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# 2006 ANNUAL REPORT

## UNITED BANCSHARES, INC.

# PUTTING IT ALL TOGETHER

## BUILDING STRONGER COMMUNITIES THROUGH LEADERSHIP, COLLABORATION AND INNOVATION

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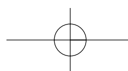

banking that matters

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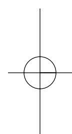

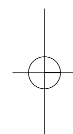



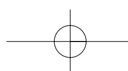

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"These collective efforts will build healthy communities and create financial strength while providing innovating solutions."

## MESSAGE FROM THE PRESIDENT & CEO

Dear Shareholder and Friends:

We are pleased to report that 2006 was a profitable year. This positive ending positions the Bank for growth through relationship-based banking. We are proud of the many relationships that we have developed over the years that are now evolving into stronger and sustainable partnerships. The Board of Directors and Management recognize that ending 2006 in the black was extremely important since a strong foundation was essential as the Bank prepared for an important milestone ——- its 15th Anniversary in 2007. I salute the senior officers, management, and staff for their focus and service to our customers. I extend our thanks and appreciation to the board of directors for its strategic direction and oversight.

United Bank of Philadelphia has stood the test of time. This leadership team has fearlessly embraced the goals, endured the economic upheavals and swings, enormous competition, increased regulatory scrutiny, with a single focus —— to diminish the economic disparities that exist in our region. We will continue to provide affordable products and services to the greater Philadelphia region with special emphasis on small businesses, religious organizations, and other non profits.

In 2006, the most tangible evidence of the Bank's impact in its communities was its community reinvestment (CRA) rating of "Outstanding" by the Federal Reserve Bank. This achievement propels this leadership team to continue to reach for greater heights in bringing low and moderate income communities into the financial mainstream. We want to insure that all urban communities have access to the capital needed to grow, compete and deliver services.

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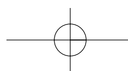


In addition, the Bank boldly embraces relationships with the corporate sector. We want to be aligned with well established companies in the region to make a greater impact while bridging the economic divide. We have demonstrated the power of such collaborations with several corporations in the region including Comcast and Exelon /PECO. We have provided fee-based financial services that heightened their visibility in our communities while diversifying the Bank's client base. This represents real economic impact and we look forward to adding more corporations to this portfolio.

As we look to our future, we see enormous opportunities for United Bank of Philadelphia. These opportunities can be realized through strong collaborations that bring it all together through strong leadership, powerful partnerships, and keen innovation. These collective efforts will build healthy communities and create financial strength while providing innovating solutions. For United Bank of Philadelphia, this is **banking that matters.**

***We are putting it all together to build stronger communities!***

Evelyn F. Smalls
President & CEO

## MANAGEMENT TEAM

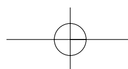
**Evelyn F. Smalls**
President
Chief Executive Officer

**Brenda M. Hudson-Nelson**
Executive Vice President
Chief Financial Officer

**Terrence D. Barclift**
Senior Vice President
Senior Lending Officer

**Norman W. Greene**
Vice President
Chief Risk Officer





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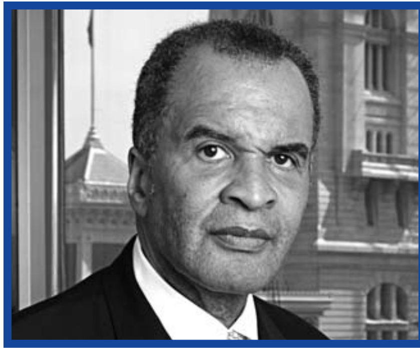


## MESSAGE FROM THE CHAIRMAN

To my fellow shareholders:

I am pleased to report to you that in 2006, the United Bank of Philadelphia grew stronger, more profitable, and, above all, had a bigger impact in our communities than ever. And as we enter our 15th year of operation, we are well positioned for significant growth.

Our record of accomplishment is clear. In the face of increasing competition in some of our key markets, our total assets increased by $1.7 million. As leader of the Board of Directors, I have been able to see first-hand the leadership and effort that has gone into making this happen.

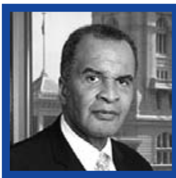
What's also clear to me is that there will continue to be a need for the unique services of United Bank. Who else but United Bank is reaching out to meet the particular needs of the religious community and nonprofit organizations, for instance? And what about the minority small business owners who need the kind of flexible, locally-controlled decision-making only we can offer?

The Board has been active in helping shape the priorities for 2007 and beyond. We'll be introducing new products, offering new services, and reaching out to our customers as never before. In short, we're committed to strengthening and expanding our role as a bank that matters for the region.

L. Armstead Edwards

L. Armstead Edwards
Chairman

## BOARD OF DIRECTORS



**L. Armstead Edwards**
Chairman
President & CEO
Edwards Entertainment

**Reverend William B. Moore**
Vice Chairman
Pastor, Tenth Memorial Baptist Church
Deputy Executive Director
Philadelphia Parking Authority

**Marionette Y. Frazier**
Secretary
Retired Partner/Co-founder
John Frazier, Inc.

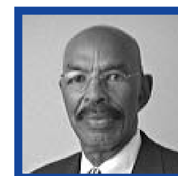
**Joseph T. Drennan**
Treasurer
Vice President, Chief Financial Officer
Universal Capital Management, Inc.

**Bernard E. Anderson**
Professor, The Wharton School
University of Pennsylvania

**David R. Bright**
Retired Executive Vice President
Meridian Bancorp

**Ashan M. Nasratullah**
President
JNA Capital, Inc.

**Evelyn F. Smalls**
President & CEO
United Bank of Philadelphia



**Ernest L. Wright**
President
Ernest L. Wright
Construction Company

banking that matters

# SELECTED FINANCIAL DATA

| | Year ended December 31 | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands, except per share data) | **2006** | **2005** | **2004** | **2003** | **2002** |
| Net interest income | $3,622 | $3,571 | $3,279 | $3,290 | $3,726 |
| Provision for loan losses | 137 | 558 | 45 | 565 | 175 |
| Noninterest income | 1,415 | 1,582 | 3,655 | 1,891 | 2,327 |
| Noninterest expense | 4,780 | 4,864 | 5,242 | 5,732 | 609 |
| Net income (loss) | 119 | (269) | 1,647 | (1,115) | (217) |
| Net income (loss) per share – basic | 0.11 | (0.25) | 1.54 | (1.03) | (0.20) |
| Net income (loss) per share – fully diluted | 0.11 | (0.25) | 1.50 | (1.03) | (0.20) |
| Balance sheet totals: | | | | | |
| Total assets | $73,936 | $72,210 | $72,301 | $74,717 | $86,044 |
| Net loans | 41,957 | 45,950 | 46,490 | 46,690 | 43,459 |
| Investment securities | 16,154 | 13,706 | 13,560 | 15,637 | 21,518 |
| Deposits | 64,924 | 63,324 | 63,172 | 67,117 | 76,929 |
| Shareholders' equity | 8,624 | 8,492 | 8,811 | 7,235 | 8,500 |
| Ratios: | | | | | |
| Tangible Equity to assets | 9.93% | 9.87% | 9.89% | 6.85% | 7.45% |
| Return on assets | 0.16% | (0.37)% | 2.38% | (1.38)% | (0.25)% |
| Return on equity | 1.63% | (3.78)% | 26.96% | (13.03)% | (2.55)% |

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Because UBS is a bank holding company for the Bank, the financial statements in this report are prepared on a consolidated basis to include the accounts of the Company and the Bank. The purpose of this discussion is to focus on information about the Bank's financial condition and results of operations, which is not otherwise apparent from the consolidated financial statements included in this annual report. This discussion and analysis should be read in conjunction with the financial statements presented elsewhere in this report.

## CRITICAL ACCOUNTING POLICIES

### Allowance for Credit Losses

The Bank considers that the determination of the amount of the allowance for loan losses involves a higher degree of judgment and complexity than its other significant accounting policies. The balance in the allowance for loan losses is determined based on management's review and evaluation of the loan portfolio in relation to past loss experience, the size and composition of the portfolio, current economic events and conditions, and other pertinent factors, including management's assumptions as to future delinquencies, recoveries and losses. All of these factors may be susceptible to significant change. To the extent actual outcomes differ from management's estimates, additional provisions for loan losses may be required that would adversely impact earnings in future periods.

### Income Taxes

Under the liability method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. For financial reporting purposes, a valuation allowance of 100% of the net deferred tax asset has been recognized to offset the net deferred tax assets related to cumulative temporary differences and tax loss carryforwards. If management determines that the Bank may be able to realize all or part of the deferred tax asset in the future, a credit to income tax expense may be required to increase the recorded value of the net deferred tax asset to the expected realizable amount.

# EXECUTIVE SUMMARY

United Bank of Philadelphia is the only minority-owned and controlled community development financial institution headquartered in Philadelphia. With the stabilization of the Bank's capital position, management can now maximize this competitive advantage by leveraging its strategic partnerships and relationships to increase market penetration and to help ensure that the communities it serves have full access to financial products and services. Understanding of the regulatory climate in which the Bank operates, the primary focus of management is to continue to increase core profitability and build franchise/shareholder value by:

- Growing and diversifying the deposit mix
- Growing and diversifying the loan mix
- Enhancing the branch network and alternative delivery options

During 2006, the Bank's total assets increased by $1.7 million, or 2.38% and modest profitability of $119,000 was achieved. Even though the Bank's net interest margin remained strong, the 2006 financial results were significantly impacted by competition from money center banks entering the region placing branches in close proximity to the Bank's branches. The neighborhoods in which the Bank's branches are located had seen a departure of these types of financial institutions in the late 80's and early 90's when the Bank was formed. There are now strategic initiatives by these institutions to capture of the "new markets" business consisting of blacks, Hispanics and women. These markets have always been included in the Bank's mission. With significantly more capital, these Bank's are often able to offer higher interest rates, longer hours, and state of the art branches with new technology. As a result, growth in deposits and loans remain management's challenge. Strategies that will be used to achieve growth include the following:

**Implementation of New Deposit Products**

A new signature savings product was introduced in 2006 that has a low minimum balance requirement and a constant premium interest rate. The product was rolled out via a targeted direct mail campaign, newspaper advertisements, and distribution in church bulletins. However, because of the rapidly increasing interest rate environment during 2006, competitive interest rates from other financial institutions made the Bank's product less attractive than projected. As a result, the Bank did not experience significant deposit growth. This strategy will be re-introduced in 2007 with higher rates and more robust marketing including radio and billboard advertising. In addition, a new high interest checking product will be introduced to attract the deposits of the many non-profit organizations in the region.

**Implementation of Remote Deposit Capture**

New technology evolved from the introduction of "Check 21" in October 2004. This new banking legislation allows for expedited clearing of check deposits through the use of images. Although planned for 2006, the Bank is currently working with its core service provider to implement a remote deposit capture service delivery option early in 2007. This new technology will allow customers near and far from the Bank's branch network to conveniently make deposits using a scanner. The implementation of remote deposit capture is a must to remain competitive in the marketplace. The initial target market for this product will be religious organizations to allow for expedited deposit processing and availability of tithes and offerings. Remote deposit capture is projected to increase the level of core noninterest-bearing checking accounts.

**New Senior Lending Officer**

In October 2006, a new senior lending officer was hired to increase business development and strengthen the Bank's credit risk management practices. The tight market for lenders and desire to have an individual with both credit administration and loan origination background delayed this hiring. Therefore, the full impact of this strategy was not realized in 2006. Momentum is expected to be gained moving into 2007 with increased loan origination activity. The focus of the lending officer is proactive relationship management to attract and retain a strong core customer base. While the Bank originated more than $7 million in commercial loans during 2006, it experienced more than $10 million in payoffs/paydowns. Many of the paydowns were attributed to loan participations the Bank has with other financial institutions. Because the Bank does not have a direct relationship with these loan customers, payoffs are often unexpectedly received.

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In addition to these strategies, the Bank will seek to improve customer service through more efficient and effective use of its technology. A new e-banking platform will be introduced in 2007 that will allow for more robust cash management by its customers including automated clearing house (ACH) origination. In addition, a new loan origination platform will be implemented to expedite the loan underwriting process as well as streamline backroom operations by integration with the Bank's core system. The Bank will also better use its website to provide information and "fillable" applications for loans and deposits.

Finally, management will engage in a more aggressive marketing and advertising campaign to get the Bank back into the marketplace and in the minds of the customers. Branding and visibility are critical to the success of the Bank's strategies. Full advantage will be taken of the co-branding opportunities with the Bank's strategic alliances to increase the Bank's consumer loan business including brochures, joint seminars, and other business development opportunities. In addition, newspaper (advertising/articles), radio (interviews/advertising), billboards, and direct mail solicitation will be utilized.

## Results of Operations

In 2006, the Company recorded net income of $119,000 ($0.11 per share) compared to a net loss of $269,000 ($0.25 per share) in 2005 and net income of $1,647,000 ($1.54 per share) in 2004. The financial results for 2006 reflect a significantly lower provision for loan losses of $137,000 compared to $558,000 in 2005 because of improved asset quality and recoveries of previously charged-off loans. The financial results for the year ended December 31, 2004 included non-recurring income of $1.9 million from the gain on the sale of the Bank's corporate headquarters and an adjacent parking lot. A detailed explanation for each component of earnings is included in the sections below.

**Table 1: Average Balances, Rates, and Interest Income and Expense Summary**

| | **2006** | | | **2005** | | | **2006** | | |
|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| ASSETS | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans | $45,863 | 3,626 | 7.91% | $47,861 | 3,429 | 7.16% | $46,037 | $3,009 | 6.54% |
| Investment securities held-to-maturity | 9,513 | 427 | 4.49 | 8,636 | 357 | 4.13 | 7,273 | 308 | 4.23 |
| Investment securities available-for-sale | 3,119 | 150 | 4.81 | 3,852 | 180 | 4.67 | 5,488 | 252 | 4.59 |
| Interest bearing balances with other banks | 281 | 8 | 2.85 | 584 | 10 | 1.71 | 880 | 30 | 3.41 |
| Federal funds sold | 7,140 | 357 | 5.00 | 5,482 | 180 | 3.29 | 6,244 | 87 | 1.39 |
| Total interest-earning assets | 65,916 | 4,568 | 6.93 | 66,415 | 4,156 | 6.26 | 65,922 | 3,685 | 5.59 |
| Noninterest-earning assets: | | | | | | | | | |
| Cash and due from banks | 3,606 | | | 3,772 | | | 3,708 | | |
| Premises and equipment, net | 1,046 | | | 1,073 | | | 2,006 | | |
| Other assets | 2,573 | | | 2,648 | | | 2,726 | | |
| Less allowance for loan losses | (510) | | | (683) | | | (542) | | |
| Total | $72,631 | | | $73,225 | | | $73,820 | | |
| Liabilities and shareholders' equity: | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Demand deposits | $9,906 | $111 | 1.12% | $9,204 | $64 | 0.71% | $9,315 | $49 | 0.53% |
| Savings deposits | 17,759 | 138 | 0.78 | 17,069 | 58 | 0.34 | 18,693 | 62 | 0.33 |
| Time deposits | 22,264 | 697 | 3.13 | 23,344 | 463 | 1.98 | 21,559 | 295 | 1.37 |
| Total interest-bearing liabilities | 49,929 | 946 | 1.89 | 49,617 | 585 | 1.18 | 49,567 | 406 | 0.82 |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Demand deposits | 13,993 | | | 14,668 | | | 16,306 | | |
| Other | 520 | | | 444 | | | 193 | | |
| Shareholders' equity | 8,189 | | | 8,496 | | | 7,754 | | |
| Total | 72,631 | | | 73,225 | | | 73,820 | | |
| Net interest earnings | | $3,622 | | | $3,571 | | | $3,279 | |
| Net yield on interest-earning assets | | | 5.50% | | | 5.38% | | | 4.98% |

*For purposes of computing the average balance, loans are not reduced for nonperforming loans.*

## Net Interest Income

Net interest income is an effective measure of how well management has balanced the Bank's interest rate-sensitive assets and liabilities. Net interest income, the difference between (a) interest and fees on interest-earning assets and (b) interest paid on interest-bearing liabilities, is a significant component of the Bank's earnings. Changes in net interest income result primarily from increases or decreases in the average balances of interest-earning assets, the availability of particular sources of funds and changes in prevailing interest rates.

Net interest income totaled $3,622,000 in 2006, an increase of $51,000, or 1.43%, compared to 2005. Net interest income was $3,571,000 in 2005, an increase of $291,000, or 8.87%, compared to 2004.

**Table 2: Rate-Volume Analysis of Changes in Net Interest Income**

| | **2006 compared to 2005** Increase (decrease) due to | | | **2005 compared to 2004** Increase (decrease) due to | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Volume | Rate | Net | Volume | Rate | Net |
| Interest earned on: | | | | | | |
| Loans | $(160) | 357 | 197 | $133 | $287 | $420 |
| Investment securities held-to-maturity | 39 | 31 | 70 | 56 | (7) | 49 |
| Investment securities available-for-sale | (35) | 5 | (30) | (77) | 5 | (72) |
| Interest-bearing deposits with other banks | (9) | 7 | (2) | (5) | (15) | (20) |
| Federal funds sold | 83 | 94 | 177 | (25) | 118 | 93 |
| Total Interest-earning assets | (82) | 494 | 412 | 82 | 388 | 470 |
| Interest paid on: | | | | | | |
| Demand deposits | $8 | 39 | 47 | $(2) | 17 | 15 |
| Savings deposits | 5 | 75 | 80 | (6) | 2 | (4) |
| Time deposits | (34) | 268 | 234 | 36 | 132 | 168 |
| Total interest-bearing liabilities | (21) | 382 | 361 | 28 | 151 | 179 |
| Net interest income | $(61) | $112 | $51 | $54 | $237 | $291 |

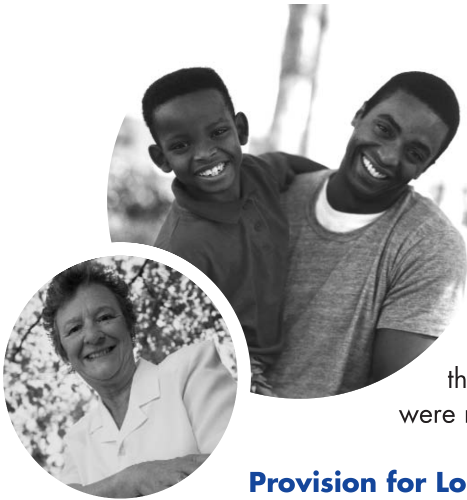
*Changes in interest income or expense not arising solely as a result of volume or rate variances are allocated to rate variances due to the interest sensitivity of consolidated assets and liabilities.*

In 2006, there was a decrease in net interest income of $61,000 due to changes in volume and an increase of $112,000 due to changes in rate. In 2005, there was an increase in net interest income of $54,000 due to changes in volume and an increase of $237,000 due to changes in rate.

Although average earning assets decreased to $65.9 million in 2006 from $66.4 million in 2005, the net interest margin of the Bank increased to 5.50% from 5.38% in 2005, and 4.98% in 2004. Management actively manages its exposure to interest rate changes. Because of the current inverted Treasury yield curve, many banks are contending with a significant level of margin compression. The Bank's deposit base includes many low cost core checking and savings deposits that are not sensitive to rate changes. Thus, although there were a series of short-term rate increases by the Federal Reserve in 2006 and 2005, the Bank's cost of funds did not increase at the same pace while floating rate assets including loans, investments and Federal Funds Sold did increase.

During 2006, the average federal funds yield was 5.00% compared to 3.29% in 2005 and 1.39% in 2004. During 2006, the average investment in federal funds increased by $1,658,000—this, coupled with an increase in the Federal Funds rate, resulted in an increase of $177,000 in interest income.

The yield on the investment portfolio increased 27 basis points to 4.57% compared to 4.30% in 2005 and 4.39% in 2004. The increase in yield was the result of the maturity of lower yielding agency securities purchased in 2004 that were replaced with higher yielding agency and mortgage-backed securities in 2006. In addition, some of the Bank's floating rate mortgage-backed securities that had Treasury and LIBOR indices repriced in 2006 in a higher interest rate environment. The average yield is projected to further increase in 2007 to at least 5.00% with the purchase of additional securities in the current higher interest rate environment.



The cost of interest-bearing liabilities increased to 1.89% in 2006 from 1.18% in 2005 and 0.82% in 2004. In 2006, the Bank introduced a premium rate statement savings account for which the rate was 3.50% compared to its normal statement savings rate of .50%. In addition, the Bank increased the rate on its certificates of deposit consistent with the average price in the market. Although short-term interest rates increased in 2006 by 100 basis points, increases in rates on the Bank's core deposits did not change at the same pace. When setting the rates for its deposits, the Bank generally uses the median rate paid by its competitors in the region. Because most of the Bank's deposits are considered core, they were not sensitive to rising interest rates and generally lag market changes.

## Provision for Loan Losses

The provision for loan losses is based on management's estimate of the amount needed to maintain an adequate allowance for loan losses. This estimate is based on the review of the loan portfolio, the level of net credit losses, past loan loss experience, the general economic outlook and other factors management feels are appropriate.

The net provision for loan losses charged against earnings in 2006 was $137,000 compared to $558,000 in 2005 and $45,000 in 2004. The decrease in the provision in 2006 was due to a review and analysis of the Bank's loan portfolio, an increased level of recoveries on previously charged-off loans and a decrease in charge-offs during the year. Refer to the Allowance for Loan Loss section on page 18 for further discussion/analysis of the Bank's credit quality.

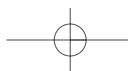
Management continues to monitor its credit quality very closely by working with borrowers in an effort to identify and control credit risk. Systematic provisions are made to the allowance for loan losses to cover potential credit losses in the portfolio. Management believes the level of the allowance for loan losses is adequate as of December 31, 2006.

## Noninterest Income

Noninterest income decreased $168,000 in 2006 compared to 2005 and decreased $2,072,000 in 2005 compared to 2004.

The customer service fee component of noninterest income reflects the volume of transactional and other accounts handled by the Bank and includes such fees and charges as low balance account charges, overdrafts, account analysis, and other customer service fees. During 2006, customer service fees declined by $79,000, 11.54%, compared to 2005 and decreased $171,000, or 20.03%, in 2005 compared to 2004. From 2004 to 2006, there has been $2.3 million decline in the Bank's average noninterest bearing demand deposits. This decline resulted in less overdraft fees, activity service charges and low balance fees.

During 2006, surcharge income on the Bank's ATM network declined by $53,000, or 9.28%, compared to 2005 and declined $28,000, or 4.63%, in 2005 compared to 2004. Some of the Bank's ATMs have experienced a drop in volume as competitors placed machines in close proximity to existing high volume ATMs of the Bank and several of the Bank's high volume ATMs were replaced with those of competitors that paid significantly higher transactional fees to site owners. New competition offering "no fee" ATM service has moved into the Philadelphia market. Volume was also impacted by down-time experienced on several machines as a result of equipment/ network upgrades. Management continues to seek high volume locations where the Bank would have a captive audience as it relates to ATM service (i.e. casinos, transportation hubs, etc.) to offset competitive pressures.



Since 2002, the Bank has served as arranger/agent for loan syndications for several major corporations throughout the country. In this capacity, the Bank syndicates back-up lines/letters of credit with other minority banks for which it receives agent/administrative fees. In 2006, these fees totaled $150,000 compared to $202,000 in 2005 and $178,000 in 2004. The decline in 2006 was the result of the non-renewal of one credit facility in June 2006 for which the Bank's fees were $50,000. The Bank continues to serve as agent/arranger for three (3) facilities. Fees on these facilities will be received annually for the administration of the credit facilities. Management plans to continue to develop this core line of business to generate fee income to support the Bank's profitability goals.

In connection with its 2004 re-capitalization plan, the Bank sold bank-owned real estate including a remote bank-owned parking lot and its corporate headquarters building located at 300 N. Third Street. The sale of these assets resulted in a non-recurring gain of approximately $1,874,000 million in 2004.

In 2006, the Bank was awarded a $50,000 grant by the Commonwealth of Pennsylvania to support a loan program for small businesses and non-profit organizations. This grant is included in other income.

## Noninterest Expense

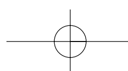
Noninterest expense decreased $84,000, or 1.72%, in 2006 compared to 2005 and decreased $379,000, or 7.23%, in 2005 compared to 2004.

Salaries and benefits decreased $84,000, or 4.59%, in 2006 compared to 2005 and decreased $105,000, or 5.42% in 2005 compared to 2004. As part of the Bank's continued effort to reduce/control expenses, there have been strategic reductions in staff and job consolidations. In addition, during 2006 there was attrition in several management and line positions. Management continues the review of its staffing model to ensure the Bank is operating with the most efficient organizational structure.

Occupancy and equipment expense decreased $1,200, or 0.13%, in 2006 compared to 2005 and decreased $108,000, or 9.79%, in 2005 compared to 2004. For the past several years, management has implemented strategies to reduce its occupancy expense including the closure/consolidation of its Two Penn Center Center City branch office and sale of its corporate headquarters building in 2004. These actions resulted in a reduction in property taxes, insurance, repairs and maintenance, and depreciation expense on leasehold improvements associated with these locations. In February 2005, the Bank began to lease a new corporate headquarters on a 10,000 square foot floor of a full service high rise office building located in center city Philadelphia. This move resulted in the stabilization of the Bank's occupancy expense during 2006.

Leasehold improvement expenses were incurred during the last quarter of 2006 to renovate the interior of the Bank's Wadsworth Avenue branch including paint, flooring and new furnishings. Additional improvements are planned for 2007 to the exterior of this branch building. Similar interior and exterior improvements are planned for the Bank's West Philadelphia branch in 2007. These renovations and relocations will result in increased leasehold/furniture depreciation expense. In addition, the Bank's Progress Plaza branch is scheduled to be re-located in the Fall of 2007 to newly built space within the shopping plaza where it is currently located. A new 10-year lease has been negotiated that will result in an annual increase of $20,000 in the Bank's rent expense.

Office operations and supplies expense decreased $36,000, or 10.43%, in 2006 compared to 2005 and decreased $67,000, or 16.18%, in 2005 compared to 2004. During 2006, the Bank's telephone expense declined by $29,000 as a result of a review and analysis that resulted in the elimination of unused lines and move to a new long distance carrier. Management continues to review all office operations expenses including supplies, storage, security, etc. to determine if additional expense reductions can be made.



Marketing and public relations expense increased $15,000, or 15.27%, in 2006 compared to 2005, and increased $18,000, or 21.5%, in 2005 compared to 2004. In 2006, the Bank launched a marketing campaign for its new signature savings account including a direct mail solicitation, ongoing newspaper advertisements, and other promotional give-aways. In 2007, the Bank will embark on a robust marketing/re-branding campaign including the use of co-branded marketing materials with its strategic alliances, advertising in community-based newspapers and church bulletins, radio, billboards, and other business periodicals.

Professional services increased $25,000, or 9.49%, in 2006 compared to 2005 and increased $26,000, or 11.06%, in 2005 compared to 2004. The increase in 2006 is primarily related to increased audit fees associated with the Company's risk profile and quarterly public filings. In addition, there was an increase in consulting expense related to the use of consultants to assist the Bank in the evaluation of several business transactions.

Data processing expenses are a result of the management decision to outsource a majority of its data processing operations to third party processors. Such expenses are reflective of the high level of accounts being serviced for which the Bank is charged a per account charge by processors. The Bank experiences a higher level of data processing expenses relative to its peer group because of the nature of its deposit base—low average balance and high transaction volume. In addition, the Bank uses outside loan servicing companies to service its mortgage, credit card, and student loan portfolios. To better serve its customers, the Bank also has an extensive ATM network of twenty-eight (28) machines for which it pays processing fees. This network is larger than most banks in its peer group.

Data processing expenses increased $14,000, or 3.53%, in 2006 compared to 2005 and decreased $155,000, or 27.61%, in 2005 compared to 2004. The increase in 2006 is primarily in the Bank's ATM processing expense associated with net interchange expenses—more Bank customers using non-proprietary ATMs for which the Bank is charged a fee versus non-customers using the Bank's ATM network for which it receives a fee. Transaction volume for the Bank's ATM network declined during 2006 as the result of new competition and ATM down-time for repairs/upgrades. In 2005, data processing expenses declined as a result of the re-negotiation of the Bank's core processing contract with FiSERV.

Federal deposit insurance premiums were $111,000 in 2006, $113,000 in 2005, and $72,000 in 2004. FDIC insurance premiums are applied to all financial institutions based on a risk-based premium assessment system. Under this system, bank strength is based on three factors: 1) asset quality, 2) capital strength, and 3) management. Premium assessments are then assigned based on the institution's overall rating, with the stronger institutions paying lower rates.

By typical regulatory guidelines, the Bank is considered "well" capitalized. However, because it is operating with a Written Agreement (Refer to "Regulatory Action" above), it is only considered to be "adequately" capitalized. The FDIC adopted new rules in 2006 to re-capitalize the deposit insurance fund that will result in increased deposit insurance premiums in 2007.

All other expenses are reflective of the general cost to do business and compete in the current regulatory environment and maintenance of adequate insurance coverage.

banking that matters

# FINANCIAL CONDITION

## SOURCES AND USES OF FUNDS

The Bank's financial condition can be evaluated in terms of trends in its sources and uses of funds. The comparison of average balances in Table 3 below indicates how the Bank has managed these elements. Average funding uses decreased $499,000, or 0.75%, in 2006 compared to 2005 and increased approximately $493,000, or 0.75%, in 2005 compared to 2004.

**Table 3: Sources and Use of Funds Trends**

| (Dollars in thousands) | 2006 | | | 2005 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Increase (decrease) amount | Percent | Average Balance | Increase (decrease) amount | Percent |
| Funding uses: | | | | | | |
| Loans | $45,863 | $(1,998) | (4.17)% | $47,861 | $1,824 | 3.96% |
| Investment securities | | | | | | |
| Held-to-maturity | 9,513 | 877 | 10.16 | 8,636 | 1,363 | 18.74 |
| Available-for-sale | 3,119 | (733) | (19.03) | 3,852 | (1,636) | (29.81) |
| Interest-bearing balances with other banks | 281 | (303) | (51.88) | 584 | (296) | (33.64) |
| Federal funds sold | 7,140 | 1,658 | 30.24 | 5,482 | (762) | (12.20) |
| Total uses | $65,916 | $(499) | | $66,415 | $493 | |
| Funding sources: | | | | | | |
| Demand deposits: | | | | | | |
| Noninterest-bearing | $13,993 | $(675) | (4.60)% | $14,668 | $(1,638) | (10.05)% |
| Interest-bearing | 9,906 | 702 | 7.63 | 9,204 | (111) | (1.19) |
| Savings deposits | 17,759 | 690 | 4.04 | 17,069 | (1,624) | (8.69) |
| Time deposits | 22,264 | (1,080) | (4.63) | 23,344 | 1,785 | 8.28 |
| Total sources | $63,922 | $(363) | | $64,285 | $(1,588) | |

**Includes held-to-maturity and available-for-sale securities*

### Investment Securities and Other Short-Term Investments

The Bank's investment portfolio is classified as either held-to-maturity or available-for-sale. Investments classified as held-to-maturity are carried at amortized cost and are those securities the Bank has both the intent and ability to hold to maturity. Investments classified as available-for-sale are those investments the Bank intends to hold for an indefinite amount of time, but not necessarily to maturity, and are carried at fair value, with the unrealized holding gains and losses reported as a component of shareholders' equity on the balance sheet.

Average investment securities, increased $144,000, or 1.15%, in 2006 and decreased $273,000, or 2.14%, in 2005 compared to 2004. The increase in investments was primarily a result of additional liquidity created by payoffs/ paydowns in the Bank's loan portfolio. Funds were re-deployed into short-term investments pending increased loan origination activity.

The Bank's current investment portfolio primarily consists of mortgage-backed pass-through agency securities and other government-sponsored agency securities. The Bank does not invest in high-risk securities or complex structured notes. As reflected in Table 4 below, the average maturity of the portfolio is 2.90 years in 2006 compared to 3.25 years in 2005. In the current interest rate environment, the duration of the investment portfolio is shortened because of the short-term nature of the Bank's callable agency securities that currently have an average life of 2.2 years. These securities are typically used as collateral for short-term jumbo governmental certificates of deposit.

At December 31, 2006, approximately 41% of the portfolio consists of mortgage-backed pass-through securities that have longer-term contractual maturities but are sometimes paid off/down before maturity or have repricing characteristics that occur before final maturity. The Bank has attempted to minimize the repayment risk (risk of very fast or very slow repayment) associated with these types of securities by investing primarily in a number of seasoned mortgage pools for which there is a repayment history. This history better enables the Bank to project the repayment speeds of these pools. In addition, the Bank has minimized the interest rate risk associated with these mortgage-backed securities by investing in a variety of pools, many of which have variable rates with indices that track closely with the current interest rate environment. Because customers are less likely to refinance in the current rising interest rate environment, the prepayment speed decreased on this component of the portfolio. The constant one year prepayment rate (CPR) at December 31, 2006 was 14.42% compared to 20.60% at December 31, 2005. This translates into only 14.42% of the mortgage-backed pools repaying on an annual basis. This results in less monthly cash flow than was received in 2005.

The Bank will continue to take steps to control the level of optionality in the portfolio by identifying replacement loans or securities that diversify risk and provide some level of monthly cashflow to be reinvested in the projected current rising rate environment.

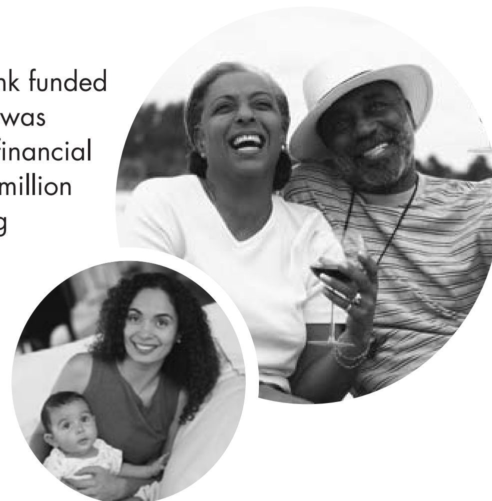
**Table 4: Analysis of Investment Securities**

| (Dollars in thousands) | Within one year | | After one but within five years | | After five but within ten years | | After ten years | | |
|---|---|---|---|---|---|---|---|---|---|
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Total |
| Other government securities | $3,248 | 4.73% | $5,749 | 4.70% | $250 | 4.67% | $ – | % | $9,247 |
| Mutual funds and other | – | | – | | – | | – | | 379 |
| Mortgage-backed securities | – | | – | | – | | – | | 6,527 |
| Total securities | $3,248 | | $5,749 | | $250 | | $ – | | $16,153 |
| Average maturity | | | | | | | | | 2.90 years |

*The above table sets forth the maturities of investment securities at December 31, 2006 and the weighted average yields of such securities (calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security).*

## Loans

Average loans decreased $1,998,000, or 4.17%, in 2006 and increased $1,824,000, or 3.96%, in 2005 compared to 2004. During 2006, the Bank funded $7 million in new commercial loans. However, growth in the loan portfolio was offset by payoffs of some large loan participations the Bank had with other financial institutions. In addition, the Bank's mortgage loan portfolio declined by $2 million as a result of customers with interest-only or adjustable rate loans refinancing into fixed rate mortgages to avoid the negative impact of future interest rate increases.



The Bank has relationships with other financial institutions in the region with which it participates in loans to supplement activity in the commercial loan portfolio. This strategy continues to be utilized while the Bank enhances it own business development capacity. At December 31, 2006, the Bank had $8 million in loan participations with other financial institutions most of which are secured by real estate.

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In December 2006, the Bank sold $568,000 of its student loan portfolio and recorded a gain of $10,700. These loans were sold to make liquidity available for the funding of higher yielding less costly to service commercial loans. Student loans are typically held in the consumer loan portfolio. As a result of the payoffs and sale of loans noted above, the Bank's loan-to-deposit ratio declined to 64.62% at December 31, 2006 compared to 72.8% at December 31, 2005. The target loan-to-deposit ratio is 75%. This level would allow the Bank to optimize interest income on earning assets while maintaining adequate liquidity.

As reflected in Table 5 below, the Bank's loan portfolio is heavily concentrated in commercial real estate loans that comprise approximately $22 million, or 51.73%, of total loans. Of the $7 million in 2006 of new commercial loan originations, many were commercial real estate transactions, including $1.3 million in loans made to religious organizations. Continued payoffs resulted in a reduction of the residential mortgage loan component of the portfolio from $7.5 million at December 31, 2005 to $5.5 million at December 31, 2006. The Bank does not originate residential mortgage loans for its portfolio.

As reflected in Table 6 below, approximately 47.30% of the Bank's loan portfolio have scheduled maturities or reprice in five years or more. This position is largely a result of the relatively high level of loans in the commercial real estate portfolio that typically have five to seven year balloon structures. While scheduled maturities and repricing exceed five years, the actual duration of the portfolio may be much shorter because of changes in market conditions and refinancing activity.

**Table 5: Loans Outstanding, Net of Unearned Income**

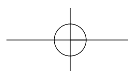
| | December 31 | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | **2006** | **2005** | **2004** | **2003** | **2002** |
| Commercial and industrial | $10,343 | $ 7,176 | $15,217 | $11,361 | $10,855 |
| Commercial real estate | 21,996 | 25,809 | 13,070 | 11,862 | 11,898 |
| Residential mortgages | 5,551 | 7,546 | 10,665 | 15,110 | 13,560 |
| Consumer loans | 4,628 | 5,891 | 6,729 | 8,695 | 7,820 |
| Total loans | $42,518 | $46,422 | $45,681 | $47,028 | $44,133 |

**Table 6: Loan Maturities and Repricing**

| (Dollars in thousands) | Within one year | After one but within five years | After five years | Total |
|---|---|---|---|---|
| Commercial and industrial | $6,312 | $4,031 | $ – | $10,343 |
| Commercial real estate | 1,272 | 5,792 | 14,932 | 21,996 |
| Residential mortgages | 343 | 1,476 | 3,732 | 5,551 |
| Consumer loans | 2,349 | 831 | 1,448 | 4,628 |
| Total loans | $10,276 | $12,130 | $20,112 | $42,518 |
| Loans maturing after one year with: | | | | |
| Fixed interest rates | | | $11,404 | |
| Variable interest rates | | | 20,835 | |

## Nonperforming Loans

Table 7 reflects the Bank's nonperforming and restructured loans for the last five years. The Bank generally determines a loan to be "nonperforming" when interest or principal is past due 90 days or more. If it otherwise appears doubtful that the loan will be repaid, management may consider the loan to be nonperforming before the lapse of 90 days. The Bank's policy is to charge off unsecured loans after 90 days past due. Interest on nonperforming loans ceases to accrue except for loans that are well collateralized and in the process of collection. When a loan is placed on nonaccrual, previously accrued and unpaid interest is reversed out of income unless adequate collateral from which to collect the principal of, and interest on, the loan appears to be available.



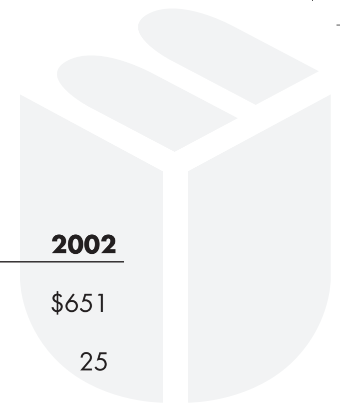


**Table 7: Nonperforming Loans**

| (Dollars in thousands) | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Nonaccrual loans | $626 | $683 | $1,366 | $1,588 | $651 |
| Interest income included in net income for the year | 39 | 37 | 22 | 62 | 25 |
| Interest income that would have been recorded under original terms | 51 | 56 | 143 | 120 | 49 |
| Loans past due 90 days and still accruing | 170 | – | 65 | 560 | 797 |
| Restructured loans | 1,311 | 554 | 1,411 | 569 | 1,266 |

At December 31, 2006, nonaccrual loans totaled $626,000 compared to $683,000 at December 31, 2005. The non-accrual loans include commercial loans with SBA guarantees or strong loan-to-values that help to mitigate potential losses. At December 31, 2006, $152,000 of the Bank's nonaccrual loans carried some level of guarantee from the SBA that provide credit enhancement to these loans.

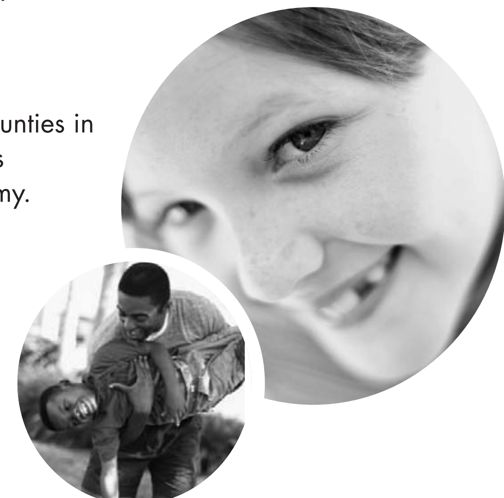
The balance of impaired loans was $896,000 and $386,000 at December 31, 2006 and 2005, respectively. The Bank identifies a loan as impaired when it is probable that interest and principal will not be collected according to the contractual terms of the loan agreement. The allowance for loan loss associated with these loans was $101,000 and $113,000 at December 31, 2006 and 2005, respectively. The allowance was determined based on careful review and analysis including collateral liquidation values and/or guarantees and is deemed adequate to cover shortfalls in loan repayment.

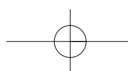
Interest income recognized on impaired loans during the year ended December 31, 2006 and 2005 was $76,000 and $37,000, respectively. The Bank recognizes income on impaired loans under the cash basis when the loans are both current and the collateral on the loan is sufficient to cover the outstanding obligation to the Bank. If these factors do not exist, the Bank will not recognize income on such loans.

From time to time, management will modify or restructure the terms of certain loans to provide relief to borrowers. Restructured loans are those loans whose terms have been modified because of deterioration in the financial condition of a borrower to provide for a reduction of either interest or principal, regardless of whether such loans are secured or unsecured and regardless of whether such credits are guaranteed by the government or by others. At December 31, 2006, restructured loans totaled $1,311,000, an increase of $709,000, or 128%, compared to 2005. The loans restructured in 2006 relate to consolidations and/or extensions in terms to enable the borrowers to better meet debt service requirements.

There is no known information about possible credit problems other than those classified as nonaccrual or impaired that causes management to be uncertain as to the ability of any borrower to comply with present loan terms.

The Bank grants commercial, residential, and consumer loans to customers primarily located in Philadelphia County, Pennsylvania and surrounding counties in the Delaware Valley. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.





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At December 31, 2006, approximately 33% of the commercial loan portfolio of the Bank was concentrated in loans made to religious organizations. This represents an increase from a 25% concentration at December 31, 2005. During 2006, the Bank funded and/or originated $2.1 million in loans to religious organizations. From inception, the Bank has received support in the form of investments and deposits and has developed strong relationships with the Philadelphia region's religious community. Loans made to these organizations are primarily for expansion and repair of church facilities. At December 31, 2006, several of these loans are now showing signs of weakness and are included in the Bank's classified loans. The Bank is actively managing these credits to avoid any further deterioration in asset quality.

## Allowance for Loan Losses

The allowance for loan losses reflects management's continuing evaluation of the loan portfolio. Table 8 below presents the allocation of loan losses by major category for the past five years. The specific allocations in any particular category may prove to be excessive or inadequate and consequently may be reallocated in the future to reflect then current conditions.

The allowance for loan losses as a percentage of total loans was 1.31% at December 31, 2006 compared to 1.02% at December 31, 2005. Systematic provisions are made to the allowance for loan losses in accordance with a detailed periodic analysis. This analysis includes specific reserves allocated to classified and impaired loans based on underlying recovery values as well as a general reserve for the portfolio based on many factors including charge-off history, migration analysis, economic conditions, concentrations of credit risk, and other relevant data.

The level of classified loans increased from $1,018,000 in 2005 to $2,671,000 in 2006. This increase is not indicative of a trend but rather several large loans that were shifted to an Other Loans Especially Mentioned (OLEM) classification. OLEM loans are defined as loans that do not presently expose the Bank to a significant degree of risk, but have potential weaknesses/deficiencies deserving management's closer attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects at some future date. No significant loss of principal or interest is envisioned on these loans. The borrowers may be experiencing adverse operating trends, which potentially could impair debt service capacity, but secondary sources of repayment are accessible and considered adequate to cover the Bank's exposure. This category may include credits with inadequate loan agreements or control over collateral. These borrowers may have limited ability to obtain credit elsewhere. Management is working proactively with these borrowers to prevent any further deterioration in credit quality.

**Table 8: Allocation of Allowance for Loan Losses**

| | 2006 | | 2005 | | 2004 | | 2003 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Amount | Percent of loans in each category to total loans | Amount | Percent of loans in each category to total loans | Amount | Percent of loans in each category to total loans | Amount | Percent of loans in each category to total loans | Amount | Percent of loans in each category to total loans |
| Commercial and industrial | $362 | 24.33% | $267 | 15.46% | $424 | 32.31% | $267 | 24.16% | $565 | 24.60% |
| Commercial real estate | 140 | 51.73 | 66 | 55.59 | 49 | 27.75 | – | 25.22 | 37 | 26.96 |
| Residential mortgages | 22 | 13.06 | 17 | 16.25 | 14 | 17.29 | 35 | 32.13 | 45 | 17.72 |
| Consumer loans | 37 | 10.88 | 79 | 12.69 | 110 | 22.65 | 37 | 18.49 | 28 | 30.72 |
| Unallocated | – | – | 43 | – | – | – | 6 | – | – | – |
| | $561 | 100.00% | $472 | 100.00% | $603 | 100.00% | $339 | 100.00% | $675 | 100.00% |

Management believes that the allowance for loan losses is adequate at December 31, 2006. While management uses available information to recognize losses on loans, future additions may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments of information available to them at the time of the examination.

**Table 9: Analysis of Allowance for Loan Losses**

| | Year ended December 31 | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | **2006** | **2005** | **2004** | **2003** | **2002** |
| Balance at January 1 | $472 | $603 | $339 | $675 | $708 |
| Charge-offs: | | | | | |
| Commercial and industrial | (70) | (762) | – | (799) | – |
| Commercial real estate | – | – | – | – | (100) |
| Residential mortgages | – | – | – | – | – |
| Consumer loans | (202) | (219) | (240) | (174) | (261) |
| | (272) | (981) | (240) | (973) | (361) |
| Recoveries—commercial loans | 57 | 165 | 265 | – | 27 |
| Recoveries—consumer loans | 168 | 127 | 194 | 72 | 126 |
| | 225 | 292 | 459 | 72 | 153 |
| Net recoveries (charge-offs) | (47) | (689) | 219 | (901) | (208) |
| Provisions charged to operations | 137 | 558 | 45 | 565 | 175 |
| Balance at December 31 | $561 | $472 | $603 | $339 | $675 |
| Ratio of net (recoveries) charge-offs to average loans outstanding | 0.10% | 1.50% | (0.48)% | 1.99% | 0.49% |

## Deposits

Average deposits declined $363,000, or .56% in 2006 and declined $1.6 million, or 2.41%, in 2005 compared to 2004. In 2006, the primary areas of decline were noninterest bearing demand deposit balances that decreased on average by $675,000, or 4.60%, compared to 2005 and certificates of deposit that decreased $1,080,000, or 4.63%, compared to 2005. These reductions were primarily related to the shift to the Bank's higher yielding signature savings account. Savings deposits increased on average $690,000, or 4.04%, compared to 2005. In addition, several jumbo certificates of deposit with corporations did not renew at maturity.

To grow and stabilize its deposit base, management will re-introduce its signature savings product with an increased interest rate along with a new high interest checking product designed to attract non-profit customers. In addition, remote deposit capture will be introduced to increase the level of core deposits.

**Table 10: Average Deposits by Class**

| | **2006** | | **2005** | | **2004** | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Amount | Rate | Amount | Rate | Amount | Rate |
| Noninterest-bearing demand deposits | $13,993 | -% | $14,668 | -% | $16,306 | - % |
| Interest-bearing demand deposits | 9,906 | 0.89 | 9,204 | 0.71 | 9,315 | 0.53 |
| Savings deposits | 17,759 | 0.59 | 17,069 | 0.34 | 18,695 | 0.33 |
| Time deposits | 22,264 | 2.79 | 23,344 | 1.98 | 21,559 | 1.37 |

## Other Borrowed Funds

The Bank did not borrow funds during 2006. Generally, the level of other borrowed funds is dependent on many items such as loan growth, deposit growth, customer collateral/security requirements and interest rates paid for these funds. The Bank's liquidity has been enhanced by loan paydowns/payoffs and called investment securities—thereby, reducing the need to borrow.

## Off Balance Sheet Arrangements

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit, which are conditional commitments issued by the Bank to guarantee the performance of an obligation of a customer to a third party. Both arrangements have credit risk essentially the same as that involved in extending loans and are subject to the Bank's normal credit policies. Collateral may be obtained based on management's assessment of the customer. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments is represented by the contractual amount of those instruments.

Summaries of the Bank's financial instrument commitments are as follows:

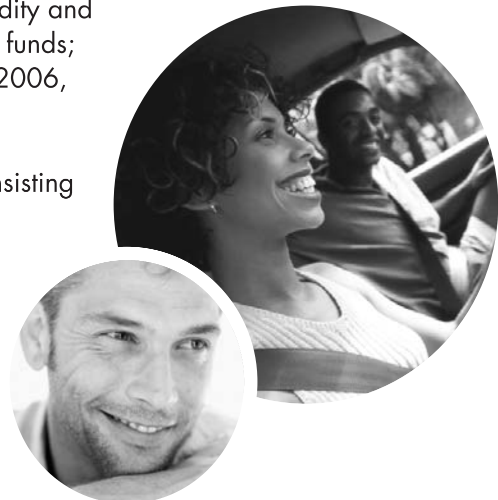
| | 2006 | 2005 |
|---|---|---|
| Commitments to extend credit | $12,995,600 | $12,727,370 |
| Outstanding letters of credit | _ | 10,000 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and unused credit card lines. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

## Liquidity and Interest Rate Sensitivity Management

The primary functions of asset/liability management are to assure adequate liquidity and maintain appropriate balance between interest-sensitive earning assets and interest-bearing liabilities. Liquidity management involves the ability to meet cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Interest rate sensitivity management seeks to avoid fluctuating net interest margins and enhance consistent growth of net interest income through periods of changing interest rates.

The Bank must maintain minimum levels of liquid assets. This requirement is evaluated in relation to the composition and stability of deposits; the degree and trend of reliance on short-term, volatile sources of funds, including any undue reliance on particular segments of the money market or brokered deposits; any difficulty in obtaining funds; and the liquidity provided by securities and other assets. In addition, consideration is given to the nature, volume and anticipated use of commitments; the adequacy of liquidity and funding policies and practices, including the provision for alternate sources of funds; and the nature and trend of off-balance-sheet activities. As of December 31, 2006, management believes the Bank's liquidity is satisfactory.



The Bank's principal sources of asset liquidity include investment securities consisting primarily of U.S. Government and agency issues, particularly those of shorter maturities, and mortgage-backed securities with monthly repayments of principal and interest. There are no securities maturing in one year or less. However, other types of assets such as federal funds sold, as well as maturing loans, are sources of liquidity. At December 31, 2006, approximately $11.4 million in loans are scheduled to mature within one year.

In addition, the Bank has several back-up sources of liquidity consisting of a borrowing arrangement with one of its correspondent banks that includes a Federal Funds line of credit totaling $2 million. Borrowings under this agreement have interest rates that fluctuate based on market conditions. In addition, the Bank has the ability to borrow on a fully secured basis at the Discount Window of the Federal Reserve Bank. As of December 31, 2006 and 2005, the Bank had no borrowings outstanding.

The Bank's overall liquidity has been enhanced by a significant level of core deposits which management has determined are less sensitive to interest rate movements. The Bank has avoided reliance on large-denomination time deposits as well as brokered deposits. Table 11 provides a breakdown of the maturity of time deposits of $100,000 or more.

**Table 11: Maturity of Time Deposits of $100,000 or More**

| (Dollars in thousands) | |
|---|---|
| 3 months or less | $10,253 |
| Over 3 through 6 months | 2,903 |
| Over 6 months through 1 year | – |
| Over 1 through 5 years | 158 |
| Over 5 years | – |
| Total | $13,314 |

The following table sets forth contractual obligation and other commitments representing required and potential cash outflows as of December 31, 2006:

**Table 12: Contractual Obligations and Other Commitments**

| (Dollars in thousands) | Total | Less than one year | One to three years | Three to five years | After five years |
|---|---|---|---|---|---|
| Certificates of Deposit | $22,199 | $21,896 | $830 | $366 | $107 |
| Rental Obligations | 2,028 | 317 | 579 | 203 | 929 |
| Total | $24,227 | $22,213 | $1,409 | $569 | $1,036 |

In April 2006, the Bank entered into a 10-year lease for a new branch in the Progress Plaza shopping center that is scheduled to be constructed by the Fall of 2007. The lease requires annual rental payments of $60,000 for Year 1, $62,500 for Years 2-5, and $71,250 for Years 5-10. This transaction is not reflected in the Bank's long-term rental obligations noted above as the lease will commence upon completion and occupancy of the new branch. The Bank currently leases the branch it occupies at Progress Plaza on a month-to-month basis.

Interest rate sensitivity varies with different types of interest-earning assets and interest-bearing liabilities. Overnight federal funds on which rates change daily and loans that are tied to prime or other short-term indices differ considerably from long-term investment securities and fixed-rate loans. Similarly, time deposits are much more interest-sensitive than passbook savings accounts. The shorter-term interest rate sensitivities are key to measuring the interest sensitivity gap or excess interest-earning assets over interest-bearing liabilities. Management of interest sensitivity involves matching repricing dates of interest-earning assets with interest-bearing liabilities in a manner designed to optimize net interest income within the limits imposed by regulatory authorities, liquidity determinations and capital considerations.

Table 13 sets forth the earliest repricing distribution of the Bank's interest-earning assets and interest-bearing liabilities at December 31, 2006, the Bank's interest rate sensitivity gap ratio (i.e., excess of interest rate-sensitive assets over interest rate-sensitive liabilities, divided by total assets), and the Bank's cumulative interest rate sensitivity gap ratio. For purposes of the table, except for savings deposits, an asset or liability is considered rate-sensitive within a specified period when it matures or could be repriced within such period in accordance with its contractual terms. At December 31, 2006, an asset-sensitive position is maintained on a cumulative basis through one year of 7.14%. Generally, because of the positive gap position of the Bank in shorter time frames, the Bank can anticipate that increases in market rates will have a positive impact on the net interest income, while decreases will have the opposite effect. This level is well within the Bank's policy guidelines of +/-15% on a cumulative one-year basis. Interest rate risk is minimized by the Bank's high level of core deposits that have been placed in shorter repricing intervals.

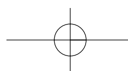
For purposes of the gap analysis, such deposits (savings, MMA, NOW) which do not have definitive maturity dates and do not readily react to changes in interest rates have been placed in longer repricing intervals versus immediate repricing time frames, making the analysis more reflective of the Bank's historical experience.

**Table 13: Interest Sensitivity Analysis**

| (Dollars in thousands) | Interest rate sensitivity gaps as of December 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | 3 months or less | Over 3 through 12 months | Over 1 year through 3 years | Over 3 through 5 years | Over 5 years | Cumulative |
| Interest-sensitive assets: | | | | | | |
| Interest-bearing deposits with banks | $ – | $282 | $ – | $ – | $ – | $282 |
| Investment securities | 4,328 | 2,017 | 3,288 | 3,897 | 2,244 | 15,774 |
| Federal funds sold | 9,158 | – | – | – | – | 9,158 |
| Loans | 12,589 | 10,851 | 5,802 | 3,453 | 9,824 | 42,519 |
| Total interest-sensitive assets | 26,075 | 13,150 | 9,090 | 7,350 | 12,068 | $67,733 |
| Cumulative totals | 26,075 | 39,225 | 48,315 | 55,665 | 67,733 | |
| Interest-sensitive liabilities: | | | | | | |
| Interest checking accounts | 2,190 | – | 2,190 | – | – | 4,380 |
| Savings accounts | 12,130 | – | 12,130 | – | – | 24,260 |
| Certificates $100,000 or more | 10,253 | 2,903 | 158 | – | – | 13,314 |
| Certificates of less than $100,000 | 3,324 | 4,418 | 671 | 472 | – | 9,665 |
| Total interest-sensitive liabilities | $26,981 | $7,407 | $14,046 | $420 | $ – | $48,854 |
| Cumulative totals | $26,981 | $34,388 | $48,434 | $48,854 | $48,854 | |
| Interest sensitivity gap | $(906) | $5,743 | $(4,956) | $6,930 | $12,068 | |
| Cumulative gap | (906) | 4,837 | (119) | 6,811 | 18,879 | |
| Cumulative gap/total earning assets | (1.34%) | 7.14% | (0.18%) | 10.05% | 27.87% | |
| Interest-sensitive assets to interest-sensitive liabilities | 0.97 | 1.78 | 0.65 | 17.50 | | |

*Core deposits such as checking and savings deposits have been placed in repricing intervals based on historical trends and management's estimates.*

While using the interest sensitivity gap analysis is a useful management tool as it considers the quantity of assets and liabilities subject to repricing in a given time period, it does not consider the relative sensitivity to market interest rate changes that are characteristic of various interest rate-sensitive assets and liabilities. Consequently, even though the Bank currently has a positive gap position because of unequal sensitivity of these assets and liabilities, management believes this position will not materially impact earnings in a changing rate environment. For example, changes in the prime rate on variable commercial loans may not result in an equal change in the rate of money market deposits or short-term certificates of deposit. A simulation model is therefore used to estimate the impact of various changes, both upward and downward, in market interest rates and volumes of assets and liabilities on the net income of the Bank.



The calculated estimates of net income or "earnings" at risk at December 31, 2006 are as follows:

| Changes in rate | Net interest income<br>(Dollars in thousands) | Percent of risk |
|---|---|---|
| +200 basis points | $3,499 | 0.26% |
| +100 basis points | 3,497 | 0.20 |
| Flat rate | 3,490 | – |
| -100 basis points | 3,469 | (0.60) |
| -200 basis points | 3,435 | (1.58) |

A simulation model is also used to estimate the impact of various changes, both upward and downward, in market interest rates and volumes of assets and liabilities on the economic value of the Bank. This model produces an interest rate exposure report that measures the long-term rate risks in the balance sheet by valuing the Bank's assets and liabilities at market. It simulates what amount would be left over if the Bank liquidated its assets and liabilities. This is otherwise known as "economic value" of the capital of the Bank. The calculated estimates of economic value at risk at December 31, 2006 are as follows:

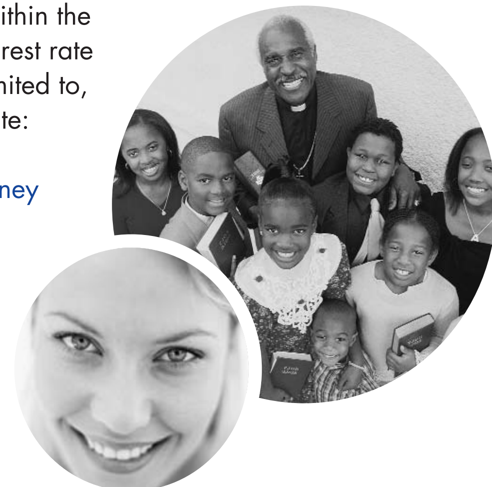
| Changes in rate | MV equity<br>(Dollars in thousands) | MV of equity<br>Risk change |
|---|---|---|
| +200 basis points | $5,239 | (23.5)% |
| +100 basis points | 6,064 | (11.50) |
| Flat rate | 6,849 | – |
| -100 basis points | 7,410 | 8.20 |
| -200 basis points | 7,855 | 14.70 |

The market value of equity may be impacted by the composition of the Bank's assets and liabilities. A shift in the level of variable versus fixed rate assets will create swings in the market value of equity. The Bank's market value of equity declines in a rising rate environment because of the high level of fixed rate loans and investments it has in its portfolio that do not follow market rate changes.

The assumptions used in evaluating the vulnerability of the Bank's earnings and equity to changes in interest rates are based on management's consideration of past experience, current position and anticipated future economic conditions. The interest sensitivity of the Bank's assets and liabilities, as well as the estimated effect of changes in interest rates on the earnings and equity, could vary substantially if different assumptions are used or actual experience differs from the assumptions on which the calculations were based.

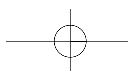
The Bank's Board of Directors and management consider all of the relevant factors and conditions in the asset/liability planning process. Interest rate exposure is within the policy limits of the Bank at December 31, 2006. However, if significant interest rate risk arises, the Board of Directors and management may take, but are not limited to, one or all of the following steps to reposition the balance sheet as appropriate:

1. Limit jumbo certificates of deposit and movement into money market deposit accounts and short-term certificates of deposit through pricing and other marketing strategies.
2. Purchase quality loan participations with appropriate interest rate/gap match for the Bank's balance sheet.
3. Restructure the Bank's investment portfolio.



The Board of Directors has determined that active supervision of the interest rate spread between yield on earning assets and cost of funds will decrease the Bank's vulnerability to interest rate cycles.





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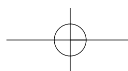


## Capital Resources

Total shareholders' equity increased $133,000 in 2006 compared to 2005 and decreased $320,000 in 2005 compared to 2004. The increase in capital in 2006 is attributable to the net income of $119,000 as well as other comprehensive income related to a decline in the unrealized loss on the securities classified as available-for-sale.

The decline in capital in 2005 is primarily attributable to the net loss of $269,000 for the year as well as other comprehensive loss related to an increase in the unrealized loss on securities classified as available-for-sale.

Management continues to implement growth and profitability strategies to increase retained earnings and will seek to leverage capital through growth generated by its strategic initiatives. In addition, management may consider other strategic business combinations to further strengthen capital, create liquidity, increase economies of scale, and better penetrate the marketplace.

The FRB standards for measuring capital adequacy for U.S. Banking organizations require that banks maintain capital based on "risk-adjusted" assets so that categories of assets with potentially higher risk will require more capital backing than assets with lower risk. In addition, banks are required to maintain capital to support, on a risk-adjusted basis, certain off-balance-sheet activities such as loan commitments. The FRB standards classify capital into two tiers, referred to as Tier I and Tier II. Tier I consists of common shareholders' equity (excluding net unrealized holding gains on available for sale securities), noncumulative and cumulative perpetual preferred stock, and minority interests less goodwill and/or intangible assets). Tier II capital consists of allowance for loan losses, hybrid capital instruments, term subordinated debt, and intermediate-term preferred stock. Banks are required to meet a minimum ratio of 8% of qualifying capital to risk-adjusted total assets with at least 4% Tier I capital and a Tier I leverage ratio of at least 6%. Capital that qualifies as Tier II capital is limited to 100% of Tier I capital.

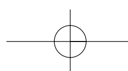
As indicated in Table 14, the Company's risk-based capital ratios are above the minimum requirements, however, the Bank's growth and operating results may have an adverse effect on its capital ratios. UBS and the Bank do not anticipate paying dividends in the near future.

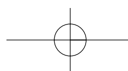
**Table 14: Capital Ratios**

| (Dollars in thousands) | 2006 | 2005 | 2004 |
|---|---|---|---|
| Total Capital | $8,624 | $8,491 | $8,812 |
| Less: Intangible Assets/Net unrealized gains (losses) on available for sale | (1,185) | (1,382) | (1,578) |
| Tier I capital | 7,433 | 7,109 | 7,234 |
| Tier II capital | 556 | 472 | 544 |
| Total qualifying capital | $7,995 | $7,581 | $7,778 |
| Risk-adjusted total assets (including off-balance-sheet exposures) | $44,464 | $44,503 | $43,436 |
| Tier I risk-based capital ratio | 16.73% | 15.97% | 16.65% |
| Total (Tier I and II) risk-based capital ratio | 17.98 | 17.03 | 17.91% |
| Tier I leverage ratio | 10.33 | 9.87 | 9.89% |

See "Regulatory Action" above for a description of and status of compliance with the regulatory Agreement under which the Bank is currently operating.







## Recent Accounting Pronouncements

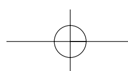
In February 2006, FASB issued SFAS 155, "Accounting for Certain Hybrid Financial Instruments", which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". The statement also subjects beneficial interests in securitized financial assets to the requirements of SFAS 133. For the Company, this statement is effective for all financial instruments acquired, issued, or subject to re-measurement after the beginning of its fiscal year that begins after September 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

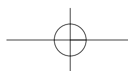
In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140." The statement amends SFAS no. 140 by (1) requiring the separate accounting for servicing assets and servicing liabilities, which arise from the sale of financial assets; (2) requiring all separately recognized serving assets and servicing liabilities to be initially measured at fair value, if practicable; and (3) permitting an entity to choose between an amortization method or a fair value method for subsequent measurement for each class of separately recognized servicing assets and servicing liabilities. This statement is effective for fiscal years beginning after September 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." This interpretation applies to all tax positions accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 clarifies the application of SFAS No. 109 by defining the criteria that an individual tax position must meet in order for the position to be recognized within the financial statements and provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim eriods, disclosure, and transition for tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this interpretation will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this interpretation will have a material impact on its financial position, results of operation and cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

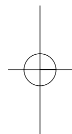


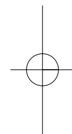




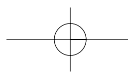


In February 2007, the FASB issued FAS No. 159 – "The Fair Value Option for Financial Assets and Liabilities including an Amendment of FASB Statement No. 115" ("FAS 159"). FAS 159 permits entities to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings without having to apply complex hedge accounting provisions. FAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is available subject to certain conditions. The Corporation did not early adopt FAS 159, and has not yet determined whether this statement will have a material impact on its consolidated financial statements upon adoption.









McGladrey & Pullen
Certified Public Accountants

**Report of Independent Registered Public Accounting Firm**

Shareholders and Board of Directors
United Bancshares, Inc.
Philadelphia, Pennsylvania

We have audited the consolidated balance sheets of United Bancshares, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of United Bancshares, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, in 2006 United Bancshares, Inc. adopted Statement of Financial Accounting Standards No. 123R, "Share-Based Payment."

McGladrey & Pullen, LLP

Blue Bell, Pennsylvania
April 4, 2007

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# CONSOLIDATED BALANCE SHEETS

**United Bancshares, Inc. and Subsidiary**
**December 31, 2006 and 2005**

| ASSETS | 2006 | 2005 |
|---|---|---|
| Cash and due from banks | $3,179,239 | $3,657,763 |
| Interest-bearing deposits with banks | 281,920 | 290,030 |
| Federal funds sold | 9,158,000 | 5,292,000 |
| Cash and cash equivalents | 12,619,159 | 9,239,793 |
| Investment securities: | | |
| Available-for-sale, at fair market value | 3,349,606 | 3,627,425 |
| Held-to-maturity, at amortized cost (fair market value of $12,683,809 and $9,906,420 in 2006 and 2005, respectively) | 12,804,351 | 10,078,441 |
| Loans, net of unearned discount of $5,204 and $21,781 in 2006 and 2005, respectively | 42,518,151 | 46,422,378 |
| Less allowance for loan losses | (561,409) | (472,198) |
| Net loans | 41,956,742 | 45,950,180 |
| Bank premises and equipment, net | 1,099,524 | 1,038,081 |
| Accrued interest receivable | 422,216 | 336,466 |
| Other real estate owned | - | 164,500 |
| Intangible assets | 1,204,202 | 1,382,279 |
| Prepaid expenses and other assets | 479,959 | 392,564 |
| Total assets | $73,935,759 | $72,209,729 |
| Liabilities and Shareholders' Equity Liabilities: | | |
| Demand deposits, noninterest-bearing | $14,082,940 | $14,469,063 |
| Demand deposits, interest-bearing | 10,585,080 | 9,788,131 |
| Savings deposits | 18,056,849 | 16,396,073 |
| Time deposits, under $100,000 | 8,885,199 | 9,665,743 |
| Time deposits, $100,000 and over | 13,313,571 | 13,004,506 |
| Total deposits | 64,923,639 | 63,323,516 |
| Accrued interest payable | 132,785 | 150,777 |
| Accrued expenses and other liabilities | 254,906 | 243,657 |
| Total liabilities | 65,311,330 | 63,717,950 |
| Commitments and Contingencies (Notes 6, 10, 14 and 15) | | |
| Shareholders' equity: | | |
| Series A preferred stock, noncumulative, 6%, $0.01 par value, 500,000 shares authorized; 136,842 issued; 6,308 shares held in treasury | 1,368 | 1,368 |
| Common stock, $0.01 par value; 1,750,000 shares authorized; 876,921 issued | 8,769 | 8,769 |
| Class B Non-voting Common Stock; 250,000 shares authorized; $0.01 par value; 191,667 issued and outstanding | 1,917 | 1,917 |
| Treasury Stock, 33,500 shares of common stock, at cost | - | - |
| Additional paid-in-capital | 14,749,852 | 14,749,852 |
| Accumulated deficit | (6,118,867) | (6,237,557) |
| Accumulated other comprehensive loss | (18,610) | (32,570) |
| Total shareholders' equity | 8,624,429 | 8,491,779 |
| Total liabilities and shareholders' equity | $73,935,759 | $72,209,729 |

*The accompanying notes are an integral part of these statements.*

banking that matters

# CONSOLIDATED STATEMENTS OF OPERATIONS

**United Bancshares, Inc. and Subsidiary**
**Years ended December 31, 2006, 2005 and 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Interest income: | | | |
| Interest and fees on loans | $3,625,617 | $3,428,778 | $3,008,532 |
| Interest on investment securities | 577,224 | 537,077 | 560,255 |
| Interest on federal funds sold | 357,080 | 180,258 | 86,935 |
| Interest on time deposits with other banks | 7,843 | 9,717 | 30,087 |
| Total interest income | 4,567,764 | 4,155,830 | 3,685,809 |
| Interest expense: | | | |
| Interest on time deposits | 696,901 | 462,910 | 294,863 |
| Interest on demand deposits | 111,128 | 64,224 | 48,602 |
| Interest on savings deposits | 137,958 | 57,940 | 62,464 |
| Total interest expense | 945,987 | 585,074 | 405,929 |
| Net interest income | 3,621,777 | 3,570,756 | 3,279,880 |
| Provision for loan losses | 137,000 | 558,000 | 45,000 |
| Net interest income after provision for loan losses | 3,484,777 | 3,012,756 | 3,234,880 |
| Noninterest income: | | | |
| Gain on sale of loans | 10,656 | 33,679 | 6,299 |
| Customer service fees | 603,259 | 681,919 | 852,806 |
| ATM Fee Income | 517,302 | 570,274 | 597,965 |
| Loan Syndication Fee Income | 150,000 | 202,171 | 178,802 |
| Gain on sale of investments | – | – | 31,115 |
| Gain on sale of fixed assets | – | – | 1,874,203 |
| Other income | 133,285 | 94,011 | 113,837 |
| Total noninterest income | 1,414,502 | 1,582,054 | 3,655,027 |
| Noninterest expense: | | | |
| Salaries, wages and employee benefits | 1,746,539 | 1,830,572 | 1,935,421 |
| Occupancy and equipment | 993,397 | 994,690 | 1,102,627 |
| Office operations and supplies | 309,268 | 345,265 | 411,920 |
| Marketing and public relations | 115,756 | 100,421 | 82,652 |
| Professional services | 290,687 | 265,487 | 239,050 |
| Data processing | 421,699 | 407,324 | 562,655 |
| Deposit insurance assessments | 110,687 | 113,144 | 72,238 |
| Other operating | 792,556 | 807,324 | 836,822 |
| Total noninterest expense | 4,780,589 | 4,864,227 | 5,243,385 |
| Net income (loss) before income taxes | $118,690 | $(269,417) | $1,646,522 |
| Provision for income taxes | – | – | – |
| Net income (loss) | $118,690 | $(269,417) | $1,646,522 |
| Net income (loss) per common share—basic | $0.11 | $(0.25) | $1.54 |
| Net income (loss) per common share—diluted | $0.11 | $(0.25) | $1.54 |
| Weighted average number of common shares | 1,068,588 | 1,068,588 | 1,068,588 |

*The accompanying notes are an integral part of these statements.*

# CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

**United Bancshares, Inc. and Subsidiary**
**Years ended December 31, 2006, 2005 and 2004**

| | Series A preferred stock | | Common Stock | | Additional paid-in capital | Accumulated deficit | Accumulated other comprehensive income (loss) | Total shareholders' equity | Comprehensive income (loss) |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | |
| Balance at December 31, 2003 | 136,842 | $1,368 | 1,068,588 | $10,686 | $14,749,852 | $(7,614,662) | 87,649 | $7,234,893 | |
| Unrealized losses on investment securities | | | | | | | (70,087) | (70,087) | $(70,087) |
| Net income | | | | | | 1,646,522 | | 1,646,522 | 1,646,522 |
| Total comprehensive income (loss) | | | | | | | | | $1,576,435 |
| Balance at December 31, 2004 | 136,842 | $1,368 | 1,068,588 | $10,686 | $14,749,852 | $(5,968,140) | $17,562 | $8,811,328 | |
| Unrealized losses on investment securities | | | | | | | (50,132) | (50,132) | $(50,132) |
| Net loss | | | | | | (269,417) | | (269,417) | (269,417) |
| Total comprehensive loss | | | | | | | | | $(319,549) |
| Balance at December 31, 2005 | 136,842 | $1,368 | 1,068,588 | $10,686 | $14,749,852 | $(6,237,557) | $(32,570) | $8,491,779 | |
| Unrealized gains on investment securities | | | | | | | 13,960 | 13,960 | $13,960 |
| Net income | | | | | | 118,690 | | 118,690 | 118,690 |
| Total comprehensive income | | | | | | | | | $132,650 |
| Balance at December 31, 2006 | $136,842 | $1,368 | $1,068,588 | $10,686 | $14,749,852 | $(6,118,867) | $18,610 | $8,624,429 | |

*The accompanying notes are an integral part of these statements.*

# CONSOLIDATED STATEMENTS OF CASH FLOWS

**United Bancshares, Inc. and Subsidiary**
**Years ended December 31, 2006, 2005 and 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income (loss) | $118,690 | $(269,417) | $1,646,522 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Provision for loan losses | 137,000 | 558,000 | 45,000 |
| Gain on sale of loans | (10,656) | (33,679) | (6,299) |
| Gain on sale of fixed assets | – | – | (1,874,203) |
| Gain on sale of investment securities | – | – | (31,115) |
| Depreciation and amortization | 447,189 | 480,976 | 610,440 |
| (Increase) decrease in accrued interest receivable and other assets | (173,145) | (211,387) | 505,173 |
| Increase (decrease) in accrued interest payable and other liabilities | 6,742 | 77,082 | (48,299) |
| Net cash provided by operating activities | 525,821 | 601,575 | 847,219 |
| Cash flows from investing activities: | | | |
| Purchase of available-for-sale investments | (503,125) | – | (496,421) |
| Purchase of held-to-maturity investments | (5,116,828) | (4,762,327) | (3,986,354) |
| Proceeds from maturity and principal reductions of available-for-sale investments | 833,197 | 1,084,929 | 3,774,398 |
| Proceeds from maturity and principal reductions of held-to-maturity investments | 2,380,686 | 3,440,765 | 1,917,765 |
| Proceeds from sale of investments available-for-sale | – | – | 786,526 |
| Proceeds from the sale of fixed assets | – | – | 3,283,536 |
| Proceeds from sale of student loans | 568,166 | 1,806,173 | – |
| Net decrease (increase) in loans | 3,277,616 | (1,771,882) | 161,493 |
| Purchase of premises and equipment | (196,945) | (244,306) | (102,935) |
| Net cash provided by (used in) investing activities | 1,253,123 | (446,648) | 5,338,008 |
| Cash flows from financing activities: | | | |
| Net increase (decrease) in deposits | 1,600,123 | 151,297 | (3,944,604) |
| Net cash provided by (used in) financing activities | 1,600,123 | 151,297 | (3,944,604) |
| Net increase in cash and cash equivalents | 3,379,366 | 306,224 | 2,240,623 |
| Cash and cash equivalents at beginning of year | 9,239,793 | 8,933,569 | 6,692,946 |
| Cash and cash equivalents at end of year | $12,619,159 | $9,239,793 | $8,933,569 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid during the year for interest | $963,979 | $512,493 | $405,508 |

*The accompanying notes are an integral part of these statements.*

# NOTES

**United Bancshares, Inc. and Subsidiary**
**Years Ended December 31, 2006, 2005, and 2004**

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation

The consolidated financial statements include the accounts of United Bancshares, Inc. (the Company) and its wholly owned subsidiary, United Bank of Philadelphia (the Bank). All significant intercompany transactions and balances have been eliminated.

### Statement of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold on an overnight basis. Changes in loans made to and deposits received from customers are reported on a net basis.

### Securities Held-to-Maturity

Bonds, notes, and debentures for which the Bank has both the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

### Securities Available-for-Sale

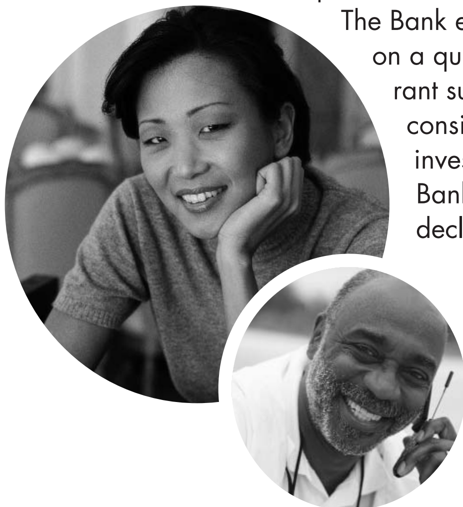
Available-for-sale securities consist of bonds, notes and debentures, and certain equity securities for which the Bank does not have positive intent to hold to maturity. These securities are carried at fair value.

Unrealized holding gains and losses on securities classified as available-for-sale are carried as a separate component of shareholders' equity net of related income tax effects.

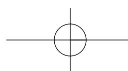
Gains and losses on the sale of available-for-sale securities are determined by the specific identification method.

Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Securities classified as available for sale or held to maturity are considered to be impaired when a decline in the fair value is judged to be other-than temporary. The Bank evaluates the securities for the other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such evaluation. The Bank employs a systematic methodology that considers available evidence in evaluating potential impairment of its investments. In the event that the cost of an investment exceeds its fair value, the Bank evaluates, among other factors, the magnitude and duration of the decline in fair value; for equity and debt securities the financial health of and business outlook of the issuer; the performance of the underlying assets in interests in securitized assets; and the Bank's intent and ability to hold the investment.



Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded in investment income and a new cost basis in the investment is established.



## Loans

The Bank has both the positive intent and ability to hold the majority of its loans to maturity. These loans are stated at the amount of unpaid principal, reduced by net unearned discount and an allowance for loan losses. Interest income on loans is recognized as earned based on contractual interest rates applied to daily principal amounts outstanding and accretion of discount. It is the Bank's policy to discontinue the accrual of interest income when a default of principal or interest exists for a period of 90 days except when, in management's judgment, the collection of principal and interest is reasonably anticipated or adequate collateral exists. Interest received on nonaccrual loans is either applied against principal or reported as interest income according to management's judgment as to collectibility of principal. When interest accruals are discontinued, interest credited to income is reversed and the loan is classified as nonperforming.

Unearned discount is amortized over the weighted average maturity of the mortgage loan portfolio. Loan origination and commitment fees and certain direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loan's yield. The Bank is amortizing these amounts over the contractual life of the loan.

For purchased loans, the discount remaining after the loan loss allocation is being amortized over the remaining life of the purchased loans using the interest method.

## Loans Held-for-Sale

Transfers of financial assets, for which the Bank has surrendered control, are accounted for as sales to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. Retained interests in a sale of financial assets are measured at the date of transfer by allocating the previous carrying amount between the assets transferred and based on their relative estimated fair values. The fair values of retained servicing rights and any other retained interests are determined based on the present value of expected future cash flows associated with those interests and by reference to market prices for similar assets.

Loans held-for-sale are carried at the lower of aggregate cost or market value

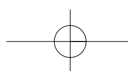
## Allowance for Loan Losses

The allowance for loan losses related to "impaired loans" is based on the discounted cash flows using the impaired loans' initial effective interest rate as the discount rate, or the fair value of the collateral for collateral-dependent loans. A loan is impaired when it meets the criteria to be placed on nonaccrual status. Loans that are evaluated for impairment are assessed on a loan-by-loan basis and include only commercial nonaccrual loans. Large groups of smaller, homogeneous loans, such as credit cards, student loans, residential mortgages, and other student loans, are evaluated collectively for impairment.

The allowance for loan losses is maintained at a level considered adequate to provide for potential losses in the portfolio. The allowance is increased by provisions charged to operating expenses and reduced by charge-offs net of recoveries. Management's determination of the adequacy of the allowance is based on continuous credit reviews of the loan portfolio, consideration of the current economic conditions, review of specific problem loans, and other relevant factors.

This evaluation is subjective as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. However, actual losses on specific loans, which are encompassed in the analysis, may vary from estimated losses. The allowance is an accounting estimate subject to short-term changes based on the outcome of periodic analysis.





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## Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. Amortization of leasehold improvements is computed over the shorter of the related lease term or the useful life of the assets.

## Income Taxes

The liability method is used in accounting for income taxes. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences expected to reverse.

## Earnings (Loss) Per Share

Basic EPS excludes dilution and is computed by dividing income available to common shareholders by the weighted average common shares outstanding during the period. Diluted EPS takes into account the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock.

## Stock-based Compensation

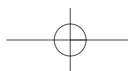
As of January 1, 2006, the Bank transitioned to fair value based accounting for stock-based compensation using a modified version of prospective application in accordance with Statement of Financial Accounting Standards No. 123R, ("FAS 123R"), Share-Based Payment. There was no compensation cost charged against income for the Plan for the years ended December 31, 2006, 2005 and 2004 as no options were granted under the Plan during these periods. All options were fully vested at December 31, 2006.

At December 31, 2006, the Company had one stock-based employee compensation plan which is more fully described in Note 12. Through December 31, 2005, the Company accounted for this plan under the recognition and measurement principles of APB No. 25, Accounting for Stock Issued to Employees and related interpretations.

The Stock Option Plan provides for the granting of options at the fair market value of the Company's common stock at the time the options are granted. Each option granted under the Stock Option Plan may be exercised within a period of ten years from the date of grant. However, no option may be exercised within one year from the date of grant. In 1998, options to purchase 29,694 shares of the Company's common stock at a price of $8.54 per share were awarded, to the former chief executive officer. Those options remain outstanding at December 31, 2006.

## Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the financial statements when they become payable.



## Financial Instruments

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

*Cash and cash equivalents:* The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values.

*Investment securities:* Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying amount of accrued interest receivable approximates fair market value.

*Loans held-for-sale:* Fair values are estimated using quoted rates based upon secondary market sources for similar loans.

*Loans:* The fair value of loans was estimated using a discounted cash flow analysis, which considered estimated prepayments and amortizations. Prepayments and discount rates were based on current marketplace estimates and pricing. Residential mortgage loans were discounted at the current effective yield, including fees, of conventional loans, adjusted for their maturities with a spread to the Treasury yield curve. The carrying amount of accrued interest receivable approximates fair market value.

*Deposit liabilities:* The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are equal to the amounts payable on demand at the reporting date (e.g., their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate the fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation. The Treasury Yield Curve was utilized for discounting cash flows as it approximates the average marketplace certificate of deposit rates across the relevant maturity spectrum. Commitments to extend credit: The carrying amounts for commitments to extend credit approximate fair value as such commitments are not substantially different from the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparts. The carrying amount of accrued interest payable approximates fair market value.

## Intangible Assets

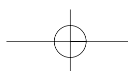
On September 24, 1999, the Bank acquired four branches from First Union Corporation with deposits totaling $31.5 million. As a result of the acquisition, the Bank recorded a core deposit intangible of $2,449,488. The core deposit intangible is being amortized over 14 years.

| | 2006 | 2005 |
|---|---|---|
| Core Deposit Premium (cost) | $2,449,488 | $2,449,488 |
| Less accumulated amortization | (1,245,286) | (1,067,209) |
| | $1,204,202 | $1,382,279 |

Amortization of the intangible totaled $178,078 for each of the years ended December 31, 2006, 2005, 2004. The amortization of the intangible is projected to be $178,078 for each of the next five years.

Intangible assets are reviewed for possible impairment when events or changed circumstances may affect the underlying basis of the net asset. Such reviews include an analysis of current results and take into consideration the discounted value of projected operating cash flows. The core deposit intangible was tested for impairment. No impairment has been recognized.





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### Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management, and the real estate is carried at the lower of carrying amount or fair value less the cost to sell. Revenue and expenses from operations and changes in valuation allowance are charged to operations. The historical average holding period for such properties is 24 months.

### Management's Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates which are particularly susceptible to significant change in the near term relate to the market value of investment securities, the determination of the allowance for loan losses, valuation of other real estate, and consideration of impairment of other intangible assets.

### Segments

SFAS No. 131 establishes standards for the way public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in subsequent interim financial reports issued to shareholders. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. The statement requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and assess performance. The statement also requires that public enterprises report a measure of segment profit or loss, certain specific revenue and expense items and segment assets. It also requires that information be reported about revenues derived from the enterprises' products or services, or about the countries in which the enterprises earn revenues and hold assets, and about major customers, regardless of whether that information is used in making operating decisions.

The Company has one reportable segment, "Community Banking." All of the Company's activities are interrelated, and each activity is dependent and assessed based on how each of the activities of the Company supports the other. For example, commercial lending is dependent upon the ability of the Bank to fund itself with retail deposits and other borrowings and to manage interest rate and credit risk. This situation is also similar for consumer and residential mortgage lending. Accordingly, all significant operating decisions are based upon analysis of the Company as one operating segment or unit.

### Reclassifications

Certain reclassifications have been made to the prior year's financial statements to conform to the 2006 presentation.

## Comprehensive Income

Comprehensive income includes net income as well as certain other items that result in a change to equity during the period. The components of other comprehensive income (loss) are as follows:

| | December 31, 2006 | | |
|---|---|---|---|
| | Before tax amount | Tax benefit (expense) | Net of tax amount |
| Unrealized gains on securities | | | |
| Unrealized holding gains arising during period | $20,836 | $(6,876) | $13,960 |
| Less: reclassification adjustment for gains realized in net income | – | – | – |
| Other comprehensive income, net | $20,836 | $(6,876) | $13,960 |

| | December 31, 2005 | | |
|---|---|---|---|
| | Before tax amount | Tax benefit (expense) | Net of tax amount |
| Unrealized losses on securities | | | |
| Unrealized holding losses arising during period | $(75,958) | $25,826 | $(50,132) |
| Less: reclassification adjustment for gains realized in net income | – | – | – |
| Other comprehensive income (loss), net | $(75,958) | $25,826 | $(50,132) |

| | December 31, 2004 | | |
|---|---|---|---|
| | Before tax amount | Tax benefit (expense) | Net of tax amount |
| Unrealized losses on securities | | | |
| Unrealized holding losses arising during period | $(74,015) | $24,776 | $(49,240) |
| Less: reclassification adjustment for gains realized in net income | 31,115 | (10,267) | 20,847 |
| Other comprehensive income (loss), net | $(105,130) | $35,043 | $(70,087) |

## Recent Accounting Pronouncements

In February 2006, FASB issued SFAS 155, "Accounting for Certain Hybrid Financial Instruments", which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". The statement also subjects beneficial interests in securitized financial assets to the requirements of SFAS 133. For the Company, this statement is effective for all financial instruments acquired, issued, or subject to re-measurement after the beginning of its fiscal year that begins after September 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140." The statement amends SFAS no. 140 by (1) requiring the separate accounting for servicing assets and servicing liabilities, which arise from the sale of financial assets; (2) requiring all separately recognized serving assets and servicing liabilities to be initially measured at fair value, if practicable; and (3) permitting an entity to choose between an amortization method or a fair value method for subsequent measurement for each class of separately recognized servicing assets and servicing liabilities. This statement is effective for fiscal years beginning after September 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

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In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." This interpretation applies to all tax positions accounted for in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 clarifies the application of SFAS No. 109 by defining the criteria that an individual tax position must meet in order for the position to be recognized within the financial statements and provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition for tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this interpretation will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this interpretation will have a material impact on its financial position, results of operation and cash flows.

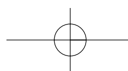
In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

In February 2007 the FASB issued FAS No. 159 – "The Fair Value Option for Financial Assets and Liabilities including an Amendment of FASB Statement No. 115" ("FAS 159"). FAS 159 permits entities to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings without having to apply complex hedge accounting provisions. FAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is available subject to certain conditions. The Corporation did not early adopt FAS 159, and has not yet determined whether this statement will have a material impact on its consolidated financial statements upon adoption.

## 2. REGULATORY AGREEMENT

In February 2000, as a result of a regulatory examination completed in December 1999, the Bank entered into a Written Agreement (Agreement) with its primary regulators with regard to, among other things, achievement of agreed-upon capital levels, implementation of a viable earnings/strategic plan, adequate funding of the allowance for loan losses, the completion of a management review and succession plan, and improvement in internal controls. The current Agreement requires the Bank to increase its capital ratio to 6.5% by June 30, 2000 and to 7% at all times thereafter. As of December 31, 2000, the Bank had met the required ratios by implementing strategies that included: increasing profitability, consolidating branches, and soliciting new and additional sources of capital. At December 31, 2006 and 2005, the Bank's tier one leverage ratio was 9.93% and 9.47%, respectively.

Management believes that the Bank is substantially in compliance with the Agreement's terms and conditions. Management continues to address all matters outlined in the Agreement. Failure to comply could result in additional regulatory supervision and/or actions.



## 3. CASH AND DUE FROM BANK BALANCES

The Bank maintains various deposit accounts with other banks to meet normal fund transaction requirements and to compensate other banks for certain correspondent services. The withdrawal or usage restrictions of these balances did not have a significant impact on the operations of the Bank as of December 31, 2006.

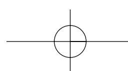
## 4. INVESTMENTS

The amortized cost, gross unrealized holding gains and losses, and estimated market value of the available-for-sale and held-to-maturity investment securities by major security type at December 31, 2006 and 2005 are as follows:

| | **2006** | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Market value |
| Available-for-sale: | | | | |
| Mortgage-backed securities | $2,997,170 | $14,335 | $(42,111) | $2,969,394 |
| Investments in mutual funds | 117,662 | | | 117,662 |
| Other investments | 262,550 | | | 262,550 |
| | $3,377,382 | $14,335 | $(42,111) | $3,349,606 |
| Held-to-maturity: | | | | |
| U.S. Government agency securities | $9,247,342 | $2,425 | $(95,430) | $9,154,337 |
| Mortgage-backed securities | 3,557,009 | 19,725 | (47,262) | 3,529,472 |
| | $12,804,351 | $22,150 | $(142,692) | $12,683,809 |

| | **2005** | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Market value |
| Available-for-sale: | | | | |
| U.S.Government agency securities | $250,000 | $ – | $(3,515) | $246,485 |
| Mortgage-backed securities | 3,085,436 | 18,348 | (63,445) | 3,040,339 |
| Total debt securities | 3,335,436 | 18,348 | (66,960) | 3,286,824 |
| Investments in mutual funds | 112,151 | | | 112,151 |
| Other investments | 228,450 | | | 228,450 |
| | $3,676,037 | $18,348 | $(66,960) | $3,627,425 |
| Held-to-maturity: | | | | |
| U.S. Government agency securities | $6,997,720 | $235 | $(133,292) | $6,864,663 |
| Mortgage-backed securities | 3,080,721 | 23,875 | (62,839) | 3,041,757 |
| | $10,078,441 | $24,110 | $(196,131) | $9,906,420 |





The table below indicates the length of time individual securities, both held-to-maturity and available-for-sale, have been in a continuous unrealized loss position at December 31, 2006 (in thousands):

| | | Less than 12 months | | 12 months or longer | | Total | |
|---|---|---|---|---|---|---|---|
| Description of securities | Number of securities | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Government agency securities | 16 | $3,246 | $(2) | $4,405 | $(93) | $7,651 | $(95) |
| Mortgage-backed securities | 19 | 395 | (1) | 3,149 | (88) | 3,544 | (89) |
| Total temporarily impaired investment securities | 35 | $3,641 | $(3) | $7,554 | $(181) | $11,195 | $(184) |

The table below indicates the length of time individual securities, both held-to-maturity and available-for-sale, have been in a continuous unrealized loss position at December 31, 2005 (in thousands):

| | | Less than 12 months | | 12 months or longer | | Total | |
|---|---|---|---|---|---|---|---|
| Description of securities | Number of securities | Fair Value | Unrealized losses | Fair Value | Unrealized losses | Fair Value | Unrealized losses |
| U.S. Government agency securities | 17 | $1,723 | $(25) | $2,569 | $(172) | $4,555 | $(197) |
| Mortgage-backed securities | 20 | 970 | (12) | 7,441 | (54) | 8,411 | (66) |
| Total temporarily impaired investment securities | 37 | $2,693 | $(37) | $10,010 | $(226) | $12,966 | $(263) |

Management does not believe any individual unrealized loss as of December 31, 2006 and 2005 represents other-than-temporary impairment. The unrealized losses on these securities are caused by the changes in general market interest rates. All securities with unrealized losses are reviewed by management at least quarterly to determine whether the unrealized losses are other-than-temporary. The Company believes it will collect all amounts contractually due on these securities as they are backed by the full faith and credit of the U.S. Government or are guaranteed by an agency of the U.S. Government. The Company has the ability and the intent to hold these securities until market price recovery or maturity.

Maturities of investment securities classified as available-for-sale and held-to-maturity at December 31, 2006 were as follows. Expected maturities may differ from contractual maturities.

| | Amortized cost | Market value |
|---|---|---|
| Available-for-sale: | | |
| Due after one month through three years | $ – | $ – |
| Due after three years through five years | – | – |
| Due after five years through fifteen years | – | – |
| Mortgage-backed securities | 2,997,170 | 2,969,394 |
| Total debt securities | 2,997,170 | 2,969,394 |
| Investments in mutual funds | 117,662 | 117,662 |
| Other investments | 262,550 | 262,550 |
| | $3,377,382 | $3,349,606 |
| Held-to-maturity: | | |
| Due in one month through three years | $5,747,342 | $5,703,084 |
| Due after three years through five years | 3,250,000 | 3,201,253 |
| Due after five years through fifteen years | 250,000 | 250,000 |
| Mortgage-backed securities | 3,557,009 | 3,529,472 |
| | $12,804,351 | $12,683,809 |

No securities were sold during 2006 and 2005. The Bank recorded a gross gain of $31,115 on the sale of investments during the year ended December 31, 2004.

As of December 31, 2006 and 2005, investment securities with a book value of $10,769,296 and $11,780,583, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

## 5. LOANS AND ALLOWANCE FOR LOAN LOSSES

The composition of the net loans is as follows:

| | **2006** | **2005** |
|---|---|---|
| Commercial loans | $32,339,517 | $32,985,265 |
| Residential mortgages | 5,551,098 | 7,545,858 |
| Consumer loans | 4,627,536 | 5,891,256 |
| Total loans | 42,518,151 | 46,422,378 |
| Less allowance for loan losses | (561,409) | (472,198) |
| Net loans | $41,956,742 | $45,950,180 |

At December 31, 2006 and 2005, unamortized net deferred fees totaled $128,552 and $127,714, respectively.

As of December 31, 2006 and 2005, the Bank had loans to certain officers and directors and their affiliated interests in aggregate dollar amounts of $1,023,076 and $856,473, respectively. During 2006, there were $212,176 in new loans to related parties and repayments amounted to $95,299. During 2005, there were $125,000 in new loans to related parties and repayments amounted to $258,000.

The Bank identifies a loan as impaired when it is probable that interest and principal will not be collected according to the contractual terms of the loan agreement. The Bank recognizes income on impaired loans under the cash basis when the loans are both current and the collateral on the loan is sufficient to cover the outstanding obligation to the Bank. If these factors do not exist, the Bank will not recognize income on such loans.

Details on the Bank's non-performing loans are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Total non-accrual loans | $626,000 | $683,000 | $1,366,000 |
| Total impaired loans | 896,000 | 386,000 | 1,034,000 |
| Average impaired loans | 538,000 | 903,000 | 1,079,000 |
| Specific allowance allocated to impaired loans | 105,000 | 113,000 | 259,000 |
| Non-accrual/impaired loans with SBA Guarantees | 152,000 | 190,000 | 888,000 |
| Interest recognized on impaired loans | 76,000 | 37,000 | – |
| Loans past due 90 days and still accruing | 170,000 | – | 65,000 |

Changes in the allowance for possible loan losses are as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Balance, beginning of year | $472,198 | $602,939 | $338,574 |
| Provision | 137,000 | 558,000 | 45,000 |
| Charge-offs | (272,459) | (981,355) | (239,757) |
| Recoveries | 224,670 | 292,614 | 459,122 |
| Balance, end of year | $561,409 | $472,198 | $602,939 |

The Bank grants commercial, residential, and consumer loans to customers primarily located in Philadelphia County, Pennsylvania and surrounding counties in the Delaware Valley. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy. At December 31, 2006, approximately 33% of the Bank's commercial loan portfolio was concentrated in loans made to religious organizations.

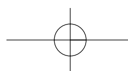
## 6. BANK PREMISES AND EQUIPMENT

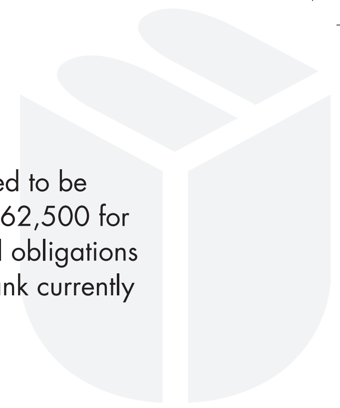
The major classes of bank premises and equipment and the total accumulated depreciation are as follows:

| | Estimated useful life | 2006 | 2005 |
|---|---|---|---|
| Buildings and leasehold improvements | 10-15 years | $1,005,923 | $853,066 |
| Furniture and equipment | 3- 7 years | 1,236,978 | 1,068,223 |
| | | 2,242,901 | 1,921,289 |
| Less accumulated depreciation | | (1,143,377) | (833,208) |
| | | $1,099,524 | $1,038,081 |

The Bank leases other facilities and other equipment under non-cancelable operating lease agreements. The amount of expense for operating leases for the years ended December 31, 2006, 2005, and 2004 was $387,144, $340,638, and $277,850. Future minimum lease payments under operating leases are as follows:

| Year ending December 31, | Operating leases |
|---|---|
| 2007 | $316,808 |
| 2008 | 312,599 |
| 2009 | 266,389 |
| 2010 | 202,530 |
| 2011 | 202,784 |
| Thereafter | 727,132 |
| Total minimum lease payments | $2,028,242 |





In April 2006, the Bank entered into a 10-year lease for a new Progress Plaza branch that is scheduled to be constructed by the Fall of 2007. The lease requires annual rental payments of $60,000 for Year 1, $62,500 for Years 2-5, and $71,250 for Years 5-10. This transaction is not reflected in the Bank's long-term rental obligations noted above as the lease will commence upon completion and occupancy of the new branch. The Bank currently leases the branch it occupies at Progress Plaza on a month-to-month basis.

## 7. DEPOSITS

At December 31, 2006, the scheduled maturities of time deposits (certificates of deposit) are as follows (dollars in thousands):

| | |
|---|---|
| 2007 | $20,896 |
| 2008 | 718 |
| 2009 | 112 |
| 2010 | 104 |
| 2011 | 262 |
| Thereafter | 107 |
| | $22,199 |

## 8. BORROWINGS

At December 31, 2006, the Bank has a borrowing arrangement with one of its correspondent banks that includes a Federal Funds line of credit totaling $2 million. Borrowings under this agreement have interest rates that fluctuate based on market conditions. In addition, the Bank has the ability to borrow on a fully secured basis at the Discount Window of the Federal Reserve Bank. As of December 31, 2006 and 2005, the Bank had no borrowings outstanding.

## 9. INCOME TAXES

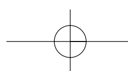
At December 31, 2006, the Bank has net operating loss carryforwards of approximately $4,718,000 for income tax purposes that expire in 2011 through 2025.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. For financial reporting purposes, a valuation allowance of $2,171,780 and $2,228,388 as of December 31, 2006 and 2005, respectively, has been recognized to offset the deferred tax assets related to the cumulative temporary differences and the tax loss carryforwards. Significant components of the Bank's deferred tax assets are as follows:

| | 2006 | 2005 |
|---|---|---|
| Deferred tax assets (liabilities): | | |
| Provision for loan losses | $9,224 | $(13,058) |
| Unrealized (gains) losses on investment securities | 43,444 | 16,528 |
| Depreciation | 424,521 | 435,472 |
| Net operating loss carryforwards | 1,600,303 | 1,634,822 |
| Other | 90,269 | 154,623 |
| Valuation allowance for deferred tax assets | (2,171,782) | (2,228,388) |
| Net deferred tax assets | $ – | $ – |

| | 2006 | 2005 |
|---|---|---|
| Effective rate reconciliation: | | |
| Tax at statutory rate (34%) | $40,355 | $(91,601) |
| Nondeductible expenses | 5,741 | 4,513 |
| (Decrease) Increase in valuation allowance | (58,807) | 298,326 |
| Other | 10,511 | (211,238) |
| Total tax expense | $ – | $ – |





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## 10. FINANCIAL INSTRUMENT COMMITMENTS

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit, which are conditional commitments issued by the Bank to guarantee the performance of an obligation of a customer to a third party. Both arrangements have credit risk essentially the same as that involved in extending loans and are subject to the Bank's normal credit policies. Collateral may be obtained based on management's assessment of the customer. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments is represented by the contractual amount of those instruments.

Summaries of the Bank's financial instrument commitments are as follows:

| | 2006 | 2005 |
|---|---|---|
| Commitments to extend credit | $12,995,600 | $12,727,370 |
| Outstanding letters of credit | – | 10,000 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and unused credit card lines. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

## 11. FAIR VALUES OF FINANCIAL INSTRUMENTS

Fair value information about financial instruments is required to be disclosed, whether or not recognized in the balance sheet, where it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flows or other valuation techniques. Those techniques are significantly affected by assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

| | 2006 | | 2005 | |
|---|---|---|---|---|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| (Dollars in thousands) | | | | |
| Assets: | | | | |
| Cash and cash equivalents | $12,619 | $12,619 | $9,240 | $9,240 |
| Investment securities | 16,154 | 16,032 | 13,705 | 13,533 |
| Loans, net of allowance for loan losses | 41,957 | 41,795 | 45,950 | 45,998 |
| Interest receivable | 422 | 422 | 336 | 336 |
| Liabilities: | | | | |
| Demand deposits | 24,688 | 24,688 | 24,257 | 24,257 |
| Savings deposits | 18,057 | 18,057 | 16,396 | 16,396 |
| Time deposits | 22,199 | 22,199 | 22,670 | 22,670 |
| Interest Payable | 133 | 133 | 150 | 150 |

## 12. EMPLOYEE COMPENSATION

In November 2004, the Bank renewed the employment agreements of its chief executive officer and its chief financial officer covering such items as salaries, bonuses and benefits for three years. In October 2006, the Bank entered into a two year employment agreement with its senior lending officer covering similar terms. These agreements provide for guaranteed minimum annual compensation over the term of the contracts. A summary of the status of the Bank's stock options as of December 31, 2006 and 2005 and the changes during the years ended on those dates is as presented below:

| | **2006** | | **2005** | |
|---|---|---|---|---|
| | # Shares of Underlying Options | Exercise Price | # Shares of Underlying Options | Exercise Price |
| Outstanding at the beginning of the period | 29,694 | $8.54 | 29,694 | $8.54 |
| Outstanding at the beginning of the period | – | – | – | – |
| Granted | – | – | – | – |
| Forfeited | – | – | – | – |
| Expired | – | – | – | – |
| Outstanding at the end of the period | 29,694 | $8.54 | 29,694 | $8.54 |
| Exercisable at the end of the period | 29,694 | $8.54 | 29,694 | $8.54 |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 1998: no dividends declared; expected volatility of 20%; a risk-free interest rate of 4.7%, and expected life of 10 years.

In 1998, the Company adopted a Stock Option Plan with the approval of its shareholders. In accordance with the contractual terms with its former chief executive officer, the Bank granted the right to acquire up to 4% of the Bank's stock as of December 31, 1993 at $8.54 per share, which was the book value at the date of grant. Under this Plan, options to acquire shares of common stock were granted to the former chief executive officer. The Stock Option Plan provides for the granting of options at the fair market value of the Company's common stock at the time the options are granted. Each option granted under the Stock Option Plan may be exercised within a period of ten years from the date of grant. However, no option may be exercised within one year from the date of grant. In 1998, options to purchase 29,694 shares of the Company's common stock at a price of $8.54 per share were awarded to the former chief executive officer. Those options remain outstanding at December 31, 2006 and have no intrinsic value as of that date. These options expire in 2008. There are 70,306 additional shares authorized under the Plan.

The Company made no stock-based compensation awards to any employee during 2006, 2005, and 2004.

## 13. CONSOLIDATED FINANCIAL INFORMATION—PARENT COMPANY ONLY

**Condensed Balance Sheets**

| (Dollars in thousands) | December 31 2006 | December 31 2005 |
|---|---|---|
| Assets: | | |
| Due from banks (subsidiary) | $289 | $289 |
| Investment in United Bank of Philadelphia | 8,335 | 8,202 |
| Total assets | $8,624 | $8,491 |
| Shareholders' equity: | | |
| Series A preferred stock | $1 | $1 |
| Common stock | 11 | 11 |
| Additional paid-in capital | 14,750 | 14,750 |
| Accumulated deficit | (6,119) | (6,238) |
| Net unrealized holding gains on securities available-for-sale | (19) | (33) |
| Total shareholders' equity | $8,624 | $8,491 |

**Condensed Statements of Operations**

| (Dollars in thousands) | Years ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| Equity in net (loss) income of subsidiary | $119 | $(269) | $1,646 |
| Net (loss) income | $119 | $(269) | $1,646 |

**Condensed Statements of Cash Flows**

| (Dollars in thousands) | Years ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income (loss) | $119 | $(269) | $1,646 |
| Equity in net income (loss) of subsidiary | (119) | 269 | (1,646) |
| Net cash provided by operating activities | – | – | – |
| Cash and cash equivalents at beginning of year | 289 | 289 | 289 |
| Cash and cash equivalents at end of year | $289 | $289 | $289 |

## 14. REGULATORY MATTERS

The Bank engages in the commercial banking business, with a particular focus on serving Blacks, Hispanics and women, and is subject to substantial competition from financial institutions in the Bank's service area. As a bank holding company and a banking subsidiary, the Company and the Bank, respectively, are subject to regulation by the Federal Reserve Board and the Pennsylvania Department of Banking and are required to maintain capital requirements established by those regulators. Prompt corrective actions may be taken by those regulators against banks that do not meet minimum capital requirements.

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Prompt corrective actions range from restriction or prohibition of certain activities to the appointment of a receiver or conservator of an institution's net assets. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices, the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total Tier I capital (as defined in the regulations) for capital adequacy purposes to risk-weighted assets (as defined).

The most recent notification from the Federal Reserve Bank categorized the Bank as "adequately capitalized" under the regulatory framework for prompt and corrective action. To be categorized as "well capitalized," the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. By typical regulatory guidelines the Bank is considered "well" capitalized, however, because it is operating with a Written Agreement, it is only considered to be "adequately" capitalized. The Bank's growth and other operating factors may have an adverse effect on its capital ratios. (Also see Note 2. REGULATORY AGREEMENT)

The Bank's actual capital amounts and ratios are as follows:

| | Actual | | For capital adequacy purposes | | To be well capitalized under prompt corrective action provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2006: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | $7,995 | 17.98% | $3,580 | 8.00% | N/A | |
| Bank | 7,706 | 17.33 | 3,557 | 8.00% | $4,446 | 10.00% |
| Tier I capital to risk-weighted assets: | | | | | | |
| Consolidated | 7,439 | 16.73 | 1,790 | 4.00% | N/A | |
| Bank | 7,150 | 16.08 | 1,779 | 4.00% | $2,668 | 6.00% |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 7,439 | 10.33 | 2,892 | 4.00% | N/A | |
| Bank | 7,150 | 9.93 | 2,880 | 4.00% | $3,600 | 5.00% |
| As of December 31, 2005: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | $7,581 | 17.03% | $3,583 | 8.00% | N/A | |
| Bank | 7,292 | 16.39 | 3,560 | 8.00 | $ 4,450 | 10.00% |
| Tier I capital to risk-weighted assets: | | | | | | |
| Consolidated | 7,109 | 15.97 | 1,792 | 4.00 | N/A | |
| Bank | 6,820 | 15.32 | 1,780 | 4.00 | $2,670 | 6.00 |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 7,109 | 9.87 | 2,891 | 4.00 | N/A | |
| Bank | 6,820 | 9.47 | 2,880 | 4.00 | $3,600 | 5.00 |

Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators. Historically, the Bank has not accepted brokered deposits and management believes this restriction does not significantly limit the Bank's ability to attract deposits and maintain adequate liquidity.

## 15. COMMITMENTS AND CONTINGENCIES

The Bank is a defendant in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated financial condition of the Company.

## 16. EARNINGS PER SHARE COMPUTATION

Net income (loss) per common share is calculated as follows:

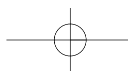
| | Year ended December 31, 2006 | | |
|---|---|---|---|
| | Income (numerator) | Shares (denominator) | Per share amount |
| Net income | $118,690 | | |
| Basic EPS | | | |
| Income available to common stockholders | $118,690 | 1,068,588 | $0.11 |
| Fully Diluted EPS | | | |
| Income available to common stockholders | $118,690 | 1,068,588 | $0.11 |

| | Year ended December 31, 2005 | | |
|---|---|---|---|
| | Income (numerator) | Shares (denominator) | Per share amount |
| Net loss | $(269,417) | | |
| Basic and fully diluted EPS | | | |
| Loss available to common stockholders | $(269,417) | 1,068,588 | $(0.25) |

| | Year ended December 31, 2004 | | |
|---|---|---|---|
| | Income (numerator) | Shares (denominator) | Per share amount |
| Net income | $1,646,522 | | |
| Basic EPS | | | |
| Income available to common stockholders | $1,646,522 | 1,068,588 | $1.54 |
| Fully Diluted EPS | | | |
| Income available to common stockholders | $1,646,522 | 1,068,588 | $1.54 |

Options to purchase 29,694 shares of common stock are not included in the computation of diluted EPS for the years ended December 31, 2006 and December 31, 2004, noting that such inclusion would be anti-dilutive.

The preferred stock is non-cumulative and the Company is restricted from paying dividends. Therefore, no effect of the preferred stock is included in the earnings per share calculations.

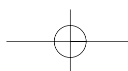


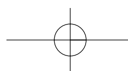
## 17. SUMMARY OF QUARTERLY RESULTS (UNAUDITED)

The following summarizes the consolidated results of operations during 2006 and 2005, on a quarterly basis, for United Bancshares, Inc. and Subsidiary:

| (Dollars in thousands) | 2006 | | | |
|---|---|---|---|---|
| | Fourth quarter | Third quarter | Second quarter | First quarter |
| Interest income | $1,161 | $1,169 | $1,124 | $1,113 |
| Interest expense | 272 | 255 | 224 | 195 |
| Net interest income | 889 | 914 | 900 | 918 |
| Provision for loan losses | 22 | 40 | 35 | 40 |
| Net interest after provision for loan losses | 867 | 874 | 865 | 878 |
| Noninterest income | 398 | 314 | 357 | 345 |
| Noninterest expense | 1,232 | 1,179 | 1,216 | 1,153 |
| Net income | $33 | $9 | $6 | $70 |
| Basic earnings per common share | $0.03 | $0.01 | $0.01 | $0.06 |
| Diluted earnings per common share | $0.03 | $0.01 | $0.01 | $0.06 |

| | 2005 | | | |
|---|---|---|---|---|
| | Fourth quarter | Third quarter | Second quarter | First quarter |
| Interest income | $1,063 | $1,075 | $1,031 | $986 |
| Interest expense | 183 | 157 | 130 | 115 |
| Net interest income | 880 | 918 | 901 | 871 |
| Provision for loan losses | 398 | 50 | 70 | 40 |
| Net interest after provisions for loan losses | 482 | 868 | 831 | 831 |
| Noninterest income | 390 | 362 | 416 | 414 |
| Noninterest expense | 1,239 | 1,193 | 1,197 | 1,234 |
| Net (loss) income | $(367) | $37 | $50 | $11 |
| Basic earnings (loss) per common share | $(0.34) | $0.03 | $0.05 | $0.01 |
| Diluted earnings (loss) per common share | $(0.34) | $0.03 | $0.05 | $0.01 |





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# CORPORATE INFORMATION

## BOARD OF DIRECTORS

**L. Armstead Edwards**
Chairman

**Evelyn F. Smalls**
President and CEO

**Rev. William B. Moore**
Vice Chairman

**Bernard E. Anderson**
Director

**Joseph T. Drennan**
Treasurer

**David R. Bright**
Director

**Marionette Y. Frazier**
Secretary

**Ahsan M. Nasratullah**
Director

**Ernest L. Wright**
Director

## MANAGEMENT TEAM

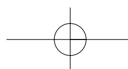
**Evelyn F. Smalls**
President and
Chief Executive Officer

**Brenda M. Hudson-Nelson**
Executive Vice President and
Chief Financial Officer

**Terrence D. Barclift**
Senior Vice President
Senior Lending Officer

**Norman W. Green**
Vice President
Chief Risk Officer





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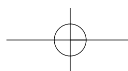

## CORPORATE OFFICE

30 S. 15th Street, Suite 1200
Philadelphia, PA 19102
215.351.4600

## FINANCIAL SERVICE CENTERS / ATM LOCATIONS

**West Philadelphia**
38th & Lancaster
215.662.5040

**Mt. Airy**
1620 E. Wadsworth Ave.
215.242.0500

**Progress Plaza**
1501 N. Broad St.
215.978.5300

## OTHER ATM LOCATIONS

**Center City**
30 S. 15th St.

**City Hall**
Broad & Market St.

**Criminal Justice Center**
13th & Filbert St.

**Traffic Court**
800 Spring Garden Ave.

**VA Medical Center**
University & Woodland Ave.

**Health First Pharmacy**
2820 W. Girard Ave.

**University City**
104 S. 40th St.

**Police Stations**
2000 Federal St.
55th & Pine St.
61st & Thompson St.
Broad & Champlost St.

**Rite Aid Stores**
1628 Chestnut St.
2017-23 S. Broad St.
7401 Ogontz Ave.
1105 N. 63rd St.
1528-30 N. Broad St.
1315 E. Washington Lane
5601 Chestnut St.
160-166 W. Chelten Ave.
City Line & Bryn Mawr Ave.
Broad St. & Wyoming Ave.

**World Communications Charter School**
Broad & South St.

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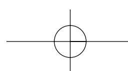

# OUR MISSION

THE PRIMARY MISSION OF UNITED BANK OF PHILADELPHIA, A COMMERCIAL BANK, IS TO DELIVER EXCELLENT CUSTOMER SERVICE AT A PROFIT AND TO MAKE UNITED BANK OF PHILADELPHIA THE "HOMETOWN" BANK OF CHOICE. OUR GOAL IS TO FOSTER COMMUNITY DEVELOPMENT BY PROVIDING QUALITY PERSONALIZED COMPREHENSIVE BANKING SERVICES TO BUSINESSES AND INDIVIDUALS IN THE GREATER PHILADELPHIA REGION, WITH A SPECIAL SENSITIVITY TO BLACKS, HISPANICS, ASIANS AND WOMEN.

**Corporate Office: 30 South 15th Street, Philadelphia, PA 19102**
**www.unitedbankofphiladelphia.com**