 consisted of real estate-secured loans, including commercial loans secured by real estate, construction loans and real estate mortgage loans. Moreover, our business activities are focused in the greater Las Vegas area. Consequently, our business is dependent on the trends of this regional economy and, in particular, the commercial and residential real estate markets. At December 31, 2005, we had 161 loans in excess of $1 million each, totaling $493 million. These loans comprise approximately 13.1% of our loan portfolio by number of loans and 74.4% by total loans outstanding. Not including credit card and consumer overdraft lines and purchased participation loans, our average loan size is approximately $545,000.

**Deposit Products and Other Sources of Funds**

Our primary sources of funds for use in our lending and investing activities consist of:

- deposits;
- maturities and principal and interest payments on loans and securities;
- other borrowings; and
- funds down-streamed into Community Bank of Nevada, from time to time by Community Bancorp.

We closely monitor rates and terms of competing sources of funds and utilize those sources that we believe to be the most cost effective, consistent with our asset and liability management policies.

*Deposits.* An important balance sheet component impacting our net interest margin is the composition and cost of our deposit base. We can improve our net interest margin to the extent that growth in deposits can be focused in the less volatile and somewhat more traditional core deposits, or total deposits less CDs greater than $100,000, commonly referred to as Jumbo CDs. We attempt to price our deposit products in order to promote deposit growth and satisfy our liquidity requirements and offer a variety of deposit products in order to satisfy our customers needs. At December 31, 2005, we had no single customer whose total average deposits were 10% or more of the Company s total average deposits.

We provide a wide array of deposit products. We have historically relied upon, and expect to continue to rely upon, deposits to satisfy our needs for sources of funds. We offer regular checking, savings, NOW and money market deposit accounts; fixed-rate, fixed maturity retail CDs ranging in terms from 30 days to two years; individual retirement accounts. For business customers, we provide courier service to pick up non-cash deposits, and for those customers that use large amounts of cash, we arrange for armored car and vault service. We are not reliant on escrow deposits, which constitute less than 3% of total deposits.

We intend to continue our efforts at attracting deposits from our business lending relationships in order to reduce our cost of funds and improve our net interest margin. Also, we believe that we have the ability to attract

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sufficient additional funding by re-pricing the yields on our CDs and/or obtaining brokered deposits in order to meet loan demands during times that growth in core deposits differs from loan demand.

In addition to our traditional marketing methods, we attract new clients and deposits by:

- expanding long-term business customer relationships, including referrals from our customers, and
- building deposit relationships through our branch relationship officers who are compensated based upon the profitability of such relationships.

*Other Borrowings.* We may occasionally use our Federal Funds lines of credit to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. We have three Fed funds lines with other financial institutions pursuant to which we can borrow up to $19 million on an unsecured basis. These lines may be terminated by the respective lending institutions at any time.

We also borrow from the Federal Home Loan Bank, or FHLB, pursuant to an agreement to obtain advances based on a blanket lien on all loans secured by real estate and all business loans. As of December 31, 2005, we had $16 million in short term advances, of which $1.0 million was acquired with Bank of Commerce. In 2005, we obtained a $15 million short term advance for funding purposes associated with the increase in our loan portfolio.

**Employees**

We had a total of 157 full-time and 9 part-time employees at December 31, 2005.

**Competition**

The banking and financial services business in Clark County, Nevada, generally, and in the greater Las Vegas area, in particular, is highly competitive. This increasingly competitive environment primarily comes as a result of growth in community banks, changes in regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial services providers. We compete for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader range of financial services than we can offer.

Competition for deposit and loan products remains strong from both banking and non-banking firms and this competition directly affects the rates of those products and the terms on which they are offered to consumers.

Mergers between financial institutions have placed additional pressure on banks to consolidate their operations, reduce expenses and increase revenues to remain competitive. In addition, competition has intensified due to federal and state interstate banking laws, which permit banking organizations to expand geographically with fewer restrictions than in the past. These laws allow banks to merge with other banks across state lines, thereby enabling banks to establish or expand banking operations in our market. The competitive environment is also significantly impacted by federal and state legislation that make it easier for non-bank financial institutions to compete with us.

Technological innovation continues to contribute to greater competition in domestic and international financial services markets. Many customers now expect a choice of several delivery systems and channels, including telephone, mail, home computers and ATMs.

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**Effect of Governmental Policies and Recent Legislation**

Banking is a business that depends on rate differentials. In general, the difference between the interest rate we pay on our deposits and our other borrowings and the interest rate we receive on loans extended to our customers and securities held in our portfolio comprise the major portion of our earnings. These rates are highly sensitive to many factors that are beyond our control. Accordingly, our earnings and growth are subject to the influence of domestic and foreign economic conditions, including inflation, recession and unemployment.

The commercial banking business is not only affected by general economic conditions but is also influenced by monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Federal Reserve. The Federal Reserve implements national monetary policies (with objectives such as curbing inflation and combating recession) by its open-market operations in United States Government securities, by adjusting the required level of reserves for financial institutions subject to its reserve requirements and by varying the discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve in these areas influence the growth of bank loans, investments and deposits and also affect interest rates charged on loans and paid on deposits. The nature and impact of any future changes in monetary policies cannot be predicted.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies and other financial institutions are frequently made in Congress, in the Nevada legislature and before various bank regulatory and other professional agencies.

**Supervision and Regulation**

The following discussion is only intended to provide summaries of significant statutes and regulations that affect the banking industry and is therefore not complete. Changes in applicable laws or regulations, and in the policies of regulators, may have a material effect on our business and prospects. We cannot accurately predict the nature or extent of the effects on our business and earnings that fiscal or monetary policies, or new federal or state laws, may have in the future.

**General**

We are extensively regulated under federal and state law. These laws and regulations are primarily intended to protect depositors, not shareholders. The discussion below describes and summarizes certain statutes and regulations. These descriptions and summaries are qualified in their entirety by reference to the particular statute or regulation. Changes in applicable laws or regulations may have a material effect on our business and prospects. Our operations may also be affected by changes in the policies of banking and other government regulators. We cannot accurately predict the nature or extent of the possible future effects on our business and earnings of changes in fiscal or monetary policies, or new federal or state laws and regulations.

**Compliance**

In order to assure that we are in compliance with the laws and regulations that apply to our operations, including those summarized below, in 2005, we hired a Chief Risk Manager and staffed an internal audit department. We also employ a Compliance Officer. We are regularly reviewed by the Board of Governors of the Federal Reserve System, or the Federal Reserve, and the Nevada Department of Business and Industry, Financial Institutions Division, or the Nevada FID, during which reviews such agencies assess our compliance with applicable laws and regulations. Based on the assessments of our outside compliance auditors and the Federal Reserve and Nevada FID, we believe that we materially comply with all of the laws and regulations that apply to our operations.

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**Federal Bank Holding Company Regulation**

*General.* Community Bancorp is a registered financial holding company as defined in the Bank Holding Company Act of 1956, as amended, or the Bank Holding Company Act, and is therefore subject to regulation, supervision and examination by the Federal Reserve. In general, the Bank Holding Company Act limits the business of bank holding companies to owning or controlling banks and engaging in other activities closely related to banking. Community Bancorp must file reports with the Federal Reserve and must provide it with such additional information as it may require.

The Federal Reserve may require Community Bancorp to terminate an activity or terminate control or liquidate or divest certain subsidiaries, affiliates or investments when the Federal Reserve believes the activity or the control of the subsidiary or affiliates constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries.

The Federal Reserve also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest ceilings and reserve requirements on such debt. Under certain circumstances, Community Bancorp must file written notice and obtain Federal Reserve approval prior to purchasing or redeeming its equity securities. Additionally, Community Bancorp is required by the Federal Reserve to maintain certain levels of capital. See Capital Adequacy below for a discussion of the applicable federal capital requirements.

*Financial Holding Company Status.* Under the Financial Services Modernization Act of 1999, a bank holding company may apply to the Federal Reserve to become a financial holding company, and thereby engage (directly or through a subsidiary) in certain activities deemed financial in nature. Community Bancorp was approved as a financial holding company on May 5, 2004.

As a financial holding company, Community Bancorp may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or are incidental or complementary to activities that are financial in nature. Activities that are financial in nature include:

- securities underwriting;
- dealing and market making;
- sponsoring mutual funds and investment companies;
- insurance underwriting and brokerage;
- merchant banking; and
- activities that the Federal Reserve, in consultation with the Secretary of the Treasury, determines from time to time to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

In order to remain a financial holding company, Community Bank of Nevada must be well capitalized, well managed, and, except in limited circumstances, in satisfactory compliance with the Community Reinvestment Act. Failure to sustain compliance with such requirements or correct any non-compliance within a fixed time period could lead to divesture of subsidiary banks or require us to conform all of our activities to those permissible for a bank holding company. A bank holding company that is not also a financial holding company can only engage in banking and such other activities determined by the Federal Reserve to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

We do not believe that the Financial Services Modernization Act will negatively affect our operations in the short term. However, to the extent the legislation permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. This consolidation could result in a growing number of larger financial institutions that offer a wider variety of financial services than we currently offer, and these companies may be able to aggressively compete in the markets we currently serve.

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*Holding Company Bank Ownership.* The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before (1) acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares, (2) acquiring all or substantially all of the assets of another bank or bank holding company or (3) merging or consolidating with another bank holding company.

*Holding Company Control of Nonbanks.* With some exceptions, the Bank Holding Company Act also prohibits a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by Federal Reserve regulation or order, have been identified as activities closely related to the business of banking or of managing or controlling banks.

*Transactions with Affiliates.* Subsidiary banks of a bank holding company are subject to restrictions imposed by the Federal Reserve Act on extensions of credit to the holding company or its subsidiaries, on investments in their securities and on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit Community Bancorp s ability to obtain funds from Community Bank of Nevada for its cash needs, including funds for payment of dividends, interest and operational expenses.

*Tying Arrangements.* We are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, neither Community Bancorp nor Community Bank of Nevada may condition an extension of credit to a customer on either (1) a requirement that the customer obtain additional services provided by us or (2) an agreement by the customer to refrain from obtaining other services from a competitor.

*Support of Subsidiary Banks.* Under Federal Reserve policy, Community Bancorp is expected to act as a source of financial and managerial strength to Community Bank of Nevada. This means that Community Bancorp is required to commit, as necessary, resources to support Community Bank of Nevada. Any capital loans a bank holding company makes to its subsidiary banks are subordinate to deposits and to certain other indebtedness of those subsidiary banks.

*State Law Restrictions.* As a Nevada corporation, Community Bancorp is subject to certain limitations and restrictions under applicable Nevada corporate law. For example, state law restrictions in Nevada include limitations and restrictions relating to indemnification of directors, maintenance of books, records and minutes, and observance of certain corporate formalities.

*Regulation as a Public Company.* Community Bancorp s common stock is registered with the Securities and Exchange Commission (the SEC ) under the Securities Exchange Act of 1934, as amended. As such, we are subject to the information, proxy solicitation, insider trading, corporate governance, and other requirements and restrictions of such Act.

**Federal and State Regulation of Community Bank of Nevada**

*General.* Community Bank of Nevada is a Nevada state chartered commercial bank with deposits insured by the FDIC. The bank is also a member of the Federal Reserve System. As a result, Community Bank of Nevada is subject to supervision and regulation by the Nevada FID and the Federal Reserve. These agencies have the authority to prohibit banks from engaging in activities that constitute unsafe or unsound banking practices.

*Lending Limits.* State banking law generally limits the amount of funds that a bank may lend to a single borrower to 25% of stockholders equity and allowance for loan and lease losses.

*Control of Financial Institutions.* Nevada banking laws require that changes in ownership of 10% or more of a bank s outstanding voting stock must be reported to the Nevada FID within three business days. If 20% or more

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of the bank s voting power is acquired by a natural person, or 10% or more is acquired by an entity, then the acquisition may be deemed a change in control requiring prior approval of the Nevada FID.

*Community Reinvestment.* The Community Reinvestment Act requires that, in connection with examinations of financial institutions within their jurisdiction, the Federal Reserve evaluate the record of the financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of the institution. These factors are also considered in evaluating mergers, acquisitions and applications to open a branch or facility.

*Insider Credit Transactions.* Banks are also subject to certain Federal Reserve restrictions on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons (i.e., insiders). Extensions of credit (1) must be made on substantially the same terms and pursuant to the same credit underwriting procedures as those for comparable transactions with persons who are neither insiders nor employees, and (2) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to insiders. A violation of these restrictions may result in regulatory sanctions on the bank or its insiders.

*Regulation of Management.* Federal law sets forth circumstances under which officers or directors of a bank may be removed by the institution s federal supervisory agency. Federal law also prohibits management personnel of a bank from serving as a director or in a management position of another financial institution whose assets exceed a specified amount or which has an office within a specified geographic area.

*Safety and Soundness Standards.* Federal law imposes upon banks certain non-capital safety and soundness standards. These standards cover internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation and benefits. Additional standards apply to asset quality, earnings and stock valuation. An institution that fails to meet these standards must develop a plan acceptable to its regulators, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Under Nevada state law, if the stockholders equity of a Nevada state chartered bank becomes impaired, the Commissioner of the Nevada FID will require the bank to make the impairment good. Failure to make the impairment good may result in the Commissioner s taking possession of the bank and liquidating it.

*Dividends.* The principal source of Community Bancorp s cash reserves are dividends received from Community Bank of Nevada. Nevada law imposes certain restrictions on a bank s ability to pay dividends and prohibits a bank from paying dividends if doing so would reduce its stockholders equity below (i) the initial stockholders equity of the bank, or (ii) 6% of the total deposit liability of the bank, as determined by the Nevada FID.

Regulations of the Federal Reserve also govern the payment of dividends by a state member bank. Under Federal Reserve regulations, dividends may not be paid unless both capital and earnings limitations have been met. First, no dividend may be paid if it would result in a withdrawal of capital or exceed the member bank s net profits then on hand, after deducting its losses and bad debts. Exceptions to this limitation are available only upon the prior approval of the Federal Reserve and the approval of two-thirds of the member bank s shareholders which, in the case of Community Bank of Nevada, would require our approval, as the sole shareholder of Community Bank of Nevada. Second, a state member bank may not pay a dividend without the prior written approval of the Federal Reserve if the total of all dividends declared in one calendar year, including the proposed dividend, exceeds the total of net income for that year plus the preceding two calendar years less any required transfers to surplus under state or federal law.

In addition, a bank may not pay cash dividends if doing so would reduce its capital below minimum applicable federal capital requirements. See Capital Adequacy below for a discussion of the applicable federal capital requirements.

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**Predatory Lending**

The term predatory lending, much like the terms safety and soundness and unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But predatory lending typically involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation, or asset-based lending;
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced, or loan flipping; and
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Federal Reserve regulations aimed at curbing such lending significantly widened the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. The following triggers coverage under the Home Ownership and Equity Protection Act of 1994:

- interest rates for first lien mortgage loans in excess of 8 percentage points above comparable Treasury securities,
- subordinate-lien loans of 10 percentage points above Treasury securities, and
- fees such as optional insurance and similar debt protection costs paid in connection with the credit transaction, when combined with points and fees if deemed excessive.

In addition, the regulation bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law, stating loans should not be made to those unable to repay them, unless documentation is maintained proving that the borrower has the ability to repay the loan. Lenders that violate these regulations face cancellation of loans and penalties equal to the finance charges paid. We do not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operations.

**Privacy**

Federal banking laws limit the ability of banks and other financial institutions to disclose nonpublic information about consumers to nonaffiliated third parties. Pursuant to these rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- annual notices of their privacy policies to current customers; and
- a reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. We have implemented its privacy policies in accordance with the laws.

**Interstate Banking and Branching**

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, or the Interstate Act, generally authorizes interstate branching. Currently, bank holding companies may purchase banks in any state, and banks

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may merge with banks in other states, as long as the home state of neither merging bank has opted out under the legislation. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area.

Nevada has enacted opting in legislation authorizing interstate mergers pursuant to the Interstate Act. The Nevada statute permits out-of-state banks and bank holding companies meeting certain requirements to maintain and operate the Nevada branches of a Nevada bank with which the out-of-state company engaged in an interstate combination. An out-of-state depository without a branch in Nevada, or an out-of-state holding company without a depository institution in Nevada, must first acquire the Nevada institution itself or its charter, before it can establish a de novo branch or acquire a Nevada branch through merger.

**Deposit Insurance**

Community Bank of Nevada s deposits are currently insured to a maximum of $100,000 per depositor through the Bank Insurance Fund administered by the FDIC. Community Bank of Nevada is required to pay deposit insurance premiums, which are assessed semiannually and paid quarterly. The premium amount is based upon a risk classification system established by the FDIC. Banks with higher levels of capital and a low degree of supervisory concern are assessed lower premiums than banks with lower levels of capital or a higher degree of supervisory concern.

The FDIC is also empowered to make special assessments on insured depository institutions in amounts determined by the FDIC to be necessary to give it adequate assessment income to repay amounts borrowed from the U.S. Treasury and other sources or for any other purpose the FDIC deems necessary.

Congress passed a recent bill that merges the Bank Insurance Fund with the Savings Association Insurance Fund, which was the equivalent insurance fund managed by the FDIC for savings institutions. The bill also increases insurance amounts for certain retirement accounts. In future years, the insurance provided for deposit accounts will be increased by an inflation index. We do not believe this recent bill will increase our deposit premiums.

**Capital Adequacy**

*Regulatory Capital Guidelines.* Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. The guidelines are risk-based, meaning that they are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies.

*Tier I and Tier II Capital.* Under the capital adequacy guidelines, the capital of an institution is divided into two broad categories, Tier I capital and Tier II capital. Tier I capital generally consists of common stockholders equity, surplus and undivided profits. Tier II capital generally consists of the allowance for loan losses, hybrid capital instruments, and subordinated debt. The sum of Tier I capital and Tier II capital represents an institution s total capital. The guidelines require that at least 50% of an institution s total capital consist of Tier I capital.

*Risk-based Capital Ratios.* The adequacy of an institution s capital is gauged primarily with reference to the institution s risk-weighted assets. The guidelines assign risk weightings to an institution s assets in an effort to quantify the relative risk of each asset and to determine the minimum capital required to support that risk. These risk weighted assets are then compared with its Tier I capital and total capital to arrive at a Tier I risk-based ratio and a total risk-based ratio, respectively. The guidelines provide that an institution must have a minimum Tier I risk-based ratio of 4%, and a minimum total risk-based ratio of 8%.

*Leverage Ratio.* The guidelines also employ a leverage ratio, which is Tier I capital as a percentage of total assets less intangibles, to be used as a supplement to risk-based guidelines. The principal objective of the

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leverage ratio is to constrain the maximum degree to which a bank holding company may leverage its equity capital base. The minimum leverage ratio is 3%; however, for all but the most highly-rated bank holding companies and for bank holding companies seeking to expand, regulators generally expect an additional 1% to 2%.

*Prompt Corrective Action.* Under the guidelines, an institution is assigned to one of five capital categories depending on its total risk-based capital ratio, Tier I risk-based capital ratio, and leverage ratio, together with certain subjective factors. The categories range from well capitalized to critically undercapitalized. Institutions that are deemed to be undercapitalized, depending on the category to which they are assigned, are subject to certain mandatory supervisory corrective actions. Both Community Bancorp and Community Bank of Nevada were well capitalized as of December 31, 2005.

**Corporate Governance and Accounting Legislation**

*Sarbanes-Oxley Act of 2002.* On July 30, 2002, the Sarbanes-Oxley Act of 2002, or SOX, was signed into law to address corporate and accounting fraud. SOX establishes a new accounting oversight board that will enforce auditing standards and restricts the scope of services that accounting firms may provide to their public company audit clients. Among other things, SOX also (i) requires chief executive officers and chief financial officers to certify to the accuracy of periodic reports filed with the SEC; (ii) imposes new disclosure requirements regarding internal controls, off-balance-sheet transactions and pro forma (non-GAAP) disclosures; (iii) accelerates the time frame for reporting of insider transactions and periodic disclosures by public companies; and (iv) requires companies to disclose whether or not they have adopted a code of ethics for senior financial officers and whether the audit committee includes at least one audit committee financial expert.

Under SOX, the SEC is required to regularly and systematically review corporate filings, based on certain enumerated factors. To deter wrongdoing, SOX: (i) subjects bonuses issued to top executives to disgorgement if a restatement of a company s financial statements was due to corporate misconduct; (ii) prohibits an officer or director from misleading or coercing an auditor; (iii) prohibits insider trades during pension fund blackout periods ; (iv) imposes new criminal penalties for fraud and other wrongful acts; and (v) extends the period during which certain securities fraud lawsuits can be brought against a company or its officers.

As a public reporting company, we are subject to the requirements of SOX and related rules and regulations issued by the SEC and NASDAQ. We have incurred, and anticipate that we will continue to incur, additional expense as a result of SOX, but we do not expect that such compliance will have a material impact on our business. In addition, other non-interest expense items, including professional expenses and other costs related to compliance with the reporting requirements of the securities laws have also significantly increased, and will be expected to continue to increase. In our first full year as a public company, we implemented Section 404 of SOX, which included additional internal audit staff, as well as the assistance of a consulting company.

**Anti-terrorism Legislation**

*USA Patriot Act of 2001.* In October 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism, or the Patriot Act, of 2001 was signed. Among other things, the Patriot Act (i) prohibits banks from providing correspondent accounts directly to foreign shell banks; (ii) imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals; (iii) requires financial institutions to establish an anti-money-laundering compliance program; and (iv) eliminates civil liability for persons who file suspicious activity reports. The Patriot Act also increases governmental powers to investigate terrorism, including expanded government access to account records. The U.S. Department of the Treasury is empowered to administer and make rules to implement the Patriot Act. Congress recently passed a bill extending portions of the Patriot Act, and President Bush is expected to sign such bill into law. While we believe the Patriot Act may, to some degree, affect our recordkeeping and reporting expenses, we do not believe that it will have a material adverse effect on our business and operations.

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**Bank Secrecy Act**

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (the Bank Secrecy Act ) is a disclosure law that forms the basis of the US federal government s framework to prevent and detect money laundering and to deter other criminal enterprises. Following the September 11, 2001 terrorist attacks, an additional purpose was added to the Bank Secrecy Act: To assist in the conduct of intelligence or counter-intelligence activities, including analysis, to protect against international terrorism. Under the Bank Secrecy Act, financial institutions such as Community Bank of Nevada are required to maintain certain records and file certain reports regarding domestic currency transactions and cross-border transportations of currency. This, in turn, allows law enforcement officials to create a paper trail for tracing illicit funds that resulted from drug trafficking or other criminal activities. Among other requirements, the Bank Secrecy Act requires financial institutions to report imports and exports of currency in the amount of $10,000 or more and, in general, all cash transactions of $10,000 or more. We have established a Bank Secrecy Act compliance policy under which, among other precautions, we keep currency transaction reports to document cash transactions in excess of $10,000 or in multiples totaling more than $10,000 during one business day, monitor certain potentially suspicious transactions such as the exchange of a large number of small denomination bills for large denomination bills, and scrutinize electronic funds transfers for Bank Secrecy Act compliance.

**Nonbank Entities**

We have two nonbank entities: Community Bancorp (NV) Statutory Trust I and Community Bancorp (NV) Statutory Trust II, both Connecticut statutory trusts. These entities are subject to the laws and regulations of both the federal government and the state in which they conduct business.

**Where You Can Find More Information**

Under the Securities Exchange Act of 1934 Sections 13 and 15(d), periodic and current reports must be filed with the SEC. We electronically file the following reports with the SEC: Form 10-K (Annual Report), Form 10-Q (Quarterly Report), Form 8-K (Current Report), and Form DEF 14A (Proxy Statement). We may file additional forms. The SEC maintains an Internet site, www.sec.gov, in which all forms filed electronically may be accessed. Additionally, all forms filed with the SEC and additional shareholder information is available free of charge on our website: www.communitybanknv.com. We post these reports to our website as soon as reasonably practicable after filing them with the SEC. None of the information on or hyperlinked from our website is incorporated into this Report**.**

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**ITEM 1A. RISK FACTORS**

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes may affect our business are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this Report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This Report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

**Factors Relating to Our Market and to Our Business**

**A deterioration in economic conditions and a slow down in growth generally, as well as a slowdown in gaming and tourism activities in particular, could adversely affect our business, financial condition, results of operations and prospects. Such deterioration could result in a variety of adverse consequences to us, including a reduction in net income and the following:**

- **loan delinquencies may increase, which would cause us to increase loan loss provisions;**
- **problem assets and foreclosures may increase, which could result in higher operating expenses, as well as possible increases in our loan loss provisions;**
- **demand for our products and services may decline including specifically, the demand for loans, which would cause our revenues, which include net interest income and non-interest income, to decline; and**
- **collateral for loans made by us may decline in value, reducing a customer s borrowing power, and reducing the value of assets and collateral associated with our loans, which could cause decreases in net interest income and increasing loan loss provisions.**

***The greater Las Vegas area economy has grown dramatically during the past several years. The failure of this economy to sustain such growth in the future could seriously affect our ability to grow and to be profitable.***

Our assets have enjoyed substantial growth with an annual compounded growth rate of 30.9% for the four-year period ending December 31, 2005. In large part, our growth has been fueled by the significant growth in the greater Las Vegas area. Diminished growth of this market in the future could have a significant adverse impact on our continued growth and profitability.

While the current economic forecasts prepared by CBER remain optimistic about the future growth of Las Vegas, albeit at lower growth rates than have recently been experienced, there are uncertainties in the economy, besides tourism and gaming discussed below, such as limitations on water, the continued measured availability of land from the Bureau of Land Management, infrastructure strains, increasing costs of housing, and tax and budgetary pressures, which may hamper future growth.

***Our market area is substantially dependent on gaming and tourism revenue, and a downturn in gaming or tourism could seriously hurt our business and our prospects***

Our business is currently concentrated in the greater Las Vegas area which has an economy unique in the United States for its level of dependence on services and industries related to gaming and tourism. Any event that negatively impacts the tourism or gaming industry will adversely impact the Las Vegas economy.

Gaming and tourism revenue (whether or not such tourism is directly related to gaming) is vulnerable to various factors. A prolonged downturn in the national economy could have a significant adverse effect on the economy of the Las Vegas area. Virtually any development or event that could dissuade travel or spending related to gaming and tourism, whether inside or outside of Las Vegas, could adversely affect the Las Vegas economy. In this regard, the Las Vegas economy is more susceptible than the economies of other cities to issues such as higher gasoline and other fuel prices, increased airfares, unemployment levels, recession, rising interest rates, and other economic conditions, whether domestic or foreign.

***An expansion of permissible gaming activities in other states, particularly in California, may lead to a decline in gaming revenue in Las Vegas, which could hurt our business and our prospects.***

Las Vegas competes with other areas of the country for gaming revenue, and it is possible that the expansion of gaming operations in other states, as a result of changes in laws or otherwise, could significantly reduce gaming revenue in the greater Las Vegas area. This is particularly true of gaming operations in California, a state from which Nevada generally, and Las Vegas in particular, draw substantial year-round visitors. Agreements negotiated between the State of California and certain Indian tribes as well as other proposals currently under consideration in California may result in substantial additional casinos throughout the state. In addition, other California legislative proposals could permit an expansion of gaming activities allowed in card clubs, including the addition of slot machines. A dramatic growth in casino gaming in California or other states could have a substantial adverse effect on gaming revenue in Nevada, including the Las Vegas area, which would adversely affect the Las Vegas economy and our business.

***A terrorist act, or the mere threat of a terrorist act, may adversely affect the Las Vegas economy and may cause substantial harm to our business.***

Gaming and tourism are also susceptible to certain political conditions or events, such as military hostilities and acts of terrorism, whether domestic or foreign. The effects of the terrorist attacks of September 11, 2001, on gaming and tourism in Las Vegas were substantial for a few months. Reduced civilian air traffic in large part caused a reduction in revenue and employee layoffs in many hotels and casinos. This resulted in a substantial loss of revenues for these businesses. Any direct attack on locations in Las Vegas would likely have an even greater adverse impact on our local economy.

***Future growth of the greater Las Vegas area is dependent, among other things, on the availability of water, and any restrictions imposed by the government on water consumption could curtail future development, which has been a source of growth in our loan portfolio.***

Future development in the greater Las Vegas area is subject to the availability of water. According to the Rocky Mountain Institute, Las Vegas has one of the highest per-capita rates of water consumption in the nation. Based upon an August 2003 U.S. Geological Survey, inflows into Lake Mead and Lake Powell on the Colorado River have been below average since the start of a persistent drought in the western United States in 2000. In 2003, Lake Mead, the primary water supply for Las Vegas, dropped to its lowest level in more than three decades. We cannot assure that governmental officials will not impose building moratoriums, restrictive building requirements, water conservation measures, or other measures to address water shortages in the future. Such restrictions could curtail future development, which has been a source of growth in our loan portfolio, or make living conditions less desirable than current conditions, which could reduce the influx of new residents from current levels.

***The value of real estate in the greater Las Vegas area is influenced by the distribution policies of the federal Bureau of Land Management. A change in such distribution policies could affect the value of real estate, which, in turn, could negatively affect our real estate loan portfolio.***

Land values in Nevada are influenced by the amount of land sold by the federal Bureau of Land Management, which controls 67% of Nevada s land, according to the Nevada State Office of the Bureau of Land

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Management. Changes to the federal Bureau of Land Management distribution policies on Nevada land could adversely affect the value of Nevada real estate.

***We have a high concentration of loans secured by real estate and a downturn in the real estate market, for any reason, could hurt our business and our prospects.***

At December 31, 2005, 80% of our loan portfolio was comprised of loans secured by real estate. Raw land loans, which are included in the categories below, represent approximately 20% of our total loans secured by real estate. Of the loans secured by real estate, approximately:

- 59% are construction and land development loans, including raw land;
- 35% are commercial real estate loans; and
- 6% are residential real estate loans.

These real estate-secured loans are concentrated in the greater Las Vegas area. A downturn in the local economy could have a material adverse effect on a borrower s ability to repay these loans due to either loss of borrower s employment or a reduction in borrower s business. Further, such reduction in the local economy could severely impair the value of the real property held as collateral. As a result, the value of real estate collateral securing our loans could be reduced. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans.

In addition, banking regulators have recently issued proposed guidance regarding institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that institutions that exceed certain levels of commercial real estate lending may be required, in the future, to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. If and when this proposed guidance becomes final, we may be subject to enhanced regulatory scrutiny and subject to higher capital requirements.

**Factors Relating to Our Business**

**Our future success involves both our ability to grow and our ability to manage such growth. Additionally, we must continue to manage the risks inherent in the banking business. We may not be able to sustain our historical growth rates, be able to grow at all, or successfully manage any growth, whether or not the greater Las Vegas area economy continues to grow. This could result in a variety of adverse consequences to us, including the following:**

- **inability to realize any benefit from our investment of resources made to support our future growth;**
- **failure to attract or retain experienced commercial bankers or other key employees;**
- **inability to maintain adequate controls and systems; and**
- **failure to comply with applicable federal, state and local laws, rules and regulations.**

***We may not be able to continue our growth at the rate we have in the past several years.***

We have grown from $304 million in total assets, $247 million in gross loans and $277 million in total deposits at December 31, 2001, to $893 million in total assets, $663 million in gross loans and $725 million in total deposits at December 31, 2005. Our business strategy calls for, among other things:

continued growth of our assets, loans, deposits and customer base;

expansion through acquisition or the establishment of new branches or banks in high growth markets, such as the greater Las Vegas area, or similar high growth markets in Arizona and California;

- recruitment of experienced commercial bankers and other key employees; and

- effective leveraging of our capital.

However, we may encounter unanticipated obstacles in implementing our strategy. If we are unable to expand our business, as we anticipate based on our strategic plan, we may not be able to maintain profitability, and there can be no assurance that we will be able to sustain our historical growth rates.

***A component of our business strategy is to expand into high growth markets by opening new branches or organizing new banks and/or acquiring of other financial institutions. We may not be able to successfully implement this part of our business strategy, and therefore our market value and profitability may suffer.***

Growth through acquisitions of banks represents a component of our business strategy. Any future acquisitions will be, accompanied by the risks commonly encountered in acquisitions. These risks include, among other things:

- difficulty of integrating the operations and personnel of acquired banks and branches;

- potential disruption of our ongoing business;

- inability of our management to maximize our financial and strategic position by the successful implementation of uniform product offerings and the incorporation of uniform technology into our product offerings and control systems; and

- inability to maintain uniform standards, controls, procedures and policies and the impairment of relationships with employees and customers as a result of changes in management.

We cannot assure you that we will be successful in overcoming these risks or any other problems encountered in connection with acquisitions. Our inability to improve the operating performance of acquired banks or to integrate successfully their operations could have a material adverse effect on our business, financial condition, results of operations and cash flows. In addition, we could incur substantial expenses, including the expenses of integrating the business of the acquired bank with our existing business.

We expect that competition for appropriate candidates may be significant. We may compete with other banks or financial service companies with similar acquisition strategies, many of which may be larger or have greater financial and other resources than we have. The purchase price of banks that might be attractive acquisition candidates for us may significantly exceed the fair values of their net assets. As a result, material goodwill and other intangible assets would be required to be recorded. We cannot assure you that we will be able to successfully identify and acquire suitable banks on acceptable terms and conditions.

Depending upon the structure of an acquisition and the consideration we may utilize, we may not seek your approval as a shareholder. Further, acquisitions may be structured to include cash consideration that may result in the depletion of a substantial portion of our available cash.

Besides the acquisition of existing financial institutions, we may consider the organization of new banks in high growth areas, especially in markets outside of the greater Las Vegas area such as California or Arizona. To date we have not specifically identified any market area where we plan to organize a new bank. Any organization of a new bank carries with it numerous risks, including the following:

- inability to obtain all required regulatory approvals;

- significant costs and anticipated operating losses during the application and organizational phases, and the first years of operations of the new bank;

inability to secure the services of qualified senior management;

local market may not accept the services of a new bank owned and managed by a bank holding company headquartered outside of the market area of the new bank; and

additional strain on management resources and internal systems and controls.

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***Our growth could be hindered unless we are able to recruit additional, qualified employees. We may have difficulty attracting additional necessary personnel, which may divert resources and limit our ability to successfully expand our operations.***

The greater Las Vegas area is experiencing a period of rapid growth, placing a premium on highly qualified employees in a number of industries, including the financial services industry. Our business plan includes, and is dependent upon, our hiring and retaining highly qualified and motivated executives and employees at every level, including a Chief Credit Officer, SBA management and support staff, experienced loan originators and branch managers. We expect to experience substantial competition in our endeavor to identify, hire and retain the top-quality employees. If we are unable to hire and retain qualified employees in the near term, we may be unable to successfully execute our business strategy and/or be unable to successfully manage our growth.

We believe that we have built our management team and personnel, and established an infrastructure, to support our current size. Our future success will depend on the ability of our executives and employees to continue to implement and improve our operational, financial and management controls and processes, reporting systems and procedures, and to manage a growing number of client relationships. We may not be able to successfully implement improvements to our management information and control systems and control procedures and processes in an efficient or timely manner. In particular, our controls and procedures must be able to accommodate an increase in expected loan volume and the infrastructure that comes with new branches.

We cannot assure you that our growth strategy will not place a strain on our administrative and operational infrastructure. If we are unable to locate additional personnel and to manage future expansion in our operations, we may experience compliance and operational issues, have to slow the pace of growth, or have to incur additional expenditures beyond current projections to support such growth, any one of which could adversely affect our business.

***Our business would be harmed if we lost the services of any of our executive management team.***

We believe that our success to date and our prospects for success in the future are substantially dependent on our executive management team, which includes our Chief Executive Officer, President and Chief Operating Officer, Executive Vice President/Chief Financial Officer, Executive Vice President/Chief Credit Officer, Executive Vice President/Credit Administrator, Executive Vice President/Director of Operations and our Executive Vice President/Chief Risk Manager. The loss of the services of any of these persons could have an adverse effect on our business. We have employment agreements with our Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President/Chief Financial Officer. In light of the relatively small pool of persons involved in the greater Las Vegas area banking industry, we could have difficulty replacing any of our executive management team or senior officers with equally competent persons who are also familiar with our market area.

***There is intense competition in our market area, and we cannot assure you that we will be able to successfully compete.***

Commercial banking in the greater Las Vegas area is a highly competitive business. Increased competition in our market may result in reduced loans and deposits. We compete for loans and deposits primarily with the local offices of major banks. We compete with other community banks in our market for customers as well. We also compete with credit unions, small loan companies, insurance companies, mortgage companies, finance companies, brokerage houses, other financial institutions and out-of-state financial intermediaries, some of which are not subject to the same degree of regulation and restriction as us and some of which have financial resources greater than us. Technological advances continue to contribute to greater competition in domestic and international products and services. Ultimately, we may not be able to compete successfully against current and future competitors.

***Our allowance for loan losses may not be adequate to cover actual losses particularly given our relatively large individual loan size.***

A significant source of risk arises from the possibility that losses could be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. The underwriting and credit monitoring policies that we have adopted to address this risk may not prevent unexpected losses that could have a material adverse affect on our business. Most of our loans, or approximately 80%, are secured by real estate. Community Bank of Nevada s legal lending limit is approximately $21 million. At December 31, 2005, we had 161 loans in excess of $1 million each, totaling $493 million. These loans comprise approximately 13.1% of our loan portfolio by number of loans and 74.4% by total loans outstanding. Our average loan size at December 31, 2005 was approximately $545,000 (excluding credit card, overdraft and purchased participation loans). This relatively large average loan size, while an advantage from a cost generation standpoint, can adversely impact us if one or more of these larger loans becomes delinquent, unstable, impaired, uncollectible or inadequately collateralized.

Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our business. Our allowance for loan losses is based on our prior experience and peer bank experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan portfolio and economic factors. The determination of the appropriate level of loan loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates. We cannot assure you that we will not increase the allowance for loan losses further or that regulators will not require us to increase this allowance. Either of these occurrences could adversely affect our business and prospects.

***Provisions in our articles of incorporation and bylaws may limit the ability of another party to acquire us.***

Various provisions of our articles of incorporation and by-laws could delay or prevent a third-party from acquiring us, even if doing so might be beneficial to our shareholders. These provisions provide for, among other things, advance notice for nomination of directors and limitations on the ability of shareholders to call a special meeting of shareholders, which can make minority shareholder representation on the board of directors more difficult to establish.

***We are subject to extensive government regulation. These regulations could adversely affect our business, financial condition, results of operations or cash flows.***

We are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations. Because our business is highly regulated, the laws, rules and regulations applicable to us are subject to regular modification and change. There are currently proposed various laws, rules and regulations that, if adopted, would impact our operations. We cannot assure you that these proposed laws, rules and regulations or any other laws, rules or regulations will not be adopted in the future, which could adversely affect our business, financial condition, results of operations or cash flows.

***Our Stock Trades Less Frequently Than Others.***

Although our common stock is listed for trading on the Nasdaq National Market, the trading volume in our common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our common stock, significant sales of our common stock, or the expectation of these sales, could cause our stock price to fall.

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***Our Stock Price Is Affected by a Variety of Factors.***

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors discussed in this section, including, among other things:

- Actual or anticipated variations in quarterly results of operations.
- Recommendations by securities analysts.
- Operating and stock price performance of other companies that investors deem comparable to our company.
- News reports relating to trends, concerns and other issues in the financial services industry.
- Perceptions in the marketplace regarding our company and/or its competitors.

***Our Common Stock Is Not An Insured Deposit.***

Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you may lose some or all of your investment.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

We own the buildings and land for five of our offices. These properties are not subject to any mortgages or encumbrances and consist of the following:

- Rainbow branch located at 1400 S. Rainbow, Las Vegas, Nevada, which is 9,600 square feet.
- Maryland Parkway branch located at 2887 S. Maryland Parkway, Las Vegas, Nevada, which is 5,600 square feet.
- Summerlin branch located at 7676 W. Lake Mead Blvd., Las Vegas, Nevada, which is 9,700 square feet.
- Green Valley branch located at 1441 W. Warm Springs, Henderson, Nevada, which is 5,600 square feet.
- Sahara branch located at 7580 W. Sahara Avenue, Las Vegas, Nevada, which is 11,100 square feet, of which 6,281 square feet is leased to an unrelated third party.

We lease approximately 10,500 square feet for our City Centre Branch located at 400 South 4th Street, Las Vegas, Nevada. Our headquarters and administration offices are also located in the City Centre site. The lease is for a ten-year term, expiring August 31, 2012. Our current monthly rent is $25,308, which increases to $29,063 by the end of the lease.

In the second half of 2005, our Russell branch and offices were opened at 8945 W. Russell Road, near Interstate 215 in Las Vegas. The office is leased space for the branch, human resources, operations support, internal audit, compliance and the real estate lending department. The initial base rent is approximately $38,000 per month beginning in October 2005. For each year following, the rent will be increased by approximately 2%. The lease expires on October 31, 2015. The agreement includes three 5-year renewal options.

As a result of the merger with Bank of Commerce, we acquired three new branches, of which two are leased spaces. The Sunset branch has approximately 6,000 square feet located in Henderson, Nevada. This is an operating lease with an unrelated third party with a base rent of $9,533 per month as of December 31, 2005. The rent increases based on the cost of living increase for the preceding period based on the average for the United States set forth in the Consumer Price Index for Urban Wage Earners and Clerical Workers for all Items, published by the Bureau of Labor Statistics of the United States Department of Labor (CPI). The lease expires on July 31, 2011. The lease includes the right to extend the term for three additional 5-year periods.

The Decatur office has 4,814 square feet, located at the intersection of Decatur Boulevard and Hacienda Avenue in southwest Las Vegas. This is an operating lease with an unrelated third party with a base rent of $12,083 per month as of December 31, 2005. The rent increases annually based on the cost of living increase for the preceding period based on the average CPI. The lease expires on March 31, 2018. The Company may extend the term of this lease for one additional 5-year period.

Although our strategic plan currently calls for one additional branch per year from 2006 through 2008, management believes that our existing facilities are adequate for our present purposes.

We also have two loan production offices, which are leased spaces: the San Diego loan production office with an initial base rent of $1,400 per month and the Phoenix loan production office with a base rent of approximately $2,500 per month.

**ITEM 3. LEGAL PROCEEDINGS**

There are no material pending legal proceedings to which we or Community Bank of Nevada is a party or to which any of our properties are subject. There are no material proceedings known to us to be contemplated by any governmental authority. We are involved in a variety of litigation matters in the ordinary course of our business and anticipate that we will become involved in new litigation matters from time to time in the future.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of security holders during the fourth quarter of 2005.

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**PART II**

**ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**
**Market Information**

Our common stock began trading on the NASDAQ National Market under the symbol CBON on December 10, 2004.

Prior to our IPO there had been no public market for our common stock. Our common stock had been traded, from time to time, by individuals on a negotiated basis between the parties. The following table sets forth those trades since January 1, 2004 through December 9, 2004 of which we have knowledge, including the quarter in which the trades occurred, the aggregate number of shares traded during such quarter and the range of sales price per share:

| Period | Number of Shares | Price Per Share |
| --- | --- | --- |
| 1st quarter 2004 | 50 | $ 9.00 |
| 2nd quarter 2004 | 3,000 | $ 9.00 |
| 3rd quarter 2004 | N/A | N/A |
| October 1, 2004 December 9, 2004 | N/A | N/A |

In the IPO shares of our common stock were sold for $23.00 per share. The following table sets forth the low and high trading prices for the period from December 10, 2004 through December 31, 2004 and each quarterly period in 2005:

| | Trading Prices | |
| --- | --- | --- |
| Period | Low | High |
| December 10, 2004 December 31, 2004 | $ 27.51 | $ 33.00 |
| 1st quarter 2005 | $ 25.03 | $ 30.90 |
| 2nd quarter 2005 | $ 23.35 | $ 32.00 |
| 3rd quarter 2005 | $ 30.57 | $ 34.75 |
| 4th quarter 2005 | $ 30.07 | $ 33.99 |

**Holders**

As of January 27, 2006, there were approximately 1,183 stockholders of record of our common stock. At such date, our directors and executive officers owned approximately 15% of our outstanding shares. There are no other classes of common equity outstanding.

**Dividends**

We have not declared a cash dividend since 2002 as we have used our current and retained earnings to support our rapid and continued growth. We do not foresee any circumstances in the immediate future in which we would consider paying cash dividends on our common stock.

Under Nevada law, a corporation may not pay a dividend if, after giving effect to the dividend, (i) the corporation would not be able to pay its debts as they become due, or (ii) the corporation s assets would be less than the sum of its total liabilities plus the amount that would be needed, if the corporations were to be dissolved at the time of distribution, to satisfy the dissolution rights of any preferred shareholders.

Additionally, our junior subordinated debt agreements contain provisions which prohibit the paying of dividends if we have deferred payment of interest on outstanding trust preferred securities. See Management s Discussion and Analysis of Financial Condition and Results of Operations.

We are a legal entity separate and distinct from Community Bank of Nevada. Since we are a holding company with no significant assets other than Community Bank of Nevada, we will be dependent upon dividends from Community Bank of Nevada for cash with which to pay dividends when, and if, our dividend policy changes. Further, federal and state banking regulations place certain restrictions on dividends paid by Community Bank of Nevada to Community Bancorp.

In addition, dividends paid by Community Bank of Nevada to Community Bancorp would be prohibited if the effect thereof would cause Community Bank of Nevada s capital to be reduced below applicable minimum capital requirements. For a discussion of the regulatory limitations on Community Bank of Nevada s ability to pay dividends, see Supervision and Regulation Federal and State Regulation of Community Bank of Nevada Dividends.

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**ITEM 6. SELECTED FINANCIAL DATA**

**Selected Consolidated Financial Data Community Bancorp**

The selected financial information in the table below as of and for the years ended December 31, 2005, 2004, 2003, 2002, and 2001 is derived from our audited consolidated financial statements. Results for past periods are not necessarily indicative of results that may be expected for any future period.

**SUMMARY CONSOLIDATED FINANCIAL DATA AND OTHER DATA**

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2002 | 2001 (1) |
| | (Dollars in thousands, except share, per share and percentage data) | | | | |
| **Consolidated Income Data:** | | | | | |
| Interest income | $ 46,337 | $ 30,038 | $ 27,143 | $ 25,449 | $ 24,119 |
| Interest expense | 12,511 | 6,862 | 7,453 | 8,709 | 10,737 |
| Net interest income | 33,826 | 23,176 | 19,690 | 16,740 | 13,382 |
| Provision for loan losses | 1,085 | 922 | 1,723 | 1,958 | 1,909 |
| Net interest income after provision for loan losses | 32,741 | 22,254 | 17,967 | 14,782 | 11,473 |
| Non-interest income | 2,275 | 1,489 | 1,563 | 1,392 | 1,670 |
| Non-interest expense | 20,512 | 15,946 | 12,020 | 9,112 | 8,460 |
| Income before income taxes | 14,504 | 7,797 | 7,510 | 7,062 | 4,683 |
| Provision for income taxes | 4,439 | 2,376 | 2,295 | 2,337 | 1,526 |
| Net Income | $ 10,065 | $ 5,421 | $ 5,215 | $ 4,725 | $ 3,157 |
| **Share Data:** | | | | | |
| Earnings per share basic | $ 1.45 | $ 1.13 | $ 1.13 | $ 1.03 | $ 0.69 |
| Earnings per share diluted | 1.42 | 1.10 | 1.10 | 1.01 | 0.68 |
| Dividend payout ratio (2) | N/A | 5.31% | 7.96% | 5.83% | 8.70% |
| Book Value per share | $ 14.47 | $ 11.49 | $ 6.96 | $ 5.91 | $ 4.87 |
| Shares outstanding at period end | 7,374,712 | 6,747,673 | 4,629,580 | 4,607,040 | 4,582,040 |
| Weighted average shares outstanding basic | 6,964,719 | 4,798,922 | 4,620,744 | 4,591,026 | 4,579,653 |
| Weighted average shares outstanding diluted | 7,091,311 | 4,940,977 | 4,729,021 | 4,682,486 | 4,675,917 |
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash and cash equivalents | $ 86,904 | $ 67,254 | $ 36,005 | $ 33,537 | $ 8,974 |
| Investments and other securities | 97,204 | 86,260 | 70,093 | 63,596 | 39,271 |
| Gross loans | 663,407 | 403,270 | 350,082 | 293,535 | 247,182 |
| Allowance for loan losses | 8,117 | 6,133 | 5,409 | 4,688 | 3,700 |
| Assets | 892,708 | 573,961 | 463,431 | 400,571 | 304,058 |
| Deposits | 725,088 | 476,252 | 403,713 | 351,584 | 277,422 |
| Junior subordinated debt | 36,083 | 15,464 | 15,464 | 15,464 | |
| Stockholders equity | 106,749 | 77,553 | 32,201 | 27,212 | 22,336 |

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| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2002 | 2001 (1) |
| | (Dollars in thousands, except share, per share and percentage data) | | | | |
| **Selected Other Balance Sheet Data:** | | | | | |
| Average assets | $ 703,556 | $ 523,766 | $ 436,843 | $ 356,097 | $ 292,866 |
| Average earning assets | 660,218 | 498,578 | 416,742 | 336,682 | 276,228 |
| Average stockholders equity | 88,664 | 35,910 | 29,279 | 24,729 | 21,186 |
| **Selected Financial Ratios:** | | | | | |
| Return on average assets | 1.43% | 1.04% | 1.19% | 1.33% | 1.08% |
| Return on average stockholders equity | 11.4% | 15.1% | 17.8% | 19.1% | 14.9% |
| Net interest margin (3) | 5.12% | 4.65% | 4.72% | 4.97% | 4.84% |
| Efficiency Ratio (4) | 56.8% | 64.7% | 56.6% | 50.3% | 56.2% |
| **Capital Ratios:** | | | | | |
| Average stockholders equity to average assets | 12.60% | 6.86% | 6.70% | 6.94% | 7.23% |
| Leverage Ratio | 13.09% | 16.91% | 8.96% | 8.84% | 7.06% |
| Tier 1 Risk-Based Capital ratio | 14.20% | 19.66% | 11.18% | 11.03% | 8.58% |
| Total Risk-Based Capital ratio | 16.29% | 20.92% | 13.61% | 14.14% | 9.83% |
| **Selected Asset Quality Ratios:** | | | | | |
| Non-performing loans to total loans (5) | 0.14% | 0.24% | 0.66% | 1.10% | 2.26% |
| Non-performing assets to total loans and OREO | 0.14% | 0.78% | 1.00% | 1.99% | 3.29% |
| Non-performing assets to total assets (6) | 0.10% | 0.55% | 0.76% | 1.47% | 2.71% |
| Allowance for loan losses to total loans | 1.22% | 1.52% | 1.55% | 1.60% | 1.50% |
| Allowance for loan losses to non-performing loans | 887.1% | 633.6% | 233.7% | 145.0% | 66.2% |
| Allowance for loan losses to non-performing assets | 887.1% | 194.3% | 154.2% | 79.6% | 45.0% |
| Net charge-offs (recoveries) to average loans | 0.01% | 0.05% | 0.31% | 0.36% | 0.47% |

(1) Community Bank of Nevada data only. The holding company reorganization was completed August 2002.

(2) There were no dividends declared in 2005. The dividend payout ratios for 2004 and 2003 are based on stock dividends, the ratio for 2002 is based on both stock and cash dividends, the ratios for years prior to 2002 are based on cash dividends.

(3) Net interest margin represents net interest income as a percentage of average interest-earning assets.

(4) Efficiency ratio represents non-interest expenses, excluding loan loss provision, as a percentage of the aggregate of net interest income and non-interest income.

(5) Non-performing loans are defined as loans that are past due 90 days or more plus loans placed in non-accrual status.

(6) Non-performing assets are defined as assets that are past due 90 days or more plus assets placed in non-accrual status plus other real estate owned.

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**ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**
The following discussion and analysis should be read in conjunction with our consolidated financial statements and footnotes to the consolidated financial statements included in Item 8 of this Report as well as Item 1A. Risk Factors.

Segment information is not presented since all of the Company s revenues are attributable to one operating segment.

**Overview**

Since we commenced operations in 1995, we have experienced strong growth and profitability. Our growth is fueled by the significant population and economic growth of the greater Las Vegas area where we operate. The growth in the greater Las Vegas area has accompanied significant investments in the gaming and tourism industry. The significant population increase has resulted in an increase in the acquisition of raw land for residential and commercial development, the construction of residential communities, shopping centers and office buildings, and the development and expansion of the businesses and professions that provide essential goods and services to this expanded population. Our results have been influenced by the following strategies, which we implemented in order to benefit from these market factors:

provide competitive commercial real estate loans, construction loans and land acquisition, development loans, and C&I loans to high quality borrowers;

focus and commitment to profitable banking relationships;

encourage business development of profitable customer relationships with a pay for performance compensation culture;

reduce our cost of funds by attracting a higher share of non-interest bearing deposit accounts;

maintain disciplined controls over non-interest expense in order to consistently grow on a profitable basis;

strengthen our underwriting standards and credit administration functions as well as increase lending capacity by the growth in capital base; and

add seasoned professionals to the staff with banking expertise, local market knowledge and a network of client relationships.

| | Key Financial Measures<br>Year Ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| | (Dollars in thousands except per share data) | | |
| Net Income | $ 10,065 | $ 5,421 | $ 5,215 |
| Basic earnings per share | 1.45 | 1.13 | 1.13 |
| Diluted earnings per share | 1.42 | 1.10 | 1.10 |
| Total Assets | 892,708 | 573,961 | 463,431 |
| Gross Loans | 663,407 | 403,270 | 350,082 |
| Total Deposits | 725,088 | 476,252 | 403,713 |
| Net interest margin | 5.12% | 4.65% | 4.72% |
| Efficiency Ratio | 56.8% | 64.7% | 56.6% |
| Return on average assets | 1.43% | 1.04% | 1.19% |
| Return on average equity | 11.4% | 15.1% | 17.8% |

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**Key Factors in Evaluating Financial Condition and Operating Performance**

In 2005, the Company earned net income of $10.1 million, or $1.42 per diluted share. This represents a 85.7% increase over the $5.4 million net income, or $1.10 per diluted share, reported for 2004. The significant factors impacting net income for 2005 compared to 2004 were:

- Strong organic loan growth due in part to the addition of new seasoned lending staff combined with the acquisition of Bank of Commerce in August 2005 led to a $260 million increase in gross loans and $16.3 million increase in interest income.
- A 47 basis point increase in net interest margin helped drive a $10.6 million increase in net interest income.
- In December 2004 as a result of our IPO, we took a non-recurring charge of $1.9 million in expenses ($1.3 million net of taxes) related to our Stock Appreciation Rights (SAR) Plan. In 2005, expenses related to the SAR Plan were $446 thousand, or $294 thousand after taxes.
- We are incurring expenses for compliance with the various SEC and NASDAQ rules and regulations, including Section 404 of the Sarbanes-Oxley Act.
- Non-interest expenses increased primarily due to the new staff, rent expense and depreciation expense added from the Bank of Commerce acquisition and costs associated with the implementation of the Sarbanes-Oxley Act.

As a community bank holding company, we focus on several key factors including:

- return to our shareholders;
- return on average assets;
- asset quality;
- asset growth; and
- operating efficiency.

*Return to our shareholders*. Our return to our shareholders is measured in the form of return on average equity, or ROE. Our net income increased $4.6 million, or 85.7%, to $10.1 million for the year ended December 31, 2005 from $5.4 million for the same period 2004. This significant increase was partially due to an accrual for SAR in December 2004 resulting from the initial public offering. Excluding the effect of the SAR accrual, net income for the year ending 2005 increased 50.5% over the year ending 2004. This 50.5% increase year over year in net income was attributed to an increase in net interest income, with only a slight increase in loan loss provision and partially offset by an increase in operating expenses. Basic EPS as of December 31, 2005 increased 28.3% to $1.45 as compared to $1.13 as of December 31, 2004. Diluted EPS as of December 31, 2005 increased 29.1% to $1.42 as compared to $1.10 as of December 31, 2004. Our ROE decreased to 11.4% at December 31, 2005 compared to 15.1% for the same period in 2004 due to additional shares issued for the IPO and Bank of Commerce acquisition. Our average ROE for the three years ended December 31, 2005 was 14.8%.

*Return on average assets.* Our return on average assets, or ROA, is a measure we use to compare our performance with other banks and bank holding companies. Our ROA at December 31, 2005 was 1.43% compared to 1.04% for the same period 2004. The increase in ROA is partially due to the non-recurring SAR expense discussed above. See Trends and Developments Impacting our Recent Results.

*Asset quality.* For all banks and bank holding companies, asset quality has a significant impact on the overall financial condition and results of operations. Asset quality is measured in terms of non-performing loans and assets as a percentage of total loans and total assets, and net charge-offs as a percentage of average loans. These measures are key elements in estimating the future earnings of a company. Non-performing loans totaled $915 thousand as of December 31, 2005 compared to $968 thousand at December 31, 2004. Non-performing

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loans as a percentage of total loans decreased to 0.14% as of December 31, 2005 compared to 0.24% at December 31, 2004. Non-performing assets were also $915 thousand as of December 31, 2005 compared to $3.2 million as of December 31, 2004. Non-performing assets as a percent of total assets were 0.10% as of December 31, 2005 compared to 0.55% at December 31, 2004. Net charge-offs to average loans were 0.01% as of December 31, 2005 as compared to 0.05% for the same period 2004. The average net charge-offs to average loans for the three years ended December 31, 2005 was 0.12%.

*Asset growth.* As revenues from both net interest income and non-interest income are a function of asset size, the continued growth in assets has a direct impact on increasing net income and EPS. The majority of our assets are loans, and the majority of our liabilities are deposits, and therefore the ability to generate loans and deposits are fundamental to our asset growth. Total assets increased 55.5% during 2005 from $574 million as of December 31, 2004 to $893 million as of December 31, 2005 and grew 30.9% by a compound annual growth rate, or CAGR, between December 31, 2001 and December 31, 2005. Total deposits increased 52.2% to $725 million as of December 31, 2005 compared to $476 million as of December 31, 2004 and had a CAGR of 27.2% between December 31, 2001 and December 31, 2005. Gross loans increased 64.5% to $663 million as of December 31, 2005 compared to $403 million as of December 31, 2004. Loans had a CAGR of 28.0% between December 31, 2001 and December 31, 2005.

*Operating efficiency.* Operating efficiency is the measure of how efficiently earnings before taxes are generated as a percentage of revenue. Our efficiency ratio (operating expenses divided by net interest income plus non-interest income) decreased to 56.8% for 2005 compared to 64.7% for the same period in 2004. Our average efficiency ratio for the three years ended December 31, 2005 was 59.4%.

**Critical Accounting Policies**

Our accounting policies are integral to understanding the financial results reported. Our most complex accounting policies require management s judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

*Allowance for Loan Losses.* The allowance for loan losses represents our best estimate of the probable losses inherent in the existing loan portfolio. The allowance for loan losses is increased by the provision for loan losses charged to expense and reduced by loans charged off, net of recoveries.

We evaluate our allowance for loan losses monthly. We believe that the allowance for loan losses, or ALLL, is a critical accounting estimate because it is based upon management s assessment of various factors affecting the collectibility of the loans, including current economic conditions, past credit experience, delinquency status, the value of the underlying collateral, if any, and a continuing review of the portfolio of loans. For a discussion of the allowance and our methodology, see Financial Condition Allowance for Loan Losses.

Like all financial institutions, we maintain an ALLL based on a number of quantitative and qualitative factors, including levels and trends of past due and non-accrual loans, asset classifications, loan grades, change in volume and mix of loans, collateral value, historical loss experience, peer group loss experience, size and complexity of individual credits and economic conditions. Provisions for loan losses are provided on both a specific and general basis. Specific allowances are provided for impaired credits for which the expected/anticipated loss is measurable. General valuation allowances are based on portfolio segmentation by loan type and risk grading, with a further evaluation of various quantitative and qualitative factors noted above.

We incorporate statistics provided through the FDIC regarding loss percentages experienced by banks in the western United States, as well as an internal five-year loss history to establish potential risk based on collateral type securing each loan. As an additional comparison, we examine local peer group banks to determine the nature and scope of their losses to date. Such examination provides a geographic-and size-specific flavor for trends in the local banking community. Finally, we closely examine each credit graded Special Mention and below to individually assess the appropriate loan loss reserve for a particular credit. See Business Classified Assets for further description of our grading system.

We periodically review the assumptions and formulae by which additions are made to the specific and general valuation allowances for losses in an effort to refine such allowances in light of the current status of the factors described above.

Although we believe the levels of the allowance as of December 31, 2005 and 2004, were adequate to absorb probable losses in the loan portfolio, a decline in local economic, or other factors, could result in increasing losses that cannot be reasonably predicted at this time.

*Available for Sale Securities.* Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires that available-for-sale securities be carried at fair value. We believe this is a critical accounting estimate in that the fair value of a security is based on quoted market prices or if quoted market prices are not available, fair values are extrapolated from the quoted prices of similar instruments. Management utilizes the services of a reputable third party vendor to assist with the determination of estimated fair values. Adjustments to the available-for-sale securities fair value impact the consolidated financial statements by increasing or decreasing assets and stockholders equity.

*Goodwill.* In connection with our acquisition of Bank of Commerce in August 2005, we recorded the excess of the purchase price over the estimated fair value of the assets received and liabilities assumed as goodwill pursuant to SFAS No. 141, *Business Combinations*. We will annually review the goodwill recorded for the acquisition for impairment in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, on October 1. Goodwill is not being amortized whereas identifiable intangible assets with finite lives are amortized over their useful lives.

**Trends and Developments Impacting Our Recent Results**

Certain trends emerged and developments have occurred that are important in understanding our recent results and that are potentially significant in assessing future performance.

*Record Setting Loan Growth Occurred in 2005.* From inception, our loan growth has been significant each year. From 2001 to 2004, we experienced a compound annual growth rate of 18%. In 2005, our loan growth was 64.5%. Several factors can be directly attributed to this considerable growth, including the acquisition of Bank of Commerce (which accounted for approximately 26% of such growth at date of acquisition), the addition of eight well-seasoned local lenders, the appreciation of real estate values and the increase in lending limits obtained by increasing capital. With all of the above-referenced factors continuing forward in to 2006, and with considerable growth in the unfunded commitments (primarily construction loans) available to be advanced in 2006, we anticipate that this historical growth rate trend will continue.

*Acquisition of Bank of Commerce.* As part of our growth strategy, on August 26, 2005, we acquired Bank of Commerce. The acquisition contributed $104 million in gross loans and $118 million in deposits and was accretive to earnings in 2005. We continue to search for strategic acquisitions, however attempting to grow through acquisition does present risks, such as problems of finding suitable opportunities at affordable prices, integrating acquired institutions and others discussed in Item 1A. Risk Factors.

*Asset Sensitivity.* Management uses various modeling strategies to manage the re-pricing characteristics of our assets and liabilities. These models contain a number of assumptions and can not take into

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account all the various factors that influence the sensitivities of our assets and liabilities. At December 31, 2005, our balance sheet was asset sensitive, demonstrating that a larger amount of our interest sensitive assets will re-price within certain time horizons than will our interest sensitive liabilities. Being asset sensitive means generally that in times of rising interest rates, a company s net interest margin will increase. It also means that in times of falling interest rates, such as we experienced from 2000 to 2003, a company s net interest margin is generally compacted. We expect that, if market interest rates continue to rise, our net interest margin and our net interest income will be favorably impacted. See Quantitative and Qualitative Disclosure about Market Risk.

*Impact of Expansion on Non-Interest Expense.* In 2005 we opened our sixth office, which caused a significant increase in occupancy and equipment expense. These offices consist of 21,566 rentable square feet at $1.73 sq. ft. per month, and house a branch, human resources, operations support, audit, compliance and our real estate lending department. We also acquired three additional branches from Bank of Commerce in August 2005, of which two are leased spaces. The Sunset office has approximately 6,000 square feet, with a monthly rent of approximately $9,500. The Decatur office has approximately 4,800 square feet, and a monthly rent of approximately $12,000. In addition, the acquisition contributed to the increase in our salaries, wages and employee benefits expense.
Additionally, as a result of being a reporting company, other non-interest expense items, including professional expenses and other costs related to compliance with the reporting requirements of the securities laws and compliance with the Sarbanes-Oxley Act of 2002, have increased significantly.

*Unusual Expense Associated With SAR.* As of December 31, 2005, we have 17,854 SAR outstanding versus 109,673 outstanding as of December 31, 2004. Expenses for the plan (before taxes) were $446,000 in 2005 versus $2.1 million in 2004. Future expenses associated with our SAR Plan will be impacted by the value of our common stock and the number of SAR that are granted.

*Impact of New Accounting Pronouncements*. Beginning in 2006, we will adopt Statement of Financial Accounting Standards ( SFAS ) 123 (revised), which, among other things, requires the recording in the financial statements of non-cash compensation expense related to stock options. Prior to 2006, we had only shown, as permitted by SFAS 123 (revised), pro forma financial results including the effects of share-based compensation expense in the footnotes to the financial statements. See Note 1, Summary of significant accounting policies, to the Consolidated Financial Statements for these pro forma results related to years 2005, 2004, and 2003. The pro forma compensation costs presented in these and prior financial statements have been calculated using a minimum value method for options granted prior to our IPO and a fair value method after that date. The pro forma costs may not be indicative of amounts which should be expected in future periods. As a result of the adoption of SFAS No. 123 (revised), we estimate additional compensation expense of approximately $332,000 before tax, or $0.05 per diluted share for the full year 2006. Estimated future levels of compensation expense recognized related to stock based awards would be impacted by new awards, modifications to awards, cancellation of awards after the adoption of SFAS No. 123 (revised), or additional options granted by the Board of Directors. There have been no additional grants as of the date of this Report.

**Results of Operations**

Our results of operations depend primarily on net interest income, which is the difference between interest income and interest expense. Interest income is the earnings we receive on our interest earning assets, such as loans and investments, and interest expense is the expense we incur on our interest bearing liabilities, such as interest bearing deposits and other borrowings. Factors that determine the level of net income include the volume of earning assets and interest bearing liabilities, yields earned and rates paid, fee income, non-interest expense, the level of non-performing loans and other non-earning assets, and the amount of non-interest bearing liabilities supporting earning assets. Non-interest income includes service charges and other deposit related fees, and non-interest expense consists primarily of employee compensation and benefits, occupancy, equipment and depreciation expense, and other operating expenses.

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***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Increase (Decrease) |
|---|---|---|---|
| | (Dollars in thousands, except per share data) | | |
| **Consolidated Statement of Earnings Data:** | | | |
| Interest income | $ 46,337 | $ 30,038 | $ 16,299 |
| Interest expense | 12,511 | 6,862 | 5,649 |
| Net interest income | 33,826 | 23,176 | 10,650 |
| Provision for loan losses | 1,085 | 922 | 163 |
| Net interest income after provision for loan losses | 32,741 | 22,254 | 10,487 |
| Non-interest income | 2,275 | 1,489 | 786 |
| Non-interest expense | 20,512 | 15,946 | 4,566 |
| Net income before income taxes | 14,504 | 7,797 | 6,707 |
| Provision for income taxes | 4,439 | 2,376 | 2,063 |
| Net income | $ 10,065 | $ 5,421 | $ 4,644 |
| Earnings per share basic | $ 1.45 | $ 1.13 | $ 0.32 |
| Earnings per share diluted | $ 1.42 | $ 1.10 | $ 0.32 |

Our net income grew by 85.7% to $10.1 million for the year ended December 31, 2005 as compared to $5.4 million for the year ended December 31, 2004. Our return on average assets was 1.43% and return on average stockholders equity was 11.4% for the year ended December 31, 2005, compared to 1.04% and 15.1%, respectively for the year ended December 31, 2004.

*Net Interest Income and Net Interest Margin.* The 46.0% increase in our net interest income for the year ended December 31, 2005 was due to an increase in interest income of $16.3 million offset by an increase of $5.6 million in interest expense. Average interest-earning assets increased to $660 million during 2005 as compared to $499 million during 2004, reflecting our continuing growth trend and the acquisition of Bank of Commerce. Total interest expense increased as a result of rising interest rates throughout the financial marketplace over the course of the year.

The average yield on our interest-earning assets increased to 7.02% in 2005 from 6.02% in 2004. The increase in the average yield on our interest-earning assets resulted from an increase in market rates, re-pricing on our adjustable rate loans, and new loans originated with higher interest rates because of the rising interest rate environment and the increase in the percentage of interest earning assets represented by loans as of December 31, 2005. Average loans as a percentage of average earning assets increased to 77.3% as of December 31, 2005 compared to 72.7% for the same period in 2004.

The cost of our average interest-bearing liabilities increased to 2.73% in 2005 from 1.90% in 2004. In addition to the increase in the average deposit balances, our average borrowings increased by $7.2 million and average junior subordinated debt increased by $5.6 million.

Our average rate on our interest-bearing deposits increased 42.4% from 1.77% as of December 31, 2004 to 2.52% as of December 31, 2005, reflecting the rise in general market rates. Our average rate on total deposits (including non-interest bearing deposits) increased to 1.85% as of December 31, 2005 from 1.30% at December 31, 2004.

Our net interest margin as of December 31, 2005 of 5.12% was higher than our net interest margin at December 31, 2004 of 4.65% primarily due to the rising rate environment and an increase in the average loans as a percentage of average earning assets.

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The following table sets forth a summary of average balances with corresponding interest income and interest expense as well as average yield and cost information for the periods presented. Average balances are derived from daily balances, and non-accrual loans are included as interest earning assets for purposes of this table.

| | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | | 2004 | | |
| | Average Balance | Interest Income or Expense | Average Yield or Cost | Average Balance | Interest Income or Expense | Average Yield or Cost |
| | (Dollars in thousands) | | | | | |
| **Assets** | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1)(2)(3) | $ 510,252 | $ 40,973 | 8.03% | $ 362,493 | $ 26,415 | 7.29% |
| Investment securities taxable | 67,504 | 2,656 | 3.93% | 57,515 | 1,981 | 3.44% |
| Investment securities non-taxable (3) | 22,448 | 838 | 3.73% | 23,593 | 874 | 3.70% |
| Federal funds sold | 56,607 | 1,738 | 3.07% | 52,554 | 692 | 1.32% |
| Other investments (4) | 3,407 | 132 | 3.87% | 2,423 | 76 | 3.14% |
| Total interest-earning assets | 660,218 | 46,337 | 7.02% | 498,578 | 30,038 | 6.02% |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 18,327 | | | 14,338 | | |
| Unearned loan fees | (2,765) | | | (1,726) | | |
| Allowance for loan losses | (6,730) | | | (5,639) | | |
| Other assets | 34,506 | | | 18,215 | | |
| Total assets | $ 703,556 | | | $ 523,766 | | |
| **Liabilities and Stockholders Equity** | | | | | | |
| Interest-bearing Liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | $ 25,678 | $ 315 | 1.23% | $ 19,459 | $ 92 | 0.47% |
| Money market | 254,793 | 6,177 | 2.42% | 190,322 | 2,891 | 1.52% |
| Savings | 6,361 | 36 | 0.57% | 6,069 | 14 | 0.23% |
| Time certificates of deposit | 138,931 | 4,185 | 3.01% | 125,898 | 3,057 | 2.43% |
| Total interest-bearing deposits | 425,763 | 10,713 | 2.52% | 341,748 | 6,054 | 1.77% |
| Short-term borrowings and long term debt | 10,757 | 405 | 3.76% | 3,555 | 44 | 1.24% |
| Junior subordinated debt | 21,108 | 1,393 | 6.60% | 15,464 | 764 | 4.94% |
| Total interest-bearing liabilities | 457,628 | 12,511 | 2.73% | 360,767 | 6,862 | 1.90% |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 152,912 | | | 124,737 | | |
| Other liabilities | 4,352 | | | 2,352 | | |
| Total liabilities | 614,892 | | | 487,856 | | |
| Stockholders equity | 88,664 | | | 35,910 | | |
| Total liabilities and stockholders equity | $ 703,556 | | | $ 523,766 | | |
| Net interest income | | $ 33,826 | | | $ 23,176 | |
| Net interest spread (5) | | | 4.29% | | | 4.12% |

| | | |
|---|---|---|
| Net interest margin (6) | 5.12% | 4.65% |

(1) Includes average non-accrual loans of $888 thousand in 2005 and $2.3 million in 2004.

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(2) Net loan fees of $4.5 million and $3.4 million are included in the yield computations for 2005 and 2004, respectively.
(3) Yields on loans and securities have not been adjusted to a tax-equivalent basis
(4) Includes Federal Reserve Bank stock, Federal Home Loan Bank stock and Pacific Coast Bankers Bank stock.
(5) Net interest spread represents the average yield earned on interest earning assets less the average rate paid on interest bearing liabilities.
(6) Net interest margin is computed by dividing net interest income by total average earning assets.

The following table shows the change in interest income and interest expense and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates:

| | 2005 Compared to 2004 | | | |
|---|---|---|---|---|
| | | Increase (Decrease) Due to Change in: | | |
| | Net Change | Rate | Volume | Mix |
| | | (Dollars in thousands) | | |
| Interest income: | | | | |
| Loans | $ 14,558 | $ 2,693 | $ 10,767 | $ 1,098 |
| Investment securities taxable | 675 | 279 | 347 | 49 |
| Investment securities non-taxable | (36) | 10 | (45) | (1) |
| Federal funds sold | 1,046 | 922 | 53 | 71 |
| Other investments | 56 | 18 | 31 | 7 |
| Total interest income | 16,299 | 3,922 | 11,153 | 1,224 |
| Interest expense: | | | | |
| Interest-bearing demand | 223 | 146 | 30 | 47 |
| Money market | 3,286 | 1,723 | 979 | 584 |
| Savings | 22 | 20 | 1 | 1 |
| Time certificates of deposit | 1,128 | 736 | 316 | 76 |
| Short-term borrowings & long term debt | 361 | 91 | 89 | 181 |
| Junior subordinated debt | 629 | 256 | 279 | 94 |
| Total interest expense | 5,649 | 2,972 | 1,694 | 983 |
| Net interest income | $ 10,650 | $ 950 | $ 9,459 | $ 241 |

*Provision for Loan Losses.* The provision for loan losses in the year ended December 31, 2005 was $1.1 million compared to $922 thousand in the year ended December 31, 2004. We experienced net loan charge-offs of $34 thousand in 2005 compared to net loan charge-offs of $198 thousand for 2004. Gross loans increased by $260 million in 2005 and $53 million in 2004. The increase in the amount of the provision for 2005 primarily relates to loan growth, offset by the decrease in net charge offs to total loans from 0.05% at December 31, 2004 to 0.01% at December 31, 2005 and non-performing loans to total loans decreasing from 0.24% at December 31, 2004 to 0.14% as of December 31, 2005. See Financial Condition Loans Non-Performing Assets.

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*Non-Interest Income.* The following table presents, for the periods indicated, the major categories of non-interest income:

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Increase (Decrease) |
|---|---|---|---|
| | (In thousands) | | |
| Service charges and other income | $ 1,563 | $ 991 | $ 572 |
| Loan brokerage and referral fees | 124 | 184 | (60) |
| Income from bank owned life insurance | 504 | 194 | 310 |
| Net gain on sales of loans | 84 | 108 | (24) |
| Net gain on sales of securities | | 12 | (12) |
| Total non-interest income | $ 2,275 | $ 1,489 | $ 786 |

The $786 thousand, or 52.8% increase in total non-interest income was primarily due to an increase in service charges and other income on deposit accounts resulting from the increased branch network accomplished with the acquisition of the Bank of Commerce, in addition to an increase in cash surrender value of bank owned life insurance purchased in July 2004.

*Non-Interest Expense.* Non-interest expenses are the costs, other than interest expense and the provision for loan losses, associated with providing banking and financial services to customers and conducting our affairs.

The following table presents, for the periods indicated, the major categories of non-interest expense:

| | Year Ended December 31, 2005 | Year Ended December 31, 2004 | Increase (Decrease) |
|---|---|---|---|
| | (In thousands) | | |
| Salaries, wages and employee benefits | $ 12,280 | $ 8,619 | $ 3,661 |
| Occupancy, equipment and depreciation | 2,173 | 1,495 | 678 |
| Professional fees | 1,415 | 359 | 1,056 |
| Advertising and public relations | 909 | 587 | 322 |
| Data processing | 730 | 558 | 172 |
| Stock appreciation rights | 446 | 2,095 | (1,649) |
| Stationery and supplies | 377 | 230 | 147 |
| Insurance | 285 | 249 | 36 |
| Core deposit intangible amortization | 254 | | 254 |
| Telephone and postage | 229 | 198 | 31 |
| Director fees | 210 | 172 | 38 |
| Loan related | 171 | 235 | (64) |
| Software maintenance | 102 | 102 | |
| Foreclosed assets, net | (234) | 117 | (351) |
| Other | 1,165 | 930 | 235 |
| Total non-interest expense | $ 20,512 | $ 15,946 | $ 4,566 |

The $4.6 million, or 28.6%, increase in total non-interest expense was primarily attributable to an increase of $3.7 million or 42.5% in salary and employee benefits. The increase in salary and employee benefit expense can be attributed to the acquisition of Bank of Commerce, and increases in personnel for the areas of lending, operations, and audit and compliance. The number of full time equivalent employees (FTEs) increased to 160 at December 31, 2005 compared to 109 at December 31, 2004. In addition to general staffing of the various departments, we were successful in recruiting a Chief Credit Officer in January 2005 and a Chief Risk Manager in September 2005. Professional fees, which include legal fees, accounting and audit services, and consulting

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fees increased $1.1 million, or 294.1%, year over year. The increase in these fees was mainly due to our duties as a public company, including the legal fees associated with SEC reporting, as well as accounting and audit fees attributed to compliance with Section 404 of the Sarbanes-Oxley Act (SOX). In our first year as a public company, we also retained the services of an outside consulting company to assist with the implementation of SOX.

On January 1, 2006, we were required to adopt Statement of Financial Accounting Standards ( SFAS ) 123 (revised), which, among other things, requires the recording in the financial statements of non-cash compensation expense related to stock options. Prior to 2006, we had only shown, as permitted by SFAS 123 (revised), pro forma financial results including the effects of share-based compensation expense in the footnotes to the financial statements. See Note 1, Summary of significant accounting policies, to the Consolidated Financial Statements for these pro forma results related to years 2005, 2004, and 2003. As a result of the adoption of SFAS No. 123 (revised), we estimate additional compensation expense of approximately $332,000 before tax, or $0.05 per diluted share for the full year 2006. Estimated future levels of compensation expense recognized related to stock based awards would be impacted by new awards, modifications to awards, cancellation of awards after the adoption of SFAS No. 123 (revised), or additional options granted in 2006 by the Board of Directors. There have been no additional grants as of the date of this report.

*Provision for Income Taxes.* We recorded tax provisions of $4.4 million in 2005 and $2.4 million in 2004. Our effective tax rates were 31% and 30% for 2005 and 2004, respectively. The difference from the expected rate in both years was largely due to the non-taxable nature of income from municipal securities and bank owned life insurance.

**Financial Overview for the Years Ended December 31, 2004 and 2003**

| | Year Ended December 31, | | Increase |
|---|---|---|---|
| | **2004** | **2003** | **(Decrease)** |
| | (Dollars in thousands, except per share data) | | |
| **Consolidated Statement of Earnings Data:** | | | |
| Interest income | $ 30,038 | $ 27,143 | $ 2,895 |
| Interest expense | 6,862 | 7,453 | (591) |
| Net interest income | 23,176 | 19,690 | 3,486 |
| Provision for loan losses | 922 | 1,723 | (801) |
| Net interest income after provision for loan losses | 22,254 | 17,967 | 4,287 |
| Non-interest income | 1,489 | 1,563 | (74) |
| Non-interest expense | 15,946 | 12,020 | 3,926 |
| Income before income taxes | 7,797 | 7,510 | 287 |
| Provision for income taxes | 2,376 | 2,295 | 81 |
| Net income | $ 5,421 | $ 5,215 | $ 206 |
| Earnings per share basic | $ 1.13 | $ 1.13 | $ 0.00 |
| Earnings per share diluted | $ 1.10 | $ 1.10 | $ 0.00 |

Our net income grew by 4.0% to $5.4 million for the year ended December 31, 2004 as compared to $5.2 million for the year ended December 31, 2003. Our return on average assets was 1.04% and return on average stockholders equity was 15.1% for the year ended December 31, 2004, compared to 1.19% and 17.8%, respectively for the year ended December 31, 2003.

*Net Interest Income and Net Interest Margin.* The 17.7% increase in our net interest income for the year ended December 31, 2004 was primarily due to an increase in interest income of $2.9 million, and a decrease of

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$591 thousand in interest expense. Average interest-earning assets increased to $499 million during 2004 as compared to $417 million during 2003, reflecting our continuing growth trend. Total interest expense decreased as a result of ongoing declines in interest rates throughout the financial marketplace over the course of the year, as well as a significant shift in our deposit mix.

The average yield on our interest-earning assets fell to 6.02% in 2004 from 6.51% in 2003. The decrease in the average yield on our interest-earning assets resulted from a reduction in market rates, re-pricing on our adjustable rate loans, and new loans originated with lower interest rates because of the lower interest rate environment and the decrease in the percentage of interest earning assets represented by loans as of December 31, 2004. Average loans as a percentage of average earning assets declined to 72.7% as of December 31, 2004 compared to 77.0% for the same period in 2003.

The cost of our average interest-bearing liabilities decreased to 1.90% in 2004 from 2.39% in 2003. In addition to broad declines in the average rates paid on deposit balances, the decrease was the results of actions taken by management to reduce the level of CD s and increase the level of non-interest bearing deposits in relation to total deposits.

Our average rate on our interest-bearing deposits decreased 22.7% from 2.29% as of December 31, 2003 to 1.77% as of December 31, 2004, reflecting reductions in general market rates as well as management s focus on shifting to lower cost deposit products. Our average rate on total deposits (including non-interest bearing deposits) decreased to 1.30% as of December 31, 2004 from 1.73% at December 31, 2003.

Our net interest margin as of December 31, 2004 of 4.65% was slightly lower than our net interest margin at December 31, 2003 of 4.72%. Despite significant lower earning asset yields, we were able to maintain the net interest margin primarily due to a lower cost of funds.

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The following table sets forth a summary of average balances with corresponding interest income and interest expense as well as average yield and cost information for the periods presented. Average balances are derived from daily balances, and non-accrual loans are included as interest earning assets for purposes of this table.

| | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2004 | | | 2003 | | |
| | Average Balance | Interest Income or Expense | Average Yield or Cost | Average Balance | Interest Income or Expense | Average Yield or Cost |
| | (Dollars in thousands) | | | | | |
| **Assets** | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1)(2)(3) | $ 362,493 | $ 26,415 | 7.29% | $ 320,758 | $ 24,679 | 7.69% |
| Investment securities taxable | 57,515 | 1,981 | 3.44% | 51,045 | 1,331 | 2.61% |
| Investment securities non-taxable (3) | 23,593 | 874 | 3.70% | 21,853 | 845 | 3.87% |
| Federal funds sold | 52,554 | 692 | 1.32% | 22,093 | 242 | 1.10% |
| Other investments (4) | 2,423 | 76 | 3.14% | 993 | 46 | 4.63% |
| Total interest-earning assets | 498,578 | 30,038 | 6.02% | 416,742 | 27,143 | 6.51% |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 14,338 | | | 12,727 | | |
| Unearned loan fees | (1,726) | | | (1,161) | | |
| Allowance for loan losses | (5,639) | | | (4,941) | | |
| Other assets | 18,215 | | | 13,476 | | |
| Total assets | $ 523,766 | | | $ 436,843 | | |
| **Liabilities and Stockholders Equity** | | | | | | |
| Interest-bearing Liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | $ 19,459 | $ 92 | 0.47% | $ 12,617 | $ 45 | 0.36% |
| Money market | 190,322 | 2,891 | 1.52% | 136,569 | 2,298 | 1.68% |
| Savings | 6,069 | 14 | 0.23% | 4,185 | 8 | 0.19% |
| Time certificates of deposit | 125,898 | 3,057 | 2.43% | 138,758 | 4,328 | 3.12% |
| Total interest-bearing deposits | 341,748 | 6,054 | 1.77% | 292,129 | 6,679 | 2.29% |
| Short-term borrowings | 3,555 | 44 | 1.24% | 4,107 | 52 | 1.27% |
| Junior subordinated debt | 15,464 | 764 | 4.94% | 15,464 | 722 | 4.67% |
| Total interest-bearing liabilities | 360,767 | 6,862 | 1.90% | 311,700 | 7,453 | 2.39% |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 124,737 | | | 94,357 | | |
| Other liabilities | 2,352 | | | 1,507 | | |
| Total liabilities | 487,856 | | | 407,564 | | |
| Stockholders equity | 35,910 | | | 29,279 | | |
| Total liabilities and stockholders equity | $ 523,766 | | | $ 436,843 | | |
| Net interest income | | $ 23,176 | | | $ 19,690 | |
| Net interest spread (5) | | | 4.12% | | | 4.12% |

| | | |
|---|---|---|
| Net interest margin (6) | 4.65% | 4.72% |

(1) Includes average non-accrual loans of $2.3 million in 2004 and $2.6 million in 2003.

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(2) Net loan fees of $3.4 million and $3.0 million are included in the yield computations for 2004 and 2003, respectively.
(3) Yields on loans and securities have not been adjusted to a tax-equivalent basis
(4) Includes Federal Reserve Bank stock, Federal Home Loan Bank stock and Pacific Coast Bankers Bank stock.
(5) Net interest spread represents the average yield earned on interest earning assets less the average rate paid on interest bearing liabilities.
(6) Net interest margin is computed by dividing net interest income by total average earning assets.

The following table shows the change in interest income and interest expense and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates.

| | 2004 compared to 2003 | | | |
|---|---|---|---|---|
| | | Increase (decrease) due to change in: | | |
| | Net Change | Rate | Volume | Mix |
| | | (In thousands) | | |
| Loans | $ 1,736 | $ (1,305) | $ 3,211 | $ (170) |
| Investment securities taxable | 650 | 410 | 183 | 57 |
| Investment securities non-taxable | 29 | (16) | 45 | |
| Federal funds sold | 450 | 49 | 334 | 67 |
| Other investments | 30 | (15) | 66 | (21) |
| Total interest income | 2,895 | (877) | 3,839 | (67) |
| Interest expense: | | | | |
| Interest-bearing demand | 47 | 15 | 24 | 8 |
| Money market | 593 | (224) | 905 | (88) |
| Savings | 6 | 2 | 4 | |
| Time certificates of deposit | (1,271) | (959) | (401) | 89 |
| Short-term borrowings | (8) | (1) | (7) | |
| Junior subordinated debt | 42 | 42 | | |
| Total interest expense | (591) | (1,125) | 525 | 9 |
| Net interest income | $ 3,486 | $ 248 | $ 3,314 | $ (76) |

*Provision for Loan Losses.* The provision for loan losses for the year ended December 31, 2004 was $922 thousand compared to $1.7 million in the year ended December 31, 2003. We experienced net loan charge-offs of $198 thousand in 2004 compared to net loan charge-offs of $1.0 million for 2003. The amount in the provision for loan losses each year relates primarily to the significant growth in loans. Gross loans increased by $53 million in 2004 and $57 million in 2003. However, the decrease in the amount of the provision for 2004 primarily relates to the decrease in net charge offs to total loans from 0.28% at December 31, 2003 to 0.05% at December 31, 2004 and non-performing loans to total loans decreasing from 0.66% at December 31, 2003 to 0.24% as of December 31, 2004. See Financial Condition Loans Non-Performing Assets.

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*Non-Interest Income.* The following table presents, for the periods indicated, the major categories of non-interest income:

| | Year Ended December 31, 2004 | Year Ended December 31, 2003 | Increase (Decrease) |
|---|---|---|---|
| | (In thousands) | | |
| Service charges and other income | $ 991 | $ 1,050 | $ (59) |
| Loan brokerage and referral fees | 184 | 446 | (262) |
| Income from bank owned life insurance | 194 | | 194 |
| Net gain on sales of loans | 108 | 65 | 43 |
| Net gain on sales of securities | 12 | 2 | 10 |
| Total non-interest income | $ 1,489 | $ 1,563 | $ (74) |

The $74 thousand, or 4.7% decrease in total non-interest income was primarily due to a decrease of $262 thousand in loan brokerage and referral fees, partially offset by an increase in cash surrender value of bank owned life insurance purchased in July 2004. The decline in loan brokerage and referral fees was caused by an industry wide slow down in the residential mortgage refinance market. As a result of this trend, we have reduced staff for the residential mortgage origination business but retained residential mortgage referral capability to generate fees. We expect that the likely reduction in fee income associated with the reduction in refinance activity will be offset by a reduction in non-interest expense from our staff reductions in this area.

*Non-Interest Expense.* Non-interest expenses are the costs, other than interest expense and the provision for loan losses, associated with the providing banking and financial services to customers and conducting our affairs.

The following table presents, for the periods indicated, the major categories of non-interest expense:

| | Year Ended December 31, 2004 | Year Ended December 31, 2003 | Increase (Decrease) |
|---|---|---|---|
| | (In thousands) | | |
| Salaries, wages and employee benefits | $ 8,619 | $ 7,157 | $ 1,462 |
| Stock appreciation rights | 2,095 | 149 | 1,946 |
| Occupancy, equipment and depreciation | 1,495 | 1,417 | 78 |
| Loan related | 235 | 127 | 108 |
| Data processing | 558 | 522 | 36 |
| Advertising and public relations | 587 | 465 | 122 |
| Professional fees | 359 | 230 | 129 |
| Stationery and supplies | 230 | 209 | 21 |
| Insurance | 249 | 173 | 76 |
| Telephone and postage | 198 | 232 | (34) |
| Director fees | | | |