PLUMAS BANCORP
Form 10-K
March 14, 2007

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

FORM 10-K

þ **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2006

or

o **Transaction report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission file number: 000-49883

PLUMAS BANCORP
(Exact name of Registrant as specified in its charter)

California	**75-2987096**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
35 S. Lindan Avenue, Quincy, CA	**95971**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(530) 283-7305**

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

Title of Each Class:	**Name of Each Exchange on which Registered:**
Common Stock, no par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: **None.**

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

o Yes þ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

o Yes þ No

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

þ Yes o No

Indicated by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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. o

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 Rule12b-2 of the Exchange Act (check one):

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

o Yes þ No

As of June 30, 2006, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately $80.5 million, based on the closing price reported to the Registrant on that date of $18.50 per share.

Shares of Common Stock held by each officer and director have been excluded in that such persons may be deemed to be affiliates. This determination of the affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of Common Stock of the registrant outstanding as of March 9, 2007 was 4,997,321.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2007 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

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PART I

Forward-Looking Information

This Annual Report on Form 10-K includes forward-looking statements and information is subject to the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements (which involve Plumas Bancorp s (the Company s) plans, beliefs and goals, refer to estimates or use similar terms) involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, but are not limited to, the following factors:

§ *Competitive pressure in the banking industry, competition in the markets the Company operates in and changes in the legal, accounting and regulatory environment*

§ *Changes in the interest rate environment and volatility of rate sensitive assets and liabilities*

§ *Declines in the health of the economy, nationally or regionally, which could reduce the demand for loans, reduce the ability of borrowers to repay loans and/or reduce the value of real estate collateral securing most of the Company s loans*

§ *Credit quality deterioration, which could cause an increase in the provision for loan and lease losses*

§ *Devaluation of fixed income securities*

§ *Asset/liability matching risks and liquidity risks*

§ *Loss of key personnel*

§ *Operational interruptions including data processing systems failure and fraud*

The Company undertakes no obligation to revise or publicly release the results of any revision to these forward-looking statements. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to Item 1A of this Form 10-K entitled Risk Factors and other information in this Report.

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ITEM 1. BUSINESS

General

The Company. Plumas Bancorp (the Company) is a California corporation registered as a bank holding company under the *Bank Holding Company Act* of 1956, as amended, and is headquartered in Quincy, California. The Company was incorporated in January 2002 and acquired all of the outstanding shares of Plumas Bank (the Bank) in June 2002. The Company s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company s only other subsidiaries are Plumas Statutory Trust I and Plumas Statutory Trust II, which were formed in 2002 and 2005 solely to facilitate the issuance of trust preferred securities.

The Company s principal source of income is dividends from the Bank, but the Company intends to explore supplemental sources of income in the future. The cash outlays of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, costs of repurchasing Company common stock, and the cost of servicing debt, will generally be paid from dividends paid to the Company by the Bank.

At December 31, 2006, the Company had consolidated assets of $473.2 million, deposits of $402.2 million and shareholders equity of $35.8 million. The Company s liabilities include $10.3 million in junior subordinated deferrable interest debentures issued in conjunction with the trust preferred securities issued by Plumas Statutory Trust I (the Trust I) in September 2002 and Plumas Statutory Trust II (the Trust II). Both Trust I and Trust II are further discussed in the section titled Trust Preferred Securities.

References herein to the Company, we, us and our refer to Plumas Bancorp and its consolidated subsidiary, unless context indicates otherwise. Our operations are conducted at 35 South Lindan Avenue, Quincy, California. Our annual, quarterly and other reports, required under the Securities Exchange Act of 1934 and filed with the Securities and Exchange Commission and are posted and are available at no cost on the Company s website, *www.plumasbank.com*, as soon as reasonably practicable after the Company files such documents with the SEC. These reports are also available through the SEC s website at *www.sec.gov*.

The Bank. The Bank is a California state-chartered bank that was incorporated in July 1980 and opened for business in December 1980. The Bank s Administrative Office is also located at 35 South Lindan Avenue, Quincy, California. At December 31, 2006 the Bank had approximately $472.7 million in assets, $354.7 million in loans and $403.0 million in deposits (including a deposit of $0.9 million from the Bancorp). It is currently the largest independent bank headquartered in Plumas County. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (the FDIC) up to maximum insurable amounts. The Bank is not a member of the Federal Reserve System.

The Bank s primary service area covers the Northeastern corner of California, with Lake Tahoe to the South and the Oregon border to the North. The Bank, through its twelve branch network, serves the seven contiguous counties of Plumas, Nevada, Sierra, Placer, Lassen, Modoc and Shasta. The branches are located in the communities of Quincy, Portola, Greenville, Westwood, Truckee, Fall River Mills, Alturas, Susanville, Chester, Tahoe City, Kings Beach and Loyalton. Additionally, within our service area, the Bank maintains sixteen automated teller machines (ATMs) tied in with major statewide and national networks. During the fourth quarter of 2006 the Bank opened a commercial lending office in Reno, Nevada. The Bank s primary business is servicing the banking needs of these communities. Its marketing strategy stresses its local ownership and commitment to serve the banking needs of individuals living and working in the Bank s primary service areas.

With a predominant focus on personal service, the Bank has positioned itself as a multi-community independent bank serving the financial needs of individuals and businesses within the Bank s geographic footprint. Our principal retail lending services include consumer, home equity and home mortgage loans. Our principal commercial lending services include term real estate, land development and construction loans. In addition, we provide commercial and industrial term, government-guaranteed and agricultural loans as well as credit lines.

The Bank s Government-guaranteed lending center, headquartered in Truckee, provides Small Business Administration (SBA) lending and USDA Rural Development lending. The Bank produces 6-10 of both of these types of loans annually and it is anticipated that this will continue at the same level for the foreseeable future. Also in Truckee, we have a senior commercial lender charged with the production and maintenance of a significant participation loan portfolio. Participations with commitments totaling $22.3 million and outstanding balances of $20.5 million were purchased during 2006. Total participations of $41.7 and $30.7 million were included in the Company s loan portfolio as of December 31, 2006 and 2005.

The Agricultural Credit Centers located in Susanville and Alturas provide a complete line of credit services in support of the agricultural activities which are key to the continued economic development of the communities we serve. Ag lending clients include a full range of individual farming customers, small- to medium-sized business farming organizations and corporate farming units.

As of December 31, 2006, the principal areas in which we directed our lending activities, and the percentage of our total loan portfolio for which each of these areas was responsible, were as follows: (i) loans secured by real estate 54.2%; (ii) commercial and industrial (including SBA) loans 10.2%; (iii) consumer loans (including residential equity lines of credit) 25.6%; and (iv) agricultural loans (including agricultural real estate loans) 10.0%.

In addition to the lending activities noted above, we offer a wide range of deposit products for the retail and commercial banking markets including checking, interest-bearing checking, business sweep, savings, time deposit and retirement accounts, as well as telephone banking and internet banking with bill-pay options. As of December 31, 2006, the Bank had 34,304 deposit accounts with balances totaling approximately $403 million, compared to 34,596 deposit accounts with balances totaling approximately $429.0 million at December 31, 2005. We attract deposits through our customer-oriented product mix, competitive pricing, convenient locations, extended hours and drive-up banking, all provided with high level of customer service. During September 2005 the Bank introduced its Money Fund Plu$ checking account. This account is intended to pay rates comparable to those available on a money fund offered by a typical brokerage firm. Since its introduction this product has been very successful in generating interest bearing checking deposits. Money Fund Plu$ balances increased by $21.6 million in 2006 and balances totaled $42.9 million at December 31, 2006.

Most of our deposits are attracted from individuals, business-related sources and smaller municipal entities. This mix of deposit customers resulted in a relatively modest average deposit balance of approximately $11,750 at December 31, 2006, but makes us less vulnerable to adverse effects from the loss of depositors who may be seeking higher yields in other markets or who may otherwise draw down balances for cash needs. We do not accept brokered deposits.

We also offer a multitude of other products and services to our customers to complement the lending and deposit services previously reviewed. These include cashier s checks, traveler s checks, bank-by-mail, ATMs, night depository, safe deposit boxes, direct deposit, electronic funds transfers, on-line banking, and other customary banking services.

In order to provide non-deposit investment options we have developed a strategic alliance with Financial Network Investment Corporation (FNIC). Through this arrangement, certain employees of the Bank are also registered and licensed representatives of FNIC. These employees provide our customers throughout our branch network with convenient access to annuities, insurance products, mutual funds, and a full range of investment products.

The Bank has not engaged in any material research activities relating to the development of new products or services during the last two fiscal years; however, a substantial investment of time and capital has been devoted to the improvement of existing Bank services during this period. In January of 2005, the Bank introduced a single close construction/permanent residential loan product. This provided the customer with the ability to obtain a construction and permanent loan on their residence with only one application, one set of loan documents and a fixed rate for the entire term. This product has become very popular with loan originations of over $17 million during 2006 and outstanding loans totaling $9.7 million at December 31, 2006. During 2006 the Bank introduced an equity line of credit product secured by investment or commercial property, including improved or unimproved lots. Although this product has generated some interest among the Bank s customers, it has not generated significant loan balances to date. Loans balances at December 31, 2006 related to this product totaled $193,000.

The officers and employees of the Bank are continually engaged in marketing activities, including the evaluation and development of new products and services to enable the Bank to retain and improve its competitive position in its service area. Alternatives for future electronic banking delivery are currently being examined in an effort to keep pace with evolving technology and continue to provide superior customer service.

We hold no patents or licenses (other than licenses required by appropriate bank regulatory agencies or local governments), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural and tourism orientation of some of the communities we serve. As our branches in less rural areas such as Truckee have expanded, however, the agriculture-related base has become less significant. We are not dependent on a single customer or group of related customers for a material portion of our deposits, nor is a material portion of our loans concentrated within a single industry or group of related industries. There has been no material effect upon our capital expenditures, earnings, or competitive position as a result of federal, state, or local environmental regulation.

Commitment to our Communities. The Board of Directors and Management believe that the Company plays an important role in the economic well being of the communities it serves. Our Bank has a continuing responsibility to provide a wide range of lending and deposit services to both individuals and businesses. These services are tailored to meet the needs of the communities served by the Company and the Bank.

We offer various loan products which promote home ownership and affordable housing, fuel job growth and support community economic development. Types of loans offered range from personal and commercial loans to real estate, construction, agricultural, mortgage and government-guaranteed community infrastructure loans. Many banking decisions are made locally with the goal of maintaining customer satisfaction.

Recent Developments. During October of 2006 we open a commercial lending office in Reno, Nevada.

Trust Preferred Securities. During the third quarter of 2002, the Company formed a wholly owned Connecticut statutory business trust, Plumas Statutory Trust I (the Trust I). On September 26, 2002, the Company issued to the Trust I, Floating Rate Junior Subordinated Deferrable Interest Debentures due 2032 (the Debentures) in the aggregate principal amount of $6,186,000. In exchange for these debentures the Trust I paid the Company $6,186,000. The Trust I funded its purchase of debentures by issuing $6,000,000 in floating rate capital securities (trust preferred securities), which were sold to a third party. These trust preferred securities qualify as Tier I capital under current Federal Reserve Board guidelines. The Debentures are the only asset of the Trust I. The interest rate and terms on both instruments are substantially the same. The rate is based on the three month LIBOR (London Interbank Offered Rate) plus 3.40%, not to exceed 11.9%, adjustable quarterly. The proceeds from the sale of the Debentures were primarily used by the Company to inject capital into the Bank.

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During the third quarter of 2005, the Company formed a wholly owned Connecticut statutory business trust, Plumas Statutory Trust II (the Trust II). On September 28, 2005, the Company issued to the Trust II, Floating Rate Junior Subordinated Deferrable Interest Debentures due 2035 (the Debentures) in the aggregate principal amount of $4,124,000. In exchange for these debentures the Trust II paid the Company $4,124,000. The Trust II funded its purchase of debentures by issuing $4,000,000 in floating rate capital securities (trust preferred securities), which were sold to a third party. These trust preferred securities qualify as Tier I capital under current Federal Reserve Board guidelines. The Debentures are the only asset of the Trust II. The interest rate and terms on both instruments are substantially the same. The rate is based on the three month LIBOR (London Interbank Offered Rate) plus 1.48%, adjustable quarterly. The proceeds from the sale of the Debentures were primarily used by the Company to inject capital into the Bank.

The Debentures and trust preferred securities accrue and pay distributions quarterly based on the floating rate described above on the stated liquidation value of $1,000 per security. The Company has entered into contractual agreements which, taken collectively, fully and unconditionally guarantee payment of: (1) accrued and unpaid distributions required to be paid on the capital securities; (2) the redemption price with respect to any capital securities called for redemption by either Trust I or Trust II, and (3) payments due upon voluntary or involuntary dissolution, winding up, or liquidation of either Trust I or Trust II.

The trust preferred securities are mandatorily redeemable upon maturity of the Debentures on September 26, 2032 for Trust I and September 28, 2035 for Trust II, or upon earlier redemption as provided in the indenture.

Neither Trust I nor Trust II are consolidated into the Company s consolidated financial statements and, accordingly, both entities are accounted for under the equity method and the junior subordinated debentures are reflected as debt on the consolidated balance sheet.

Business Concentrations. No individual or single group of related customer accounts is considered material in relation to the Banks assets or deposits, or in relation to our overall business. However, at December 31, 2006 approximately 64% of the Bank s total loan portfolio consisted of real estate-secured loans, including real estate mortgage loans, real estate construction loans, consumer equity lines of credit, and agricultural loans secured by real estate. Moreover, our business activities are currently focused in the California counties of Plumas, Nevada, Placer, Lassen, Modoc, Shasta and Sierra and Washoe County in Nevada. Consequently, our results of operations and financial condition are dependent upon the general trends in these economies and, in particular, the residential and commercial real estate markets. In addition, the concentration of our operations in these areas of California and Nevada exposes us to greater risk than other banking companies with a wider geographic base in the event of catastrophes, such as earthquakes, fires and floods in these regions in California and Nevada.

Competition. With respect to commercial bank competitors, the business is largely dominated by a relatively small number of major banks with many offices operating over a wide geographical area. These banks have, among other advantages, the ability to finance wide-ranging and effective advertising campaigns and to allocate their resources to regions of highest yield and demand. Many of the major banks operating in the area offer certain services that we do not offer directly but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, such banks also have substantially higher lending limits than we do. For customers whose loan demands exceed our legal lending limit, we attempt to arrange for such loans on a participation basis with correspondent banks.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, and investment banking firms. In recent years, increased competition has also developed from specialized

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finance and non-finance companies that offer wholesale finance, credit card, and other consumer finance services, including on-line banking services and personal financial software. Strong competition for deposit and loan products affects the rates of those products as well as the terms on which they are offered to customers. Mergers between financial institutions have placed additional pressure on banks within the industry to streamline their operations, reduce expenses, and increase revenues to remain competitive. Competition has also intensified due to federal and state interstate banking laws enacted in the mid-1990 s, which permit banking organizations to expand into other states, and the relatively large California market has been particularly attractive to out-of-state institutions. The Financial Modernization Act, which became effective March 11, 2000, has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions.

Currently, within the Bank s branch service area there are 23 traditional banking branch offices of competing institutions, including 19 branches of 4 major banks. As of June 30, 2006, the Federal Deposit Insurance Corporation estimated the Bank s market share of insured deposits within the communities it serves to be as follows: Chester 71%, Quincy 66%, Portola 49%, Susanville 40%, Alturas 38%, Kings Beach 31%, Truckee 20%, Fall River Mills/Burney 20%, Tahoe City 3% and 100% in the communities of Greenville, Westwood and Loyalton. Tahoe City is the location of our most recently opened branch, which opened its doors in November 2003.

Technological innovations have also resulted in increased competition in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. In addition, many customers now expect a choice of delivery systems and channels, including telephone, mail, home computer, ATMs, full-service branches, and/or in-store branches. The sources of competition in such products include traditional banks as well as savings associations, credit unions, brokerage firms, money market and other mutual funds, asset management groups, finance and insurance companies, internet-only financial intermediaries, and mortgage banking firms.

For many years we have countered rising competition by providing our own style of community-oriented, personalized service. We rely on local promotional activity, personal contacts by our officers, directors, employees, and shareholders, automated 24-hour banking, and the individualized service that we can provide through our flexible policies. This appears to be well-received by our customers throughout our service area, who appreciate a more personal and customer-oriented environment in which to conduct their financial transactions. We have also embraced the electronic age and installed telephone banking and personal computer and internet banking with bill payment capabilities to meet the needs of customers with electronic access requirements. This high tech and high touch approach allows the customers to customize their access to our services based on their particular preference.

Employees. At December 31, 2006, the Company and its subsidiary employed 205 persons. On a full-time equivalent basis, we employed 181 persons. We believe our employee relations are excellent.

Supervision and Regulation

The Company. As a bank holding company, we are subject to regulation under the Bank Holding Company Act of 1956, as amended, (the BHCA), and are registered with and subject to the supervision of the Federal Reserve Bank (the FRB). It is the policy of the FRB, that each bank holding company serve as a source of financial and managerial strength to its subsidiary banks. We are required to file reports with the FRB and provide such additional information as the FRB may require. The FRB has the authority to examine us and our subsidiary, as well as any arrangements between us and our subsidiary, with the cost of any such examination to be borne by us.

The BHCA requires us to obtain the prior approval of the FRB before acquisition of all or substantially all of the assets of any bank or ownership or control of the voting shares of any bank if, after giving effect to the acquisition, we would own or control, directly or indirectly, more than 5% of the voting shares of that bank. Amendments to the BHCA expand the circumstances under which a bank holding company may acquire control of all or substantially all of the assets of a bank located outside the State of California.

We may not engage in any business other than managing or controlling banks or furnishing services to our subsidiary, with the exception of certain activities which, in the opinion of the FRB, are so closely related to banking or to managing or controlling banks as to be incidental to banking. In addition, we are generally prohibited from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company unless that company is engaged in such authorized activities and the Federal Reserve approves the acquisition.

We and our subsidiary are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or provision of services. For example, with certain exceptions, the bank may not condition an extension of credit on a customer obtaining other services provided by us, the bank or any other subsidiary of ours, or on a promise by the customer not to obtain other services from a competitor. In addition, federal law imposes certain restrictions on transactions between the bank and its affiliates. As affiliates, the bank and we are subject, with certain exceptions, to the provisions of federal law imposing limitations on and requiring collateral for extensions of credit by the bank to any affiliate.

The Bank. As a California state-chartered bank that is not a member of the Federal Reserve, Plumas Bank is subject to primary supervision, examination and regulation by the FDIC, the California Department of Financial Institutions (the DFI) and is subject to applicable regulations of the FRB. The Bank s deposits are insured by the FDIC to applicable limits. As a consequence of the extensive regulation of commercial banking activities in California and the United States, banks are particularly susceptible to changes in California and federal legislation and regulations, which may have the effect of increasing the cost of doing business, limiting permissible activities or increasing competition. Various other requirements and restrictions under the laws of the United States and the State of California affect the operations of the Bank. Federal and California statutes and regulations relate to many aspects of the Bank s operations, including reserves against deposits, interest rates payable on deposits, loans, investments, mergers and acquisitions, borrowings, dividends, branching, capital requirements and disclosure obligations to depositors and borrowers. California law presently permits a bank to locate a branch office in any locality in the state. Additionally, California law exempts banks from California usury laws.

Capital Standards. The FRB and the FDIC have risk-based capital adequacy guidelines intended to provide a measure of capital adequacy that reflects the degree of risk associated with a banking organization s operations for both transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are reported as off-balance-sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance-sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. government securities, to 100% for assets with relatively higher credit risk, such as business loans.

A banking organization s risk-based capital ratios are obtained by dividing its qualifying capital by its total risk-adjusted assets and off-balance-sheet items. The regulators measure risk-adjusted assets and off-balance-sheet items against both total qualifying capital (the sum of Tier 1 capital and limited amounts of Tier 2 capital) and Tier 1 capital. Tier 1 capital consists of common stock, retained earnings, noncumulative perpetual preferred stock and minority interests in certain subsidiaries, less most other intangible assets. Tier 2 capital may consist of a limited amount of the allowance for loan and lease losses and certain other instruments with some characteristics of equity. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies. Since

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December 31, 1992, the FRB and the FDIC have required a minimum ratio of qualifying total capital to risk-adjusted assets and off-balance-sheet items of 8%, and a minimum ratio of Tier 1 capital to risk-adjusted assets and off-balance-sheet items of 4%.

In addition to the risk-based guidelines, the FRB and FDIC require banking organizations to maintain a minimum amount of Tier 1 capital to average total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets is 3%. It is improbable, however, that an institution with a 3% leverage ratio would receive the highest rating by the regulators since a strong capital position is a significant part of the regulators ratings. For all banking organizations not rated in the highest category, the minimum leverage ratio is at least 100 to 200 basis points above the 3% minimum. Thus, the effective minimum leverage ratio, for all practical purposes, is at least 4% or 5%.

In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the FRB and FDIC have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios.

A bank that does not achieve and maintain the required capital levels may be issued a capital directive by the FDIC to ensure the maintenance of required capital levels. As discussed above, we are required to maintain certain levels of capital, as is the Bank. The regulatory capital guidelines as well as our actual capitalization on a consolidated basis and for the Bank and Bancorp as of December 31, 2006 follow:

	Requirement for the Bank to be:			
	Adequately Capitalized	Well Capitalized	Plumas Bank	Plumas Bancorp
Tier 1 leverage capital ratio	4.0%	5.0%	9.3%	9.5%
Tier 1 risk-based capital ratio	4.0%	6.0%	10.6%	10.9%
Total risk-based capital ratio	8.0%	10.0%	11.6%	11.8%

Prompt Corrective Action. Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including those institutions that fall below one or more prescribed minimum capital ratios described above. An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the agency would be harmed if such equitable relief was not granted. Additionally, a holding company s inability to serve as a source of strength to its subsidiary banking organizations could serve as an additional basis for a regulatory action against the holding company.

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Premiums for Deposit Insurance. The deposit insurance fund or DIF of the FDIC insures our customer deposits up to prescribed limits for each depositor. The Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 amended the insurance of deposits by the FDIC and collection of assessments from insured depository institutions for deposit insurance. Passed on such amendments enacted, the FDIC approved a final rule to determine risk-based assessment rates on November 2, 2006. An insured depository institution s assessment rate under the final rule is based on the new assessment rate schedule, its long-term debt issuer ratings or recent financial ratios and supervisory ratings. Any increase in assessments or the assessment rate could have a material adverse effect on our business, financial condition, results of operations or cash flows, depending on the amount of the increase. Furthermore, the FDIC is authorized to raise insurance premiums under certain circumstances.

The FDIC is authorized to terminate a depository institution s deposit insurance upon a finding by the FDIC that the institution s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution s regulatory agency. The termination of deposit insurance for the bank would have a material adverse effect on our business, financial condition, results of operations or cash flows.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank of San Francisco (the FHLB-SF). Among other benefits, each Federal Home Loan Bank (FHLB), serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. A new capital plan of the FHLB-SF was approved and implemented by the Federal Housing Finance Board on April 1, 2004. The new capital plan incorporates a single class of stock with a par value of $100 per share, and may be issued, exchanged, redeemed, and repurchased only at par value. As an FHLB member, the bank is required to own capital stock in an FHLB in an amount equal to the greater of:

§ a membership stock requirement with an initial cap of $25 million (100% of membership asset value as defined), or

§ an activity based stock requirement (based on percentage of outstanding advances).

The new capital stock is redeemable on five years written notice, subject to certain conditions.

In April 2005 the Bank was required to purchase an additional 12,810 shares, or $1,281,000, of capital stock under the FHLB-SF s new capital plan. At December 31, 2006 the Bank owned 21,034 shares of the FHLB-SF capital stock. We do not believe that the FHLB-SF s new capital plan had a material impact upon our business, financial condition, results of operations or cash flows.

Federal Reserve System. The FRB requires all depository institutions to maintain non-interest bearing reserves at specified levels against their transaction accounts and non-personal time deposits. At December 31, 2006, we were in compliance with these requirements.

Impact of Monetary Policies. The earnings and growth of the Company are subject to the influence of domestic and foreign economic conditions, including inflation, recession and unemployment. The earnings of the Company are affected not only by general economic conditions but also by the monetary and fiscal policies of the United States and federal agencies, particularly the FRB. The FRB can and does implement national monetary policy, such as seeking to curb inflation and combat recession, by its open market operations in United States Government securities and by its control of the discount rates applicable to borrowings by banks from the FRB. The actions of the FRB in these areas influence the growth of bank loans and leases, investments and deposits and affect the interest rates charged on loans and leases and paid on deposits. The FRB s policies have had a significant effect on the operating results of commercial banks and are expected to continue to do so in the future. The nature and timing of any future changes in monetary policies are not predictable.

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Extensions of Credit to Insiders and Transactions with Affiliates. The *Federal Reserve Act* and FRB *Regulation O* place limitations and conditions on loans or extensions of credit to:

§ a bank s or bank holding company s executive officers, directors and principal shareholders (*i.e.*, in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities),

§ any company controlled by any such executive officer, director or shareholder, or

§ any political or campaign committee controlled by such executive officer, director or principal shareholder.

Loans and leases extended to any of the above persons must comply with loan-to-one-borrower limits, require prior full board approval when aggregate extensions of credit to the person exceed specified amounts, must be made on substantially the same terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group cannot exceed the bank s unimpaired capital and unimpaired surplus. Regulation O also prohibits a bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the bank.

Consumer Protection Laws and Regulations. The banking regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. The Company is subject to many federal and state consumer protection and privacy statutes and regulations, some of which are discussed below.

The *Community Reinvestment Act* (the CRA) is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations**.** The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of outstanding to a low of substantial noncompliance. In its last examination for CRA compliance, as of August 2005, the Bank was rated satisfactory.

The *Equal Credit Opportunity Act* (the ECOA) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The *Truth in Lending Act* (the TILA) is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The *Fair Housing Act* (the FH Act) regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The *Home Mortgage Disclosure Act* (the HMDA), in response to public concern over credit shortages in certain urban neighborhoods, requires public disclosure of information that shows whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a fair lending aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The *Right to Financial Privacy Act* (the RFPA) imposes a new requirement for financial institutions to provide new privacy protections to consumers. Financial institutions must provide disclosures to consumers of its privacy policy, and state the rights of consumers to direct their financial institution not to share their nonpublic personal information with third parties.

Finally, the *Real Estate Settlement Procedures Act* (the RESPA) requires lenders to provide noncommercial borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

Penalties for noncompliance or violations under the above laws may include fines, reimbursement and other penalties. Due to heightened regulatory concern related to compliance with CRA, ECOA, TILA, FH Act, HMDA, RFPA and RESPA generally, the Company may incur additional compliance costs or be required to expend additional funds for investments in its local community.

Recent Legislation and Other Changes. Federal and state laws affecting banking are enacted from time to time, and similarly federal and state regulations affecting banking are also adopted from time to time. The following include some of the recent laws and regulations affecting banking.

On February 8, 2006, the President signed The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) into law. The Federal Deposit Insurance Reform Conforming Amendments Act of 2005, which the President signed into law on February 15, 2006, contains necessary technical and conforming changes to implement deposit insurance reform, as well as a number of study and survey requirements. The Reform Act provides for the following changes:

Merging the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new fund, the Deposit Insurance Fund (DIF). This change was made effective March 31, 2006.

Increasing the coverage limit for retirement accounts to $250,000 and indexing the coverage limit for retirement accounts to inflation as with the general deposit insurance coverage limit. This change was made effective April 1, 2006.

Establishing a range of 1.15 percent to 1.50 percent within which the FDIC Board of Directors may set the Designated Reserve Ratio (DRR).

Allowing the FDIC to manage the pace at which the reserve ratio varies within this range.

1. If the reserve ratio falls below 1.15 percent or is expected to within 6 months the FDIC must adopt a restoration plan that provides that the DIF will return to 1.15 percent generally within 5 years.

2. If the reserve ratio exceeds 1.35 percent, the FDIC must generally dividend to DIF members half of the amount above the amount necessary to maintain the DIF at 1.35 percent, unless the FDIC Board, considering statutory factors, suspends the dividends.

3. If the reserve ratio exceeds 1.5 percent, the FDIC must generally dividend to DIF members all amounts above the amount necessary to maintain the DIF at 1.5 percent.

Eliminating the restrictions on premium rates based on the DRR and granting the FDIC Board the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the reserve ratio.

Granting a one-time initial assessment credit (of approximately $4.7 billion) to recognize institutions past contributions to the fund.

The Federal Reserve Board in February 2006 approved a final rule that expands the definition of a small bank holding company under its Small Bank Holding Company Policy Statement and the Board s risk-based and leverage capital guidelines for bank holding companies. The policy statement facilitates the transfer of ownership of small community banks by permitting debt levels at small bank holding companies that are higher than what would typically be permitted for larger small bank holding companies. In its revisions to the Policy Statement, the Federal Reserve Board has raised the small bank holding company asset size threshold from $150 million to $500 million and amended the related qualitative criteria for determining eligibility as a small bank holding company for the purposes of the policy statement and the capital guidelines.

The FDIC finalized its interim final rule, with changes, that amended its deposit insurance regulations to implement applicable revisions to the Federal Deposit Insurance Act made by the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005. The final rule provides for consideration of inflation adjustments to increase the current standard maximum deposit insurance amount of $100,000 on a five-year cycle beginning in 2010; increases the deposit insurance limit for certain retirement accounts from $100,000 to $250,000, also subject to inflation adjustments; and provides per-participant insurance coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits. The final rule is effective on October 12, 2006.

The Board of Governors of the Federal Reserve System amended Regulation E, which implements the Electronic Fund Transfer Act, and the official staff commentary to the regulation, which interprets the requirements of Regulation E to become effective on July 1, 2006. The final rule provides that Regulation E covers payroll card accounts that are established directly or indirectly through an employer, and to which transfers of the consumer s salary, wages, or other employee compensation are made on a recurring basis. The final rule also provides financial institutions with an alternative to providing periodic statements for payroll card accounts if they make account information available to consumers by specified means.

The federal financial regulatory agencies in September 2006 issued final guidance to address the risks posed by nontraditional residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest, including interest-only mortgages and payment option adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments later. The lack of principal amortization and the potential for negative amortization and features that compound risks (such as no document loans and simultaneous second mortgages) elevate the concern of the federal banking agencies for nontraditional mortgage products. The guidelines require depository institutions to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower s repayment capacity, to recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. The guidelines also express the need for depository institutions to have strong risk management standards, capital levels commensurate with the risk, an allowance for loan and lease losses that reflects the collectibility of the portfolio, and the need to make sure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice.

The federal financial regulatory agencies in December 2006 issued a new interagency policy statement on the allowance for loan and lease losses (ALLL) along with supplemental frequently asked questions. The policy statement revises and replaces a 1993 policy statement on the ALLL. The agencies issued the revised policy statement in view of today s uncertain economic environment and the presence of concentrations in untested loan products in the loan portfolios of insured depository institutions. The policy statement has also been revised to conform with generally accepted accounting principles (GAAP) and post-1993 supervisory guidance. The 1993 policy statement described the responsibilities of the boards of directors, management, and banking examiners regarding the ALLL; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. The policy statement reiterates that each institution has a responsibility for developing, maintaining and documenting a comprehensive, systematic, and consistently applied process appropriate to its size and the nature, scope, and risk of its lending activities for determining the amounts of the ALLL and the provision for loan and lease losses and states that each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution s stated policies and procedures, management s best judgment and relevant supervisory guidance.

The policy statement also restates that insured depository institutions must maintain an ALLL at a level that is appropriate to cover estimated credit losses on individually evaluated loans determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio, and that estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. The policy statement states that prudent, conservative, but not excessive, loan loss allowances that represent management s best estimate from within an acceptable range of estimated losses are appropriate.

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation in December 2006 issued final guidance on sound risk management practices for concentrations in commercial real estate lending. The agencies observed that the commercial real estate is an area in which some banks are becoming increasingly concentrated, especially with small- to medium- sized banks that face strong competition in their other business lines. The agencies support banks serving a vital role in their communities by supplying credit for business and real estate development. However, the agencies are concerned that rising commercial real estate loan concentrations may expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in commercial real estate markets. The guidance provides supervisory criteria, including numerical indicators to assist in identifying institutions with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny, but such criteria are not limits on commercial real estate lending.

In California, effective January 1, 2007, a new law Financial Code Section 854.1 recognizes the ability of mortgage brokers to obtain the benefit of non interest-bearing accounts on trust funds deposited in a commercial bank. The provision applies to real estate brokers who collect payments or provide services in connection with a loan secured by a lien on real property and permits a mortgage broker to earn interest on an interest-bearing account at a financial institution. Interest on funds received by a real estate broker who collects payments or provides services for an institutional investor in connection with a loan secured by commercial real property may inure to the broker, if agreed to in writing by the broker and the institutional investor. For purposes of this law, commercial real property means real estate improved with other than a one-to-four family residence.

A new California law makes it easier for California banks to accept deposits from local government agencies. Under the old law, local agency deposits over $100,000 had to be secured by collateral. Pursuant to the enactment of Assembly Bill 2011, banks would be able to acquire surplus public deposits exceeding $100,000 without pledging collateral if they participate in a deposit placement service where excess amounts are placed in certificates of deposit at other institutions within a network. Such a network (of which currently there is only one available in the market) permits the entire amount of a customer s deposit to be FDIC-insured, and the bank taking the original deposit retains the benefit of the full amount of the

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deposit for lending or other purposes. AB 2011 clarifies that a local agency may deposit up to 30% of its surplus funds in certificates of deposit at a bank, savings association, savings bank, or credit union that participates in such a deposit-sharing network. Since the entire amount of the deposits would be FDIC-insured, a bank would not be required to pledge collateral. The bill permits agencies to make these deposits until January 1, 2012.

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

Recent Accounting Pronouncements

Accounting for Servicing of Financial Assets

In March 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 156 (SFAS 156), *Accounting for Servicing of Financial Assets An Amendment of FASB Statement No. 140*. SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. Under SFAS 156, an entity can elect subsequent fair value measurement of its servicing assets and servicing liabilities by class. An entity should apply the requirements for recognition and initial measurement of servicing assets and servicing liabilities prospectively to all transactions after the effective date. SFAS 156 permits an entity to reclassify certain available-for-sale securities to trading securities provided that they are identified in some manner as offsetting the entity s exposure to changes in fair value of servicing assets or servicing liabilities subsequently measured at fair value. The provisions of SFAS 156 are effective for an entity as of the beginning of its first fiscal year that begins after September 15, 2006. Management does not expect the adoption of SFAS 156 to have a material impact on the Company s financial position or results of operations.

Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006.

The Company presently recognizes income tax positions based on management s estimate of whether it is reasonably possible that a liability has been incurred for unrecognized income tax benefits by applying FASB Statement No. 5, Accounting for Contingencies.

The provisions of FIN 48 will be effective for the Company on January 1, 2007 and are to be applied to all tax positions upon initial application of this standard. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption.

The cumulative effect of applying the provisions of FIN 48, if any, will be reported as an adjustment to the opening balance of retained earnings for the fiscal year of adoption. Management does not expect the adoption of FIN 48 to have a material impact on the Company s financial position or results of operations.

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Accounting for Purchases of Life Insurance

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) on Issue No. 06-5, *Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance*. FASB Technical Bulletin No. 85-4 requires that the amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. Since the issuance of FASB Technical Bulletin No. 85-4, questions arose regarding whether the amount that could be realized should consider 1) any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value and 2) the contractual ability to surrender all of the individual-life policies (or certificates in a group policy) at the same time. EITF 06-5 determined that the amount that could be realized should 1) consider any additional amounts included in the contractual terms of the policy and 2) assume the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). Any amount that is ultimately realized by the policy holder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized. An entity should apply the provisions of EITF 06-5 through either a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through retrospective application to all prior periods. The provisions of EITF 06-5 are effective for fiscal years beginning after December 15, 2006. Management has not yet completed its evaluation of the impact that EITF 06-5 will have.

Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements

In September 2006, the FASB ratified the consensuses reached by the Task Force on Issue No. 06-4 (EITF 06-4), *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. A question arose when an employer enters into an endorsement split-dollar life insurance arrangement related to whether the employer should recognize a liability for the future benefits or premiums to be provided to the employee. EITF 06-4 indicates that an employer should recognize a liability for future benefits and that a liability for the benefit obligation has not been settled through the purchase of an endorsement type policy. An entity should apply the provisions of EITF 06-4 either through a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through retrospective application to all prior periods. The provisions of EITF 06-4 are effective for fiscal years beginning after December 15, 2007. Management has not yet completed its evaluation of the impact that EITF 06-4 will have.

Fair Value Measurements

In September 2006, the FASB issued Statement No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The provisions should be applied prospectively, except for certain specifically identified financial instruments. Management does not expect the adoption of SFAS 157 to have a material impact to the Company s financial position or result of operations.

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Consideration of the Effects of Prior Year Misstatements
In September 2006, the Securities and Exchange Commission published Staff Accounting Bulleting No. 108 (SAB 108) *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* The interpretations in this Staff Accounting Bulleting were issued to address diversity in practice in quantifying financial statement misstatements and the potential under current practice to build up improper amounts on the balance sheet. This guidance will apply to the first fiscal year ending after November 15, 2006 or December 31, 2006 for the Company. The adoption of SAB 108 did not have a material impact on the Company s financial position, results of operations or cash flows and no cumulative adjustment was required.

ITEM 1A. RISK FACTORS

Our high concentration of real estate loans expose us to increased lending risks, especially in the event of a recession or natural disaster. Our loan portfolio is strongly concentrated in real estate loans. As of December 31, 2006, 64% of our loan portfolio was concentrated in real estate related loans. There has been a relatively rapid increase in real estate values in our market area in recent years, and the occurrence of a real estate recession affecting our market areas would likely reduce the security for many of our loans and adversely affect the ability of many of our borrowers to repay their loan from us. Therefore, our financial condition may be adversely affected by a decline in the value of the real estate securing our loans. In addition, acts of nature, including earthquakes, fires and floods, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition.

Deterioration of local economic conditions could hurt our profitability. Our operations are primarily located in Northeastern California and are concentrated in Plumas, Nevada, Placer, Lassen, Modoc, Shasta and Sierra Counties and Washoe County, Nevada and surrounding areas. As a result of this geographic concentration, our financial results depend largely upon economic conditions in these areas. The local economy relies heavily on real estate, agriculture and ranching, timber and tourism. A significant downturn in any or all of these industries could result in a decline in the local economy in general, which could in turn negatively impact us. Poor economic conditions could cause us to incur losses associated with higher default rates and decreased collateral values in our loan portfolio. Also, if there were significant recessionary conditions in our market area, our financial condition would be negatively impacted.

Our growth and expansion strategy may not prove to be successful and our market value and profitability may suffer. We plan to grow our operations, however our ability to manage any such growth will depend primarily on our ability to attract and retain qualified personnel, monitor operations, maintain earnings and control costs. We expect to continue to grow our assets and deposits, the products and services which we offer and the scale of our operations, generally. Our ability to manage our growth successfully will depend on our ability to maintain cost controls and asset quality while attracting additional loans and deposits on favorable terms. If we grow too quickly and are not able to control costs and maintain asset quality, this rapid growth could materially adversely affect our financial performance. Our future successful growth will depend on the ability of our officers and other key employees to continue to implement and improve our operational, credit, financial, management and other internal risk controls and processes and our reporting systems and procedures, and to manage a growing number of client relationships. We may not successfully implement improvements to our management information and control systems and control procedures and processes in an efficient or timely manner and may discover deficiencies in existing systems and controls. In particular, our controls and procedures must be able to accommodate an increase in expected loan volume and the infrastructure that comes with growth. Thus, our growth strategy may divert management from our existing businesses and may require us to incur additional expenditures to expand our administrative and operational infrastructure. If we are unable to manage future expansion in our operations, we may experience compliance and operational problems, 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.

Loss of any of our executive officers or key personnel could be damaging to us. We depend upon the skills and reputations of our executive officers and key employees for our future success. The loss of any of these key persons or the inability to attract and retain other key personnel could adversely affect our business. We cannot assure you that we will be able to retain our existing key personnel or attract other qualified persons. All of our current executive officers have been with us since at least 2001. While we have an employment agreement with Douglas N. Biddle, our President and CEO, which contains an agreement not to compete following termination, we do not have employment agreements with our other executive officers and, therefore, upon leaving the employ of Plumas Bank, such executives other than Mr. Biddle may become employed by our competitors.

Our performance is subject to interest rate risk. Our operations are significantly influenced by general economic conditions and by the related monetary and fiscal policies of the federal government. Deposit flows and the cost of funds are influenced by interest rates of competing investments and general market rates of interest. Lending activities are affected by the demand for loans, which in turn is affected by the interest rates at which such financing may be offered and by other factors affecting the availability of funds.

Our operations are substantially dependent on our net interest income, which is the difference between the interest income received from our interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities. To reduce exposure to interest rate fluctuations, we seek to manage the balances of our interest sensitive assets and liabilities, and maintain the maturity and repricing of these assets and liabilities at appropriate levels. A mismatch between the amount of rate sensitive assets and rate sensitive liabilities in any time period is referred to as a gap . Generally, if rate sensitive assets exceed rate sensitive liabilities, the net interest margin will be positively impacted during a rising rate environment and negatively impacted during a declining rate environment. When rate sensitive liabilities exceed rate sensitive assets, the net interest margin will generally be positively impacted during a declining rate environment and negatively impacted during a rising rate environment. Increases in the level of interest rates may reduce the amount of loans originated by us, and, thus, the amount of loan and commitment fees, as well as the value of our investment securities and other interest-earning assets. Moreover, fluctuations in interest rates also can result in disintermediation, which is the flow of funds away from depository institutions into direct investments, such as corporate securities and other investment vehicles which, because of the absence of federal deposit insurance, generally pay higher rates of return than depository institutions.

We could experience loan losses which exceed our allowance for loan losses. The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower, and, in the case of a collateralized loan, the value and marketability of the collateral. We maintain an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, we make various assumptions and determinations about the ultimate collectibility of our loan portfolio and provide an allowance for losses based upon a percentage of the outstanding balances and for specific loans where their collectibility is considered to be questionable.

As of December 31, 2006, our allowance for loan losses was approximately $3.9 million representing 1.1% of gross outstanding loans. Although we believe that this allowance is adequate, we can give no assurance that it will be sufficient to cover future loan losses. Although we use the best information available to make our determinations with respect to this allowance, future adjustments may be necessary if economic conditions change substantially from the assumptions used or if negative developments occur with respect to non-performing or performing loans. If our assumptions or conclusions prove to be incorrect and the allowance for loan losses is not adequate to absorb future losses, or if bank regulatory agencies require us to increase our allowance, our earnings and potentially even our capital could be significantly and adversely impacted.

We face strong competition which may adversely affect our operating results. In recent years, competition for bank customers, the source of deposits and loans, has greatly intensified. This competition includes:

- larger national and regional banks in many of the communities we serve;
- finance companies, investment banking and brokerage firms, and insurance companies that offer bank-like products;
- credit unions, which can offer highly competitive rates on loans and deposits because they receive tax advantages not available to commercial banks; and
- technology-based financial institutions including large national and super-regional banks offering on-line deposit, bill payment, and mortgage loan application services.

Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions. As a result, these nonbank competitors have certain advantages over us in accessing funding and in providing various services.

By virtue of their larger capital, major banks have substantially larger lending limits then we have and can perform certain functions for their customers which we are not equipped to offer directly, such as trust and international services. Many of these also operate with economies of scale which result in lower operating costs than ours on a per loan or per asset basis.

Other existing single or multi-branch community banks, or new community bank start-ups, have marketing strategies similar to ours. These other community banks can open new branches in the communities we serve and compete directly for customers who want the high level of service community banks offer. Other community banks also compete for the same management personnel and the same potential acquisition and merger candidates. Ultimately, competition can drive down our interest margins and reduce our profitability, as well as make it more difficult to increase the size of our loan portfolio and deposit base. See **ITEM 1. BUSINESS** **General - Competition**.

Our future growth may be hindered if we do not raise additional capital. Banks and bank holding companies are required to meet capital adequacy guidelines and maintain their capital to specified percentages of their assets. See **ITEM 1. BUSINESS** **Supervision and Regulation** **Capital Standards**. A failure to meet these guidelines will limit our ability to grow and could result in banking regulators requiring us to increase our capital or reduce our assets. Therefore, in order for us to continue to increase our assets and net income, we may be required from time to time to raise additional capital. We cannot assure that such capital will be available or, if it is, that it will be available on reasonable terms. Any such future capital raising may include the sale of additional securities, which could have a dilutive effect on the earnings per share and book value of per share for our stockholders prior to that offering. We have recently incurred long-term debt in order to maintain our capital adequacy and we may need to continue to do so in the future. Adequate funding sources for such borrowing may not be available in the future which would cause us to fall below the required capital ratios. In such an event, the FDIC could proceed with regulatory actions and Plumas Bank may be required to reduce its asset base in order to comply with the capital guidelines until such time as borrowings become available or an additional offering is successfully completed.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

No comments have been submitted to the registrant by the staff of the Securities Exchange Commission.

ITEM 2. PROPERTIES

Of the Company s twelve depository branches, ten are owned and two are leased. In addition the Company owns three administrative facilities and leases two lending offices. The Company purchased a building located at 424 N. Mill Creek, Quincy, California during the first quarter of 2006 which, after modifications to be undertaken in 2007, is expected to house the Company s data processing facilities.

Owned Properties

35 South Lindan Avenue Quincy, California (1)	32 Central Avenue Quincy, California (1)	80 W. Main St. Quincy, California (1)
424 N. Mill Creek Quincy, California (4)	336 West Main Street Quincy, California	120 North Pine Street Portola, California
43163 Highway 299E Fall River Mills, California	121 Crescent Street Greenville, California	315 Birch Street Westwood, California (2)
255 Main Street Chester, California	510 North Main Street Alturas, California	3000 Riverside Drive Susanville, California
8475 North Lake Boulevard Kings Beach, California	11638 Donner Pass Road Truckee, California	

Leased Properties

243 North Lake Boulevard Tahoe City, California	604 Main Street Loyalton, California	2625 Fair Oaks Blvd., Ste. 7 Sacramento, California (3)
1895 Plumas Ste 2 Reno, Nevada (3)		

(1) Non-branch administrative or credit administrative offices.

(2) The Westwood branch is a mortgaged property with an outstanding balance of $63,000 at December 31, 2006.

(3) Commercial lending offices

(4) Future location of Company s data processing facilities

Total rental expenses under all leases, including premises, totaled $221,000, $242,000 and $264,000, in 2006, 2005 and 2004 respectively. The expiration dates of the leases vary, with the first such lease expiring during 2007 and the last such lease expiring during 2009. Future minimum lease payments in thousands of dollars are as follows:

Year Ending December 31,	
2007	$ 164
2008	49
2009	22
Total	$ 235

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The Company maintains insurance coverage on its premises, leaseholds and equipment, including business interruption and record reconstruction coverage. The branch properties and non-branch offices are adequate, suitable, in good condition and have adequate parking facilities for customers and employees. The Company and Bank are limited in their investments in real property under Federal and state banking laws. Generally, investments in real property are either for the Company and Bank use or are in real property and real property interests in the ordinary course of the Bank s business.

ITEM 3. LEGAL PROCEEDINGS

From time to time, the Company and/or its subsidiary are a party to claims and legal proceedings arising in the ordinary course of business. In the opinion of the Company s management, the amount of ultimate liability with respect to such proceedings will not have a material adverse effect on the financial condition or results of operations of the Company taken as a whole.

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

No matters were submitted to vote of the security holders during the fourth quarter of the period covered by this report.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCK- HOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

The Company s common stock is quoted on the NASDAQ Capital Market under the ticker symbol PLBC . As of December 31, 2006, there were 5,023,205 shares of the Company s stock outstanding held by approximately 2,038 shareholders of record as of the same date. The following table shows the high and low sales prices for the common stock, for each quarter as reported by Yahoo Finance.

Quarter	Dividends	High	Low
4th Quarter 2006	$0.13	$17.45	$14.50
3rd Quarter 2006		$19.00	$15.77
2nd Quarter 2006	$0.13	$19.89	$15.50
1st Quarter 2006		$23.00	$17.00
4th Quarter 2005	$0.11	$27.00	$20.77
3rd Quarter 2005		$26.07	$17.34
2nd Quarter 2005	$0.11	$21.33	$14.20
1st Quarter 2005		$15.67	$13.33

On August 17, 2005 the Company s Board of Director approved a three-for-two stock split for shareholders of record at the close of business on September 2, 2005 and effective on September 16, 2005. All share and per share data in the consolidated financial statements have been retroactively adjusted to give effect to the stock split.

Dividends paid to shareholders by the Company are subject to restrictions set forth in California General Corporation Law, which provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal to the amount of the proposed distribution. As a bank holding company without significant assets other than its equity position in the Bank, the Company s ability to pay dividends to its shareholders depends primarily upon dividends it receives from the Bank. Such dividends paid by the Bank to the Company are subject to certain limitations. See Item 1 Business Supervision and Regulation Capital Standards .

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It is the policy of the Company to periodically distribute excess retained earnings to the shareholders through the payment of cash dividends. Such dividends help promote shareholder value and capital adequacy by enhancing the marketability of the Company s stock. All authority to provide a return to the shareholders in the form of a cash or stock dividend or split rests with the Board of Directors (the Board). The Board will periodically, but on no regular schedule, review the appropriateness of a cash dividend payment. The Board by resolution shall set the amount, the record date and the payment date of any dividend after considering numerous factors, including the Company s regulatory capital requirements, earnings, financial condition and the need for capital for expanded growth and general economic conditions. Although no assurance can be given that cash or stock dividends will be paid in the future the Company s cash dividend payout ratio over the last five years has averaged approximately 25% of net income.

On January 22, 2007 the Company announced that the Board authorized a common stock repurchase plan. The plan calls for the repurchase of up to 250,000 shares, or approximately 5%, of the Company s shares outstanding as of January 22, 2007. The repurchases will be made from time to time by the Company in the open market or privately negotiated transactions as conditions allow. All such transactions will be structured to comply with Securities and Exchange Commission Rule 10b-18 and all shares repurchased under this plan will be retired. The number, price and timing of the repurchases shall be at the Company s sole discretion and the plan may be re-evaluated depending on market conditions, liquidity needs or other factors. The Board, based on such re-evaluations, may suspend, terminate, modify or cancel the plan at any time without notice.

Securities Authorized for Issuance under Equity Compensation Plans. The following table sets forth securities authorized for issuance under equity compensation plans as for December 31, 2006.

Plan Category	Number of securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	290,914	$ 11.62	615,037
Equity compensation plans not approved by security holders	None	Not Applicable	None
Total	290,914	$ 11.62	615,037

For additional information related to the above plans see Note 10 of the Company s Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10K.

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Plumas Bancorp Stock Performance Graph

The graph below compares the cumulative total shareholder return on Plumas Bancorp s (Plumas Bank s prior to June 2002) common stock to the cumulative total return of the NASDAQ Composite Index, a broad market index of all stocks traded on the NASDAQ Exchange, the SNL NASDAQ Bank Index, a cumulative total of almost 400 banks traded on the NASDAQ Exchange, and the SNL OTC-BB & Pink Banks Index, a cumulative total of over 600 banks traded on either the Over-The-Counter Bulletin Board or Pink Sheets. These Indexes were prepared by SNL Financial LC. The graph assumes that a $100 investment was made in the Company s Common Stock as well as the other indexes on December 31, 2001 and that all dividends were reinvested. The chart represents the average closing price for the month of December in each of the years presented.

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
Plumas Bancorp	100.00	158.08	208.63	227.57	337.24	243.04
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
SNL NASDAQ Bank Index	100.00	102.85	132.76	152.16	147.52	165.62
SNL All OTC-BB & Pink Banks Index	100.00	124.40	170.92	204.07	221.37	242.38

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ITEM 6. SELECTED FINANCIAL DATA

The following table presents a summary of selected financial data and should be read in conjunction with the Company s consolidated financial statements and notes thereto included under Item 8 Financial Statements and Supplementary Data.

	At or for the year ended December 31,				
	2006	2005	2004	2003	2002
	(dollars in thousands except per share information)				
Statement of Income					
Interest income	$ 29,483	$ 25,497	$ 20,110	$ 18,549	$ 18,389
Interest expense	6,954	4,793	2,914	3,013	4,038
Net interest income	22,529	20,704	17,196	15,536	14,351
Provision for loan losses	1,000	1,100	750	750	825
Noninterest income	5,159	5,073	5,099	3,639	3,278
Noninterest expense	18,290	17,549	15,898	13,126	11,604
Provision for income taxes	3,196	2,600	2,001	2,018	2,046
Net income	$ 5,202	$ 4,528	$ 3,646	$ 3,281	$ 3,154
Balance sheet (end of period)					
Total assets	$ 473,239	$ 472,803	$ 417,346	$ 390,262	$ 325,650
Total loans	$ 354,712	$ 321,646	$ 266,913	$ 217,957	$ 207,721
Allowance for loan losses	$ 3,917	$ 3,256	$ 2,722	$ 2,524	$ 2,431
Total deposits	$ 402,176	$ 426,560	$ 378,567	$ 355,842	$ 293,941
Total shareholders equity	$ 35,852	$ 31,137	$ 27,891	$ 25,749	$ 23,286
Balance sheet (period average)					
Total assets	$ 468,988	$ 452,225	$ 409,335	$ 339,160	$ 294,708
Total loans	$ 335,226	$ 302,596	$ 233,759	$ 214,736	$ 197,900
Total deposits	$ 415,700	$ 403,818	$ 373,267	$ 304,840	$ 268,773
Total shareholders equity	$ 33,682	$ 29,548	$ 26,829	$ 24,558	$ 22,184
Capital ratios					
Leverage ratio	9.5%	8.5%	7.6%	8.4%	8.8%
Tier 1 risk-based capital	10.9%	10.3%	10.1%	10.4%	11.8%
Total risk-based capital	11.8%	11.1%	10.9%	11.3%	12.8%
Asset quality ratios					
Nonperforming loans/total loans	0.29%	0.52%	0.45%	0.40%	0.86%
Nonperforming assets/total assets	0.22%	0.36%	0.30%	0.22%	0.59%
Allowance for loan losses/total loans	1.10%	1.01%	1.03%	1.18%	1.19%
Net loan charge-offs	$ 339	$ 566	$ 552	$ 657	$ 507
Performance ratios					
Return on average assets	1.11%	1.00%	0.89%	0.97%	1.07%
Return on average equity	15.4%	15.2%	13.5%	13.3%	14.2%
Net interest margin	5.32%	5.06%	4.77%	5.20%	5.48%

Loans to Deposits	88.2%	75.4%	70.5%	61.3%	70.7%
Efficiency ratio	66.1%	68.1%	71.3%	68.5%	65.8%
Per share information					
Basic earnings	$ 1.04	$ 0.92	$ 0.75	$ 0.68	$ 0.66
Diluted earnings	$ 1.02	$ 0.89	$ 0.73	$ 0.66	$ 0.64
Cash dividends	$ 0.26	$ 0.22	$ 0.19	$ 0.16	$ 0.18
Dividend payout ratio	25.0%	23.9%	25.1%	23.7%	27.3%
Book value	$ 7.14	$ 6.26	$ 5.69	$ 5.29	$ 4.84
Common shares outstanding at period end	5,023,205	4,976,654	4,901,197	4,863,040	4,813,975

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

We are a bank holding company for Plumas Bank, a California state-chartered commercial bank. We derive our income primarily from interest received on real estate related, commercial and consumer loans and, to a lesser extent, interest on investment securities, fees received in connection with servicing deposit and loan customers and fees from the sale or referral of loans. Our major operating expenses are the interest we pay on deposits and borrowings and general operating expenses. We rely on locally-generated deposits to provide us with funds for making loans.

We are subject to competition from other financial institutions and our operating results, like those of other financial institutions operating in California, are significantly influenced by economic conditions in California, including the strength of the real estate market. In addition, both the fiscal and regulatory policies of the federal and state government and regulatory authorities that govern financial institutions and market interest rates also impact the Bank s financial condition, results of operations and cash flows.

One of our strategic objectives is to expand our banking service activities in the Truckee/Tahoe region and the adjacent communities. Consistent with this objective, in late 2003 we opened a de novo branch in Tahoe City. Also in late 2003, we bought five branches located within our existing service area from another community bank. Of the five branches purchased, two were located in the Truckee/Tahoe region, specifically in the communities of Truckee and Kings Beach. This helped further strengthen our presence in this region. In October, 2006 we completed construction and opened a new Bank owned branch in Truckee, California. This replaced a much smaller leased facility. During the fourth quarter of 2006 we opened a commercial real estate loan office in Reno, Nevada.

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. 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 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 quarterly. We believe that the allowance for loan losses 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.

We determine the appropriate level of the allowance for loan losses, primarily on an analysis of the various components of the loan portfolio, including all significant credits on an individual basis. We segment the loan portfolio into as many components as practical. Each component has similar characteristics, such as risk classification, past due status, type of loan or lease, industry or collateral.

We cannot provide you with any assurance that economic difficulties or other circumstances which would adversely affect our borrowers and their ability to repay outstanding loans will not occur which would be reflected in increased losses in our loan portfolio, which could result in actual losses that exceed reserves previously established.

Available for Sale Securities. Available-for-sale securities are required to 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. Adjustments to the available-for-sale securities fair value impact the consolidated financial statements by increasing or decreasing assets and shareholders equity.

Deferred Income Taxes. Deferred income taxes reflect the estimated future tax effects of temporary differences between the reported amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations. We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced.

Impairment of Core Deposit Intangible. The core deposit intangible represents the excess of the premiums paid over the fair value of the assets and liabilities acquired in the branch acquisitions. The core deposit intangible is required to be amortized over its expected useful life and required to be evaluated for impairment at least annually and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the fair value of the asset is determined to be less than the carrying amount, the core deposit intangible will be written down through a charge to operations.

Stock-Based Compensation. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (R), *Share-Based Payment* (SFAS 123 (R)). Under SFAS 123(R), compensation cost is recognized for all awards that vest subsequent to the date of adoption based on the grant-date fair value estimated in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* and SFAS 123(R). We believe this is a critical accounting estimate since the grant-date fair value is estimated using the Black-Scholes option-pricing formula, which involves making estimates of the assumptions used, including the expected term of the option, expected volatility over the option term, expected dividend yield over the option term and risk-free interest rate. In addition, when determining the compensation expense to amortize over the vesting period, management makes estimates about the expected forfeiture rate of options.

The following discussion is designed to provide a better understanding of significant trends related to the Company s financial condition, results of operations, liquidity, capital resources and interest rate sensitivity. It pertains to the Company s financial condition, changes in financial condition and results of operations as of December 31, 2006 and 2005 and for each of the three years in the period ended December 31, 2006. The discussion should be read in conjunction with the Company s audited consolidated financial statements and notes thereto and the other financial information appearing elsewhere herein.

Overview

The Company reported its eighteenth consecutive year of earnings growth in 2006. The Company s net income increased $674,000, or 14.9%, to $5,202,000 for the year ended December 31, 2006 from $4,528,000 for the same period in 2005. Net income was $3,646,000 for the year ended December 31, 2004. During 2006 the Company increased its average interest earning assets and its net interest margin resulting in an increase in net interest income of $1,825,000. This increase in net interest income was the primary contributor to the increase in net income for 2006. In addition, during 2006 the Company s non-interest income increased slightly by $86,000 and its provision for loan losses decreased by $100,000. Partially offsetting these increases in income in 2006 was an increase of $741,000 in non-interest expense and an increase of $596,000 in the provision for income taxes.

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Total assets at December 31, 2006 increased $436,000 to $473 million. Growth in the Company s loan portfolio was offset by decreases in Federal funds sold and investment securities. Net loans grew $32.8 million, or 10% to $352 million at December 31, 2006, compared to $319 million at December 31, 2005. Growth in loans was funded by a decrease of $23.1 million in investment securities and a decrease of $7.3 million in Federal funds sold and an increase in short-term borrowings. At December 31, 2006 investments securities totaled $75 million, there were no Federal funds sold and short-term borrowings were $20 million.

Deposits declined by $24 million, or 6%, to $402 million at December 31, 2006 from $426 million at December 31, 2005. Competition for deposit dollars throughout the Company s service area, both from bank and non-bank sources, and a lack of significant deposit growth in the Company s service area have contributed to this decline in deposits. The Company believes that additional deposits could be generated through aggressive pricing, but has chosen to rely on alternative sources of liquidity, such as short-term FHLB borrowings, to fund additions to its loan portfolio during 2006.

The return on average assets was 1.11% for 2006, up from 1.00% for 2005. The return on average equity was 15.4% for 2006, up from 15.2% for 2005.

Results of Operations

Net Interest Income

The following table presents for the years indicated the distribution of consolidated average assets, liabilities and shareholders equity. It also presents the amounts of interest income from interest-earning assets and the resultant yields expressed in both dollars and yield percentages, as well as the amounts of interest expense on interest-bearing liabilities and the resultant cost expressed in both dollars and rate percentages. Nonaccrual loans are included in the calculation of average loans while nonaccrued interest thereon is excluded from the computation of yields earned:

	Year ended December 31,								
	2006			2005			2004		
	Average balance	Interest income/ expense	Rates earned / paid	Average balance	Interest income/ expense	Rates earned / paid	Average balance	Interest income/ expense	Rates earned / paid
	(dollars in thousands)								
Assets									
Federal funds sold	$ 3,616	$ 164	4.54%	$ 5,930	$ 218	3.68%	$ 12,729	$ 163	1.28%
Investment securities[(1)]	84,794	3,047	3.59	100,633	3,324	3.30	113,684	3,483	3.06
Total loans [(2)(3)]	335,226	26,272	7.84	302,596	21,955	7.26	233,759	16,464	7.04
Total earning assets	423,636	29,483	6.96%	409,159	25,497	6.23%	360,172	20,110	5.58%
Cash and due from banks	13,547			15,953			23,813		
Other assets	31,805			27,357			25,551		
Total assets	$ 468,988			$ 452,469			$ 409,536		
Liabilities and shareholders equity									
Interest bearing demand deposits	$ 80,685	1,489	1.85%	$ 48,577	196	0.40%	$ 44,244	58	0.13%
Money market deposits	56,496	661	1.17	64,025	747	1.17	65,026	490	0.75
Savings deposits	59,802	423	0.71	67,702	445	0.66	64,472	292	0.45
Time deposits	93,515	3,314	3.54	98,946	2,704	2.73	93,684	1,760	1.88
Short-term borrowings	4,446	237	5.33	6,921	210	3.03			
Trust preferred securities	10,310	810	7.86	7,259	479	6.60	6,186	305	4.93
Other	285	20	7.02	245	12	4.90	215	9	4.19
Total interest bearing liabilities	305,539	6,954	2.28%	293,675	4,793	1.63%	273,827	2,914	1.06%

Noninterest bearing demand deposits	125,202			124,568			105,841		
Other liabilities	4,565			4,434			2,838		
Shareholders equity	33,682			29,792			27,030		
Total liabilities and shareholders equity	$ 468,988			$ 452,469			$ 409,536		
Net interest income		$ 22,529			$ 20,704			$ 17,196	
Net interest spread (4)			4.68%			4.60%			4.52%
Net interest margin (5)			5.32%			5.06%			4.77%

(1) Interest income is reflected on an actual basis and is not computed on a tax-equivalent basis.

(2) Average nonaccrual loan balances of $1.2 million for 2006, $1.3 million for 2005 and $1.6 million for 2004 are included in average loan balances for computational purposes.

(3) Loan origination fees and costs are included in interest income as adjustments of the loan yields over the life of the loan using the

interest method. Loan interest income includes net loan costs of $539,000 and $21,000 for 2006 and 2005, respectively and net loan fees of $317,000 for 2004.

(4) Net interest spread represents the average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

(5) Net interest margin is computed by dividing net interest income by total average earning assets.

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The following table sets forth changes in interest income and interest expense, for the years indicated 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:

	2006 compared to 2005 Increase (decrease) due to change in:				2005 compared to 2004 Increase (decrease) due to change in:			
	Average Volume(1)	Average Rate(2)	Mix(3)	Total	Average Volume(1)	Average Rate(2)	Mix(3)	Total
	(dollars in thousands)							
Interest-earning assets:								
Federal funds sold	$ (85)	$ 51	$ (20)	$ (54)	$ (87)	$ 305	$ (163)	$ 55
Investment securities	(523)	292	(46)	(277)	(400)	272	(31)	(159)
Loans	2,367	1,760	190	4,317	4,848	497	146	5,491