Sabre Corp
Form 10-Q
May 01, 2018

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 001-36422

Sabre Corporation
(Exact name of registrant as specified in its charter)

Delaware	20-8647322
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3150 Sabre Drive
Southlake, TX 76092
(Address, including zip code, of principal executive offices)
(682) 605-1000
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer”, “smaller reporting company”, and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

As of April 26, 2018, 275,740,537 shares of the registrant's common stock, par value $0.01 per share, were outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SABRE CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Revenue	$988,369	$915,353
Cost of revenue	692,857	607,586
Selling, general and administrative	130,111	144,441
Operating income	165,401	163,326
Other income (expense):		
Interest expense, net	(38,109)	(39,561)
Loss on extinguishment of debt	(633)	—
Joint venture equity income	1,171	898
Other, net	(1,106)	(15,234)
Total other expense, net	(38,677)	(53,897)
Income from continuing operations before income taxes	126,724	109,429
Provision for income taxes	36,275	31,707
Income from continuing operations	90,449	77,722
Loss from discontinued operations, net of tax	(1,207)	(477)
Net income	89,242	77,245
Net income attributable to noncontrolling interests	1,362	1,306
Net income attributable to common stockholders	$87,880	$75,939
Basic net income per share attributable to common stockholders:		
Income from continuing operations	$0.32	$0.28
Income from discontinued operations	—	—
Net income per common share	$0.32	$0.28
Diluted net income per share attributable to common stockholders:		
Income from continuing operations	$0.32	$0.27
Income from discontinued operations	—	—
Net income per common share	$0.32	$0.27
Weighted-average common shares outstanding:		
Basic	274,720	277,353
Diluted	276,844	279,559
Dividends per common share	$0.14	$0.14

See Notes to Consolidated Financial Statements.

SABRE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2018	2017
Net income	$89,242	$77,245
Other comprehensive income, net of tax:		
Foreign currency translation adjustments ("CTA"), net of tax		
Foreign CTA gains (losses), net of tax	2,975	(814)
Net change in foreign CTA gains (losses), net of tax	2,975	(814)
Retirement-related benefit plans:		
Amortization of prior service credits, net of tax	(278)	(358)
Amortization of actuarial losses, net of tax	1,397	1,875
Net change in retirement-related benefit plans, net of tax	1,119	1,517
Derivatives and available-for-sale securities:		
Unrealized gains, net of taxes of $(2,021) and $(844)	7,412	4,655
Reclassification adjustment for realized (losses) gains, net of taxes of $352 and $(915)	(1,749)	2,871
Net change in derivatives and available-for-sale securities, net of tax	5,663	7,526
Share of other comprehensive income (loss) of joint venture	129	(68)
Other comprehensive income	9,886	8,161
Comprehensive income	99,128	85,406
Less: Comprehensive income attributable to noncontrolling interests	(1,362)	(1,306)
Comprehensive income attributable to Sabre Corporation	$97,766	$84,100

See Notes to Consolidated Financial Statements.

SABRE CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	March 31, 2018	December 31, 2017
Assets		
Current assets		
Cash and cash equivalents	$361,103	$361,381
Accounts receivable, net	583,624	490,558
Prepaid expenses and other current assets	148,328	108,753
Total current assets	1,093,055	960,692
Property and equipment, net of accumulated depreciation of $1,306,875 and $1,236,523	791,662	799,194
Investments in joint ventures	27,962	27,527
Goodwill	2,557,025	2,554,987
Acquired customer relationships, net of accumulated amortization of $693,387 and $687,072	345,598	351,034
Other intangible assets, net of accumulated amortization of $605,270 and $594,015	320,916	332,171
Deferred income taxes	32,497	31,817
Other assets, net	615,837	591,942
Total assets	$5,784,552	$5,649,364
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$173,644	$162,755
Accrued compensation and related benefits	61,598	112,343
Accrued subscriber incentives	314,757	271,200
Deferred revenues	94,662	110,532
Other accrued liabilities	244,918	198,353
Current portion of debt	57,204	57,138
Tax Receivable Agreement	61,755	59,826
Total current liabilities	1,008,538	972,147
Deferred income taxes	147,127	99,801
Other noncurrent liabilities	395,882	480,185
Long-term debt	3,387,008	3,398,731
Commitments and contingencies (Note 11)		
Stockholders' equity		
Common Stock: $0.01 par value; 450,000 authorized shares; 290,912 and 289,138 shares issued, 275,732 and 274,342 shares outstanding at March 31, 2018 and December 31, 2017, respectively	2,909	2,891
Additional paid-in capital	2,190,401	2,174,187
Treasury Stock, at cost, 15,180 and 14,796 shares at March 31, 2018 and December 31, 2017, respectively	(350,317)	(341,846)
Retained deficit	(924,973)	(1,053,446)
Accumulated other comprehensive loss	(78,598)	(88,484)
Noncontrolling interest	6,575	5,198
Total stockholders' equity	845,997	698,500

Total liabilities and stockholders’ equity	$ 5,784,552	$ 5,649,364

See Notes to Consolidated Financial Statements.

SABRE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31, 2018	2017
Operating Activities		
Net income	$89,242	$77,245
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	101,876	105,670
Deferred income taxes	20,413	20,296
Amortization of upfront incentive consideration	19,456	16,132
Stock-based compensation expense	12,606	8,034
Allowance for doubtful accounts	2,396	2,476
Debt modification costs	1,558	11,730
Loss from discontinued operations	1,207	477
Joint venture equity income	(1,171)	(898)
Amortization of debt issuance costs	1,003	2,475
Dividends received from joint venture investments	865	—
Loss on extinguishment of debt	633	—
Other	4,252	848
Changes in operating assets and liabilities:		
Accounts and other receivables	(89,417)	(119,056)
Prepaid expenses and other current assets	8,482	(15,701)
Capitalized implementation costs	(11,484)	(17,096)
Upfront incentive consideration	(25,699)	(25,534)
Other assets	(1,816)	(15,967)
Accrued compensation and related benefits	(53,525)	(35,646)
Accounts payable and other accrued liabilities	98,675	69,188
Deferred revenue including upfront solution fees	15,640	38,362
Cash provided by operating activities	195,192	123,035
Investing Activities		
Additions to property and equipment	(64,699)	(88,318)
Cash used in investing activities	(64,699)	(88,318)
Financing Activities		
Payments on Tax Receivable Agreement	(58,908)	(99,241)
Cash dividends paid to common stockholders	(38,560)	(38,939)
Payments on borrowings from lenders	(11,828)	(1,844,553)
Net (payments) receipts on the settlement of equity-based awards	(4,797)	2,111
Debt issuance and modification costs	(1,567)	(10,055)
Proceeds of borrowings from lenders	—	1,897,625
Repurchase of common stock	—	(11,540)
Other financing activities	(12,811)	(3,196)
Cash used in financing activities	(128,471)	(107,788)
Cash Flows from Discontinued Operations		
Cash used in operating activities	(1,139)	(1,846)

Cash used in discontinued operations	(1,139)	(1,846)
Effect of exchange rate changes on cash and cash equivalents	(1,161)	(1,558)
Decrease in cash and cash equivalents	(278)	(76,475)
Cash and cash equivalents at beginning of period	361,381	364,114
Cash and cash equivalents at end of period	$361,103	$287,639

See Notes to Consolidated Financial Statements.

SABRE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. General Information
Sabre Corporation is a Delaware corporation formed in December 2006. On March 30, 2007, Sabre Corporation acquired Sabre Holdings Corporation (“Sabre Holdings”). Sabre Holdings is the sole subsidiary of Sabre Corporation. Sabre GLBL Inc. ("Sabre GLBL") is the principal operating subsidiary and sole direct subsidiary of Sabre Holdings. Sabre GLBL or its direct or indirect subsidiaries conduct all of our businesses. In these consolidated financial statements, references to “Sabre,” the “Company,” “we,” “our,” “ours” and “us” refer to Sabre Corporation and its consolidated subsidiaries unless otherwise stated or the context otherwise requires.
We connect people and places with technology that reimagines the business of travel. We operate our business and present our results through three business segments: (i) Travel Network, our global travel marketplace for travel suppliers and travel buyers, (ii) Airline Solutions, a broad portfolio of software technology products and solutions primarily for airlines, and (iii) Hospitality Solutions, an extensive suite of leading software solutions for hoteliers.
Basis of Presentation—The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these financial statements contain all adjustments, consisting of normal recurring accruals, necessary to present fairly the financial position, results of operations and cash flows for the periods indicated. Operating results for the three months ended March 31, 2018 are not necessarily indicative of results that may be expected for any other interim period or for the year ending December 31, 2018. The accompanying interim financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018.
Effective the first quarter of 2018, our business has three reportable segments and each segment now reflects a portion of our shared corporate costs that historically were not allocated to a business unit, based on relative consumption of shared technology infrastructure costs and defined revenue metrics. These changes have no impact on our consolidated results of operations, but result in a decrease of segment profitability only. Prior year amounts have been recast for the disaggregation of our segments and the modification of our allocation of shared corporate costs where applicable.
We consolidate all majority-owned subsidiaries and companies over which we exercise control through majority voting rights. No entities are consolidated due to control through operating agreements, financing agreements or as the primary beneficiary of a variable interest entity.
The consolidated financial statements include our accounts after elimination of all significant intercompany balances and transactions. All dollar amounts in the financial statements and the tables in the notes, except per share amounts, are stated in thousands of U.S. dollars unless otherwise indicated. All amounts in the notes reference results from continuing operations unless otherwise indicated.
Use of Estimates—The preparation of these interim financial statements in conformity with GAAP requires that certain amounts be recorded based on estimates and assumptions made by management. Actual results could differ from these estimates and assumptions. Our accounting policies, which consist of significant estimates and assumptions, include, among other things, the estimation of the collectability of accounts receivable, estimation of future cancellations of bookings processed through the Sabre global distribution system (“GDS”), revenue recognition for software arrangements, determination of the fair value of assets and liabilities acquired in a business combination, determination of the fair value of derivatives, the evaluation of the recoverability of the carrying value of intangible assets and goodwill, assumptions utilized in the determination of pension and other postretirement benefit liabilities, the evaluation of the recoverability of customer implementation costs, assumptions utilized to evaluate the recoverability of deferred customer advance and discounts, and estimation of uncertainties surrounding the calculation of our tax assets and liabilities. Our use of estimates and the related accounting policies are discussed in the consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K filed with the

SEC on February 16, 2018. Additionally, see Note 2. Revenue from Contracts with Customers for additional information on the use of significant estimates and assumptions in recognizing revenue.

Stockholders’ Equity—During the three months ended March 31, 2018, we issued 1,774,147 shares of our common stock as a result of the exercise and settlement of employee equity-based awards. In addition, we had $5 million in net payments from the exercise of employee stock-option awards, which included a $8 million payment of income tax withholdings associated with the settlement of employee restricted-stock awards. We paid quarterly cash dividends on our common stock of $0.14 per share, totaling $39 million, during each of the three months ended March 31, 2018 and 2017.

During the three months ended March 31, 2018, certain of our stockholders sold an aggregate of 15,000,000 shares of our common stock through a secondary public offering. We did not offer any shares or receive any proceeds from this secondary public offering.

Share Repurchase Program

In February 2017, we announced the approval of a multi-year share repurchase program to purchase up to $500 million of Sabre's common stock outstanding. Repurchases under the program may take place in the open market or privately negotiated transactions. Approximately $391 million remains authorized for repurchases under the Share Repurchase Program as of March 31, 2018. For the three months ended March 31, 2018, there were no shares repurchased pursuant to this share repurchase program.

Adoption of New Accounting Standards

In March 2017, the Financial Accounting Standards Board ("FASB") issued updated guidance improving the presentation requirements related to reporting the service cost component of net benefit costs to require that the service cost component be reported in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period, disaggregating the component from other net benefit costs. Net benefit cost is composed of several items, which reflect different aspects of an employer's financial arrangements as well as the cost of benefits earned by employees. The updated guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those annual periods for public business entities. We adopted this standard in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In February 2017, the FASB issued updated guidance on gains and losses from the derecognition of non-financial assets. The updated guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those annual periods for public business entities. We adopted this standard in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In January 2016, the FASB issued updated guidance on accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure for financial instruments. Under this updated standard, entities must measure equity investments at fair value and recognize changes in fair value in net income. For equity investments without readily determinable fair values, entities have the option to either measure these investments at fair value or at cost adjusted for changes in observable prices less impairment. The updated guidance does not apply to equity method investments or investments in consolidated subsidiaries. This new standard is effective for public companies for annual periods, including interim periods, beginning after December 15, 2017. We adopted this standard in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.

In May 2014, the FASB issued a comprehensive update to revenue recognition guidance that replaces current standards. Under the updated standard, revenue is recognized when a company transfers promised goods or services to customers in an amount that reflects the consideration that is expected to be received for those goods and services. The updated standard also requires additional disclosures on the nature, timing and uncertainty of revenue and related cash flows. On July 9, 2015, the FASB approved to defer the effective date of the new standard, which is now effective for annual and interim reporting periods beginning after December 15, 2017. In the first quarter of 2018, we adopted this new standard using the modified retrospective transition method, which resulted in a cumulative adjustment as of the date of the adoption. See Note 2. Revenue from Contracts with Customers for more information on the impacts from adoption and ongoing considerations.

Recent Accounting Pronouncements

In February 2018, the FASB issued updated guidance to give entities the option to reclassify to retained earnings the tax effects of items within accumulated other comprehensive income ("stranded tax effects") resulting from a reduction of the federal corporate income tax rate from 35% to 21% due to the Tax Cuts and Jobs Act (“TCJA”) signed into law in December 2017. The Accounting Standards Update ("ASU") is effective for annual periods beginning after December 15, 2018, with early adoption permitted. We plan to early adopt the updated standard and have elected to reclassify the stranded income tax effects related to the application of the TCJA to retained earnings and are in the process of evaluating the impact. We do not expect that the adoption of this updated standard will have a material impact on our consolidated results of operations and statement of cash flows. See Note 7. Income Taxes in our consolidated financial statements included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018 for additional information on the impacts from the enactment of the TCJA.

In August 2017, the FASB issued updated guidance to expand and simplify the application of hedge accounting. The updated standard eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The guidance also eases certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. The ASU is effective for annual periods beginning after December 15, 2018, with early adoption permitted. We do not expect that the adoption of this updated standard will have a material impact on our consolidated financial statements.

In February 2016, the FASB issued updated guidance requiring organizations that lease assets—referred to as "lessees"—to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases, when the lease has a term of more than 12 months. The updated standard is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the impact of this standard on our consolidated financial statements.

2. Revenue from Contracts with Customers

In the first quarter of 2018, we adopted the comprehensive update to revenue recognition guidance for Revenue from Contracts with Customers ("ASC 606"), which replaced the previous standard ("ASC 605"), using the modified retrospective approach, applied to contracts that were not completed as of the adoption date. Under ASC 606, revenue is recognized when a company transfers the promised goods or services to customers in an amount that reflects the consideration that is expected to be received for those goods and services. The key areas of impact on our financials include:

• Revenue recognition for our Travel Network and Hospitality Solutions businesses did not change significantly. The definition of a performance obligation for Travel Network under the new guidance impacts the calculation for our booking fee cancellation reserve, which resulted in a beginning balance sheet adjustment.

• Our Airline Solutions business is primarily impacted by ASC 606 due to the following:

- Under ASC 605, we recognized revenue related to license fee and maintenance agreements ratably over the life of the contract. Under ASC 606, revenue for license fees is recognized upon delivery of the license and ongoing maintenance services are to be recognized ratably over the life of the contract. For existing open agreements, this change resulted in a beginning balance sheet adjustment and reduced revenue in subsequent years from these agreements.
- Allocation of contract revenues among various products and solutions, and the timing of the recognition of those revenues, are impacted by agreements with tiered pricing or variable rate structures that do not correspond with the goods or services delivered to the customer. For existing open agreements, this change resulted in a beginning balance sheet adjustment and reduced revenue in subsequent years from these agreements.

• Capitalization of incremental contract acquisition costs (such as sales commissions), and recognition of these costs over the customer benefit period resulted in the recognition of an asset on our balance sheet and impacted our Airline Solutions and Hospitality Solutions businesses.

Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts have not been adjusted and continue to be reported in accordance with ASC 605. The impacts described above resulted in a net reduction to our opening retained deficit as of January 1, 2018 of approximately $102 million (net of tax, $78 million) with a corresponding increase primarily in current and long-term unbilled receivables, contract assets, other assets and other accrued liabilities.

The following tables set forth the impact of the adoption of the revenue recognition standard to our reported results on our consolidated statement of operations and consolidated balance sheet, respectively (in thousands):

	Three Months Ended March 31, 2018		
	As reported ASC 606	Adjustments	ASC 605
Revenue	$988,369	$ 3,202	$991,571
Cost of Revenue	692,857	2,135	694,992
Selling, general and administrative	130,111	597	130,708
Operating income	165,401	470	165,871
Income from continuing operations before income taxes	126,724	470	127,194
Provision for income taxes	36,275	118	36,393
Income from continuing operations	90,449	352	90,801
Net income	89,242	352	89,594
Net income attributable to common stockholders	87,880	352	88,232

	March 31, 2018		
	As reported ASC 606	Adjustments	ASC 605
Accounts receivable, net	$583,624	$ (32,916)	$550,708
Prepaid expenses and other current assets	148,328	(23,203)	125,125
Total current assets	1,093,055	(56,119)	1,036,936
Other assets, net	615,837	(11,416)	604,421
Total assets	5,784,552	(67,535)	5,717,017
Accrued subscriber incentives	314,757	5,257	320,014
Deferred revenues	94,662	56,669	151,331
Other accrued liabilities	244,918	(28,657)	216,261
Total current liabilities	1,008,538	33,269	1,041,807
Deferred income taxes	147,127	(22,982)	124,145
Other noncurrent liabilities	395,882	467	396,349
Retained deficit	(924,973)	(78,289)	(1,003,262)
Total stockholders' equity	845,997	(78,289)	767,708
Total liabilities and stockholders' equity	5,784,552	(67,535)	5,717,017

Contract Balances

Revenue recognition for a significant portion of our revenue coincides with normal billing terms, including Travel Network's transactional revenues, and Airline Solutions' and Hospitality Solutions' Software-as-a-Service ("SaaS") and hosted revenues. Timing differences among revenue recognition, unconditional rights to bill, and receipt of contract consideration may result in contract assets or contract liabilities. Contract liabilities are included within deferred revenues and other noncurrent liabilities on the consolidated balance sheet. Contract liabilities totaled $158 million and $173 million as of January 1, 2018 and March 31, 2018, respectively. During the three months ended March 31, 2018, we recognized revenue of approximately $11 million from contract liabilities that existed as of January 1, 2018. Contract assets are included within prepaid expenses and other current assets and other assets, net on the consolidated balance sheet. The following table presents the changes in our contract assets balance (in thousands):

Contract assets as of January 1, 2018	$75,624
Additions	6,588
Deductions	(5,133)
Contract assets as of March 31, 2018	$77,079

Our contract assets include deferred customer advances and discounts, which are capitalized and amortized in future periods as the related revenue is earned. The contract assets also include revenue recognized for services already transferred to a customer, for which the fulfillment of another contractual performance obligation is required, before we have the unconditional right to bill and collect based on contract terms. These assets are reviewed for recoverability on a periodic basis based on review of impairment indicators. For the three months ended March 31, 2018, we did not impair any of our contract assets as a result of the related contract becoming uncollectable, modified or canceled. Our trade accounts receivable, net recorded in accounts receivable, net on the consolidated balance sheet as of March 31, 2018 and January 1, 2018 was $577 million and $506 million, respectively. Our long-term trade unbilled receivables, net recorded in other assets, net on the consolidated balance sheet as of March 31, 2018 and January 1, 2018 was $53 million and $54 million, respectively. We evaluate collectability of our accounts receivable based on a combination of factors and record reserves as reflected in Note 1. Summary of Business and Significant Accounting Policies in our consolidated financial statements in our Annual Report on Form 10-K filed with the SEC on February 16, 2018.

We may occasionally recognize revenue in the current period for performance obligations partially or fully satisfied in the previous periods resulting from changes in estimates for the transaction price, including any changes to our assessment of whether an estimate of variable consideration is constrained. For the three months ended March 31, 2018, the impact on revenue recognized in the current period, from performance obligations partially or fully satisfied in the previous period, is immaterial.

Performance Obligations

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account under the new revenue recognition standard. The transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. Most of our contracts in the Travel Network and Hospitality Solutions businesses have a single performance obligation. In the Airline Solutions business, many of our contracts may have multiple performance obligations, which generally include software and product solutions through SaaS and hosted delivery, and other service fees. In addition, at times we enter into agreements with customers to provide access to Travel Network’s GDS and, at or near the same time, enter into a separate agreement to provide Airline Solutions' software solutions through SaaS and hosted delivery, resulting in multiple performance obligations within a combined agreement.

For contracts with multiple performance obligations where the contracted price differs from the standalone selling price ("SSP") for any distinct good or service, we may be required to allocate the contract's transaction price to each performance obligation using our best estimate for the SSP. SSP is assessed annually using a historical analysis of contracts with customers executed in the most recently completed calendar year to determine the range of selling prices applicable to distinct good or service. In making these judgments, we analyze various factors, including value differentiators, customer segmentation and overall market and economic conditions. Based on these results, the estimated SSP is set for each distinct product or service delivered to customers.

We recognize revenue under long-term contracts that primarily includes variable consideration based on transactions processed. A majority of our consolidated revenue is recognized as a stand-ready performance obligation with the amount recognized based on the invoiced amounts for services performed, known as right to invoice revenue recognition. Certain of our contracts, primarily in the Airlines Solutions business, contain minimum transaction volumes, which in many instances are not considered substantive as the customer is expected to exceed the minimum in the contract. Unearned performance obligations primarily consist of deferred revenue for fixed implementation fees and future product implementations, which are included in deferred revenue and other noncurrent liabilities in our consolidated balance sheet. We have not disclosed the performance obligation related to contracts containing minimum transaction volume, as it represents a subset of our business, and therefore would not be meaningful in understanding the total future revenues expected to be earned from our long term contracts. See the discussion below regarding revenue recognition of our various revenue streams for more information.

Revenue Recognition

Travel Network and Hospitality Solutions' revenue recognition is primarily driven by GDS and central reservation system ("CRS") transactions, respectively. Airline Solutions' revenue recognition is primarily driven by passengers boarded or other variable metrics relevant to the software service provided. Timing of revenue recognition is based on the consistent provision of services in a stand-ready series SaaS environment and the amount of revenue recognized varies with the volume of transactions processed. Our significant product and services and methods of recognition are as follows:

Stand-ready series revenue recognition

Travel Network—Travel Network's service offering is a GDS or GDS services linking and engaging transactions between travel agents (those that seek travel on behalf of travelers) and travel suppliers (such as airlines, hotels, car rental companies and cruise lines). Revenue is generated from contracts with the travel suppliers as each booking is made or transaction occurs and represents a stand-ready performance obligation where our systems perform the same service each day for the customer, based on the customer's level of usage. Variability in the amounts billed to the customer and revenue recognized coincides with the customer's level of usage or value received by the customer. Travel Network's revenue for air transactions is recognized at the time of booking of the reservation, net of estimated future cancellations. Travel Network's revenue for car rental, hotel transactions and other travel providers is recognized at the time the reservation is used by the customer.

Airline Solutions and Hospitality Solutions—Airline Solutions and Hospitality Solutions provide technology solutions and other professional services to airlines, hotels and other business consumers in the travel industry. The technology solutions are primarily provided in a SaaS or hosted environment. Customers are normally charged an upfront solutions fee and a recurring usage-based fee for the use of the software, which represents a stand-ready performance obligation where our systems perform the same service each day for the customer, based on the customer's level of usage. Upfront solutions fees are recognized primarily on a straight-line basis over the relevant contract term, upon cut-over of the primary SaaS solution. Variability in the usage-based fee that does not align with the value provided to the customer can result in a difference between billings to the customer and the timing of contract performance and revenue recognition. This may result in a requirement to forecast expected usage-based fees and volumes over the contract term in order to determine rate for revenue recognition. This variable consideration is constrained if there is an inability to reliably forecast this revenue.

Other revenue recognition patterns

Airline Solutions also provides other services including development labor or professional consulting. These services can be sold separately or with other products and services, and Airline Solutions may bundle multiple technology solutions in one arrangement with these other services. Revenue from other services consisting of development services that represent minor configuration or professional consulting is generally recognized over the period the services are performed or upon completed delivery.

Airline Solutions also directly licenses certain software to its customers where the customer obtains control of the license. Revenue from software license fees is recognized when the customer gains control of the software enabling them to directly use the software and obtain substantially all of the remaining benefits. Fees for ongoing software maintenance are recognized ratably over the life of the contract. Under these arrangements, often we are entitled to minimum fees which are collected over the term of the agreement, while the revenue from the license is recognized at the point when the customer gains control, which results in current and long-term unbilled receivables for these arrangements.

Variability in the amounts billed to the customer and revenue recognized coincides with the customer’s level of usage with the exception of upfront solution fees, variable consideration, license and maintenance agreements and other services including development labor and professional consulting. Contracts with the same customer which are entered into at or around the same period are analyzed for revenue recognition purposes on a combined basis across our businesses which can impact our revenue recognized.

Revenue recognition from our Airline Solutions business requires significant judgments such as identifying distinct performance obligations including material rights within an agreement, estimation of SSP, determination of whether variable pricing within a contract meets the allocation objective and forecasting future volumes. For a small subset of our contracts, we are required to forecast volumes as a result of pricing variability within the contract in order to calculate the net effective rate. Any changes in these judgments and estimates could have an impact on the revenue recognized in future periods.

We evaluate whether it is appropriate to record the gross amount of our revenues and related costs by considering whether the entity is a principal (gross presentation) or an agent (net presentation) by evaluating the nature of our promise to the customer. We report revenue net of any revenue based taxes assessed by governmental authorities that are imposed on and concurrent with specific revenue producing transactions.

The following table presents our revenues disaggregated by business (in thousands):

	Three Months Ended March 31, 2018
Air	$ 593,245
Lodging, Ground and Sea	84,117
Other	43,774
Total Travel Network	721,136
SabreSonic Passenger Reservation System	120,022
Commercial and Operations Solutions	84,568
Other	2,013
Total Airline Solutions[(1)]	206,603
SynXis Software and Services	60,270
Other	7,858
Total Hospitality Solutions	68,128
Eliminations	(7,498)
Total Sabre Revenue	$ 988,369

(1) Revenue recognized upon delivery of a license to certain software from our Airline Solutions business for the three months ended March 31, 2018 was immaterial.

Contract Costs

We incur contract acquisition costs related to new contracts with our customers in the form of sales commissions based on estimated contract value for our Airline Solutions and Hospitality Solutions businesses. These costs are capitalized, and our capitalization policy for these costs includes an annual review of the historical costs incurred to specifically obtain a new contract, as a percentage of total costs, to determine the capitalized amount for the annual period. We generally amortize these costs over the average contract term for those businesses, excluding commissions on contracts with a term of one year or less, which are generally expensed in the period earned and recorded within selling, general and administrative expenses. We also capitalize contract fulfillment costs, also referred to as capitalized implementation costs. We periodically assess capitalized implementation costs for recoverability, and our assessment did not result in an impairment for the three months ended March 31, 2018. See Note 1. Summary of

Business and Significant Accounting Policies in our consolidated financial statements included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018 for an overview of our policy for capitalization of implementation costs. The following table presents the changes in contract acquisition costs and capitalized implementation costs (in thousands):

	Three Months Ended March 31, 2018
Contract acquisition costs:	
Beginning balance (1/1/2018)	$19,353
Additions	2,443
Amortization	(1,513)
Ending balance	$20,283
Capitalized implementation costs:	
Beginning balance (1/1/2018)	$194,501
Additions	11,484
Amortization	(10,017)
Other	(378)
Ending balance	$195,590

Practical Expedients and Exemptions

There are several practical expedients and exemptions allowed under ASC 606 that impact timing of revenue recognition and our disclosures. Below is a list of practical expedients we applied in the adoption and application of ASC 606:

Application

- When we have a right to receive consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, we recognize revenue in the amount to which we have a right to invoice.
- We apply the allocation objective expedient where applicable, which precludes the requirement to allocate revenue across multiple performance obligations based on total transaction price.
- We do not evaluate a contract for a significant financing component if payment is expected within one year or less from the transfer of the promised items to the customer.
- We generally expense sales commissions when incurred when the amortization period would have been one year or less. These costs are recorded within selling, general and administrative expenses. We also used the practical expedient to calculate contract acquisition costs based on a portfolio of contracts with similar characteristics instead of a contract by contract analysis.

Modified Retrospective Transition Adjustments

- For contract modifications, we reflected the aggregate effect of all modifications that occurred prior to the adoption date when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to satisfied and unsatisfied performance obligations for the modified contract at transition.

3. Impairment and Related Charges

Capitalized implementation costs and deferred customer advances and discounts (now referred to as contract assets) are reviewed for impairment if events and circumstances indicate that their carrying amounts may not be recoverable. See Note 1. Summary of Business and Significant Accounting Policies and Note 4. Impairment and Related Charges in our consolidated financial statements included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018 for more information. During the year ended December 31, 2017, we evaluated the recoverability of net capitalized contract costs related to an Airline Solutions' customer and recorded a charge of $81 million. Given the uncertainty associated with the ultimate resolution of the dispute with the customer, there could be further adjustments to our consolidated statement of operations. For the three months ended March 31, 2018, there have been no adjustments to amounts previously recorded in 2017.

4. Income Taxes

On December 22, 2017, the TCJA was signed into law. The TCJA contains significant changes to the U.S. corporate income tax system, including a reduction of the federal corporate income tax rate from 35% to 21%, a limitation of the tax deduction for interest expense to 30% of adjusted taxable income (as defined in the TCJA), base erosion and anti-avoidance tax ("BEAT"), foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI"), one-time taxation of offshore earnings at reduced rates in connection with the transition of U.S. international taxation from a worldwide tax system to a territorial tax system, elimination of U.S. tax on foreign earnings (subject to certain important exceptions), and modifying or repealing many business deductions and credits. As of March 31, 2018, we have neither completed nor made changes to our December 31, 2017 accounting of the tax effects of the enactment of the TCJA due to complexities of the TCJA, pending clarifications and additional information needed to finalize certain calculations. We recorded a reasonable estimate in our results of operations for the year ended December 31, 2017 of the effects on our existing deferred tax balances, the one-time transition tax and the effect of the TCJA on our liability related to the tax receivable agreement ("TRA"). See Note 7. Income Taxes in our consolidated financial statements included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018 for more information. We expect to finalize the accounting for the effects of the TCJA no later than the fourth quarter of 2018, in accordance with Securities and Exchange Commission ("SEC") Staff Accounting Bulletin No. 118 ("SAB 118"). Future adjustments made to the provisional effects will be reported as a component of income tax expense from continuing operations in the reporting period in which any such adjustments are determined.

Our effective tax rates for each of the three months ended March 31, 2018 and 2017 were 29%. A relative increase in full-year forecasted earnings across all operating jurisdictions was offset by a net decrease in the effective tax rate due to the impacts of the TCJA for the three months ended March 31, 2018 as compared to the same period in 2017. The difference between our effective tax rates and the U.S. federal statutory income tax rate primarily results from our geographic mix of taxable income in various tax jurisdictions.

We recognize liabilities when we believe that an uncertain tax position may not be fully sustained upon examination by the tax authorities. This requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. When facts and circumstances change, we reassess these probabilities and record any changes in the consolidated financial statements as appropriate. In the first quarter of 2018, we recognized a tax benefit of $1 million associated with the net reversal of income tax reserves across our jurisdictions. Our net unrecognized tax benefits, excluding interest and penalties, included in our consolidated balance sheets, were $73 million and $74 million as of March 31, 2018 and December 31, 2017, respectively.

Tax Receivable Agreement

Immediately prior to the closing of our initial public offering in April 2014, we entered into the TRA, which provides the right to receive future payments from us to stockholders and equity award holders that were our stockholders and equity award holders, respectively, immediately prior to the closing of our initial public offering (collectively, the “Pre-IPO Existing Stockholders”). The future payments will equal 85% of the amount of cash savings, if any, in U.S. federal income tax that we and our subsidiaries realize as a result of the utilization of certain tax assets attributable to periods prior to our initial public offering, including federal net operating losses (“NOLs”), capital losses and the ability to realize tax amortization of certain intangible assets (collectively, the “Pre-IPO Tax Assets”). Consequently, stockholders who are not Pre-IPO Existing Stockholders will only be entitled to the economic benefit of the Pre-IPO Tax Assets to the extent of our continuing 15% interest in those assets. These payment obligations are our obligations and not obligations of any of our subsidiaries. The actual utilization of the Pre-IPO Tax Assets, as well as the timing of any payments under the TRA, will vary depending upon a number of factors, including the amount, character and timing of our and our subsidiaries’ taxable income in the future.

Based on current tax laws and assuming that we and our subsidiaries earn sufficient taxable income to realize the full tax benefits subject to the TRA, we estimate that payments under the TRA relating to the Pre-IPO Tax Assets total $328 million, excluding interest. This includes a provisional reduction recorded in the fourth quarter of 2017 of $60 million in the TRA liability primarily resulting from the enactment of TCJA which reduced the U.S. corporate income tax rate. The TRA payments accrue interest in accordance with the terms of the TRA. The estimate of future payments considers the impact of Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), which imposes an annual limit on the ability of a corporation that undergoes an ownership change to use its net operating loss carryforwards ("NOLs") to reduce its liability. We do not anticipate any material limitations on our ability to utilize NOLs under Section 382 of the Code. We expect a majority of the future payments under the TRA to be made over the next two years. We made payments of $60 million and $101 million, which included accrued interest of approximately $1 million each year, in January 2018 and 2017, respectively. As of March 31, 2018, the current portion of our TRA liability totaled $62 million and the remaining portion of $108 million, which includes less than $1 million of accrued interest, is included in other noncurrent liabilities in our consolidated balance sheet as of March 31, 2018. Payments under the TRA are not conditioned upon the parties’ continuing ownership of the company. Changes in the utility of the Pre-IPO Tax Assets will impact the amount of the liability recorded in respect of the TRA. Changes in the utility of these Pre-IPO Tax Assets are recorded in income tax expense and any changes in the obligation under the TRA are recorded in other expense.

5. Debt

As of March 31, 2018 and December 31, 2017, our outstanding debt included in our consolidated balance sheets totaled $3,444 million and $3,456 million, respectively, which are net of debt issuance costs of $21 million and $23 million, respectively, and unamortized discounts of $9 million for each period presented. The following table sets forth the face values of our outstanding debt as of March 31, 2018 and December 31, 2017 (in thousands):

	Rate	Maturity	March 31, 2018	December 31, 2017
Senior secured credit facilities:				
Term Loan A	L + 2.00%	July 2022	$548,625	$555,750
Term Loan B[(1)]	L + 2.00%	February 2024	1,876,345	1,881,048
Revolver, $400 million	L + 2.00%	July 2022	—	—
5.375% senior secured notes due 2023	5.375%	April 2023	530,000	530,000

5.25% senior secured notes due 2023	5.25%	November 2023	500,000	500,000
Capital lease obligations			19,381	21,235
Face value of total debt outstanding			3,474,351	3,488,033
Less current portion of debt outstanding			(57,204)	(57,138)
Face value of long-term debt outstanding			$3,417,147	$3,430,895

(1) Pursuant to the March 2, 2018 refinancing, the interest rate on the Term Loan B was reduced from L+2.25% to L+2.00%.

Senior Secured Credit Facilities

In February 2013, Sabre GLBL entered into the Amended and Restated Credit Agreement. The agreement replaced (i) the existing term loans with new classes of term loans of $1,775 million (the “2013 Term Loan B”) and $425 million (the “2013 Term Loan C”) and (ii) the existing revolving credit facility with a new revolving credit facility of $352 million (the “2013 Revolver”). In September 2013, Sabre GLBL entered into an agreement to amend the Amended and Restated Credit Agreement to add a new class of term loans in the amount of $350 million (the “2013 Incremental Term Loan Facility”).

In July 2016, Sabre GLBL entered into a series of amendments (the “Credit Agreement Amendments”) to our Amended and Restated Credit Agreement to provide for an incremental term loan under a new class with an aggregate principal amount of $600 million (the “2016 Term Loan A”) and to replace the 2013 Revolver with a new revolving credit facility totaling $400 million (the “2016 Revolver”). The proceeds of $597 million, net of $3 million discount, from the 2016 Term Loan A, were used to repay $350 million of outstanding principal on our 2013 Term Loan B and 2013 Incremental Term Loan Facility, on a pro rata basis, repay the $120 million then-outstanding balance on the 2016 Revolver, and pay $11 million in associated financing fees. We recognized a $4 million loss on extinguishment of debt in connection with these transactions during the year ended December 31, 2016.

On February 22, 2017, Sabre GLBL entered into a Third Incremental Term Facility Amendment to our Amended and Restated Credit Agreement (the “2017 Term Facility Amendment”). The new agreement replaced the 2013 Term Loan B, 2013 Incremental Term Loan Facility and 2013 Term Loan C with a single class of term loan (the "2017 Term Loan B") with an aggregate principal amount of $1,900 million maturing on February 22, 2024. The proceeds of $1,898 million, net of $2 million discount on the 2017 Term Loan B, were used to pay off approximately $1,761 million of all existing classes of outstanding term loans (other than the 2016 Term Loan A), pay related accrued interest and pay $12 million in associated financing fees, which were recorded as debt modification costs in Other, net in the consolidated statement of operations during the three months ended March 31, 2017. The remaining proceeds of the 2017 Term Loan B were used to pay off approximately $80 million of Sabre’s outstanding mortgage on its corporate headquarters on March 31, 2017, and for other general corporate purposes. Unamortized debt issuance costs and discount related to existing classes of outstanding term loans prior to the 2017 Term Facility Amendment of $9 million and $3 million, respectively, will continue to be amortized over the remaining term of the 2017 Term Loan B along with the Term Loan B discount of $2 million. See Note 6. Derivatives for information regarding the discontinuation of hedge accounting related to our existing interest rate swaps as a result of the 2017 Term Facility Amendment.

On August 23, 2017, Sabre GLBL entered into a Fourth Incremental Term Facility Amendment to our Amended and Restated Credit Agreement, Term Loan A Refinancing Amendment to the Credit Agreement, and Second Revolving Facility Refinancing Amendment to the Credit Agreement to refinance and modify the terms of the 2017 Term Loan B, the 2016 Term Loan A, and the 2016 Revolver, resulting in a reduction of the applicable margins for each of these instruments and approximately a one-year extension of the maturity of the 2016 Term Loan A and 2016 Revolver (the “2017 Refinancing”). We incurred no additional indebtedness as a result of the 2017 Refinancing. The 2017 Refinancing included a $400 million revolving credit facility ("Revolver") that replaced the 2016 Revolver, as well as the application of the proceeds of the approximately $1,891 million incremental Term Loan B facility (“Term Loan B”) and $570 million Term Loan A facility (“Term Loan A”) to replace the 2017 Term Loan B and the 2016 Term Loan A. The maturity of the Revolver and the Term Loan A was extended from July 18, 2021 to July 1, 2022. The applicable margins for the Term Loan B were reduced to 2.25% per annum for Eurocurrency rate loans and 1.25% per annum for base rate loans. The applicable margins for the Term Loan A and the Revolver were reduced to (i) between 2.50% and 1.75% per annum for Eurocurrency rate loans and (ii) between 1.50% and 0.75% per annum for base rate loans, in each case with the applicable margin for any quarter reduced by 25 basis points (up to 75 basis points total) if the Senior Secured First-Lien Net Leverage Ratio (as defined in the Amended and Restated Credit Agreement) is less than 3.75 to 1.0, 3.00 to 1.0, or 2.25 to 1.0, respectively.

On March 2, 2018, Sabre GLBL entered into a Fifth Incremental Term Facility Amendment to our Amended and Restated Credit Agreement to refinance and modify the terms of the Term Loan B, resulting in a reduction of the applicable margins for the Term Loan B to 2.00% per annum for Eurocurrency rate loans and 1.00% per annum for base rate loans. We incurred no additional indebtedness as a result of this transaction and incurred $2 million in financing fees recorded within Other, net and a $1 million loss on extinguishment of debt, in our consolidated results of operations during the three months ended March 31, 2018.

We had no balance outstanding under the Revolver as of March 31, 2018 and as of December 31, 2017. We had outstanding letters of credit totaling $17 million and $21 million as of March 31, 2018 and December 31, 2017, respectively, which reduced our overall credit capacity under the Revolver.

6. Derivatives

Hedging Objectives—We are exposed to certain risks relating to ongoing business operations. The primary risks managed by using derivative instruments are foreign currency exchange rate risk and interest rate risk. Forward contracts on various foreign currencies are entered into to manage the foreign currency exchange rate risk on operational expenditures' exposure denominated in foreign currencies. Interest rate swaps are entered into to manage interest rate risk associated with our floating-rate borrowings.

In accordance with authoritative guidance on accounting for derivatives and hedging, we designate foreign currency forward contracts as cash flow hedges on operational exposure and certain interest rate swaps as cash flow hedges of floating-rate borrowings.

Cash Flow Hedging Strategy—To protect against the reduction in value of forecasted foreign currency cash flows, we hedge portions of our revenues and expenses denominated in foreign currencies with forward contracts. For example, when the dollar strengthens significantly against the foreign currencies, the decline in present value of future foreign currency expense is offset by losses in the fair value of the forward contracts designated as hedges. Conversely, when the dollar weakens, the increase in the present value of future foreign currency expense is offset by gains in the fair value of the forward contracts.

We enter into interest rate swap agreements to manage interest rate risk exposure. The interest rate swap agreements modify our exposure to interest rate risk by converting floating-rate debt to a fixed rate basis, thus reducing the impact of interest rate changes on future interest expense and net earnings. These agreements involve the receipt of floating rate amounts in exchange for fixed rate interest payments over the life of the agreements without an exchange of the underlying principal amount.

For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income (loss) (“OCI”) and reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any (ineffective portion), and hedge components excluded from the assessment of effectiveness, are recognized in Other, net in the consolidated statements of operations during the current period. Derivatives not designated as hedging instruments are carried at fair value with changes in fair value reflected in Other, net in the consolidated statements of operations.

Forward Contracts—In order to hedge our operational expenditures' exposure to foreign currency movements, we are a party to certain foreign currency forward contracts that extend until March 2019. We have designated these instruments as cash flow hedges. No hedging ineffectiveness was recorded in earnings relating to the forward contracts during the three months ended March 31, 2018 and 2017. As of March 31, 2018, we estimate that $5 million in gains will be reclassified from other comprehensive income (loss) to earnings over the next 12 months.

As of March 31, 2018 and December 31, 2017, we had the following unsettled purchased foreign currency forward contracts that were entered into to hedge our operational exposure to foreign currency movements (in thousands, except for average contract rates):

Outstanding Notional Amounts as of March 31, 2018

Buy Currency	Sell Currency	Foreign Amount	USD Amount	Average Contract Rate
Polish Zloty	US Dollar	211,700	59,612	0.2816
Singapore Dollar	US Dollar	67,500	50,431	0.7471
British Pound Sterling	US Dollar	23,800	32,444	1.3632
Indian Rupee	US Dollar	1,515,000	22,783	0.015
Australian Dollar	US Dollar	23,900	18,462	0.7725
Swedish Krona	US Dollar	55,200	6,764	0.1225
Brazilian Real	US Dollar	21,950	6,468	0.2947

Outstanding Notional Amounts as of December 31, 2017

Buy Currency	Sell Currency	Foreign Amount	USD Amount	Average Contract Rate
Polish Zloty	US Dollar	225,000	61,016	0.2712
Singapore Dollar	US Dollar	70,750	52,065	0.7359
British Pound Sterling	US Dollar	25,900	34,307	1.3246
Indian Rupee	US Dollar	1,720,000	25,939	0.0151
Australian Dollar	US Dollar	20,750	15,932	0.7678
Swedish Krona	US Dollar	44,100	5,353	0.1214
Brazilian Real	US Dollar	16,800	4,976	0.2962

Interest Rate Swap Contracts—Interest rate swaps outstanding during the three months ended March 31, 2018 and 2017 are as follows:

Notional Amount	Interest Rate Received	Interest Rate Paid	Effective Date	Maturity Date
Designated as Hedging Instrument				
$750 million	1 month LIBOR(2)	1.15%	March 31, 2017	December 31, 2017
$750 million	1 month LIBOR(2)	1.65%	December 29, 2017	December 31, 2018
$750 million	1 month LIBOR(2)	2.08%	December 31, 2018	December 31, 2019
$750 million	1 month LIBOR(2)	1.86%	December 31, 2019	December 31, 2020

Not Designated as Hedging Instrument[1]				
$750 million	1 month LIBOR[3]	2.19%	December 30, 2016	December 29, 2017
$750 million	1.18%	1 month LIBOR	March 31, 2017	December 31, 2017
$750 million	1 month LIBOR[3]	2.61%	December 29, 2017	December 31, 2018
$750 million	1.67%	1 month LIBOR	December 29, 2017	December 31, 2018

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(1) Subject to a 1% floor.
(2) Subject to a 0% floor.
(3) As of February 22, 2017.

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As a result of the 2017 Term Facility Amendment in the first quarter of 2017, we discontinued hedge accounting for our existing swap agreements as of February 22, 2017. Accumulated losses of $14 million in other comprehensive income as of the date hedge accounting was discontinued is amortized into interest expense through the maturity date of the respective swap agreements, and interest rate swap payments made are recorded in Other, net in the consolidated statement of operations. Losses reclassified from other comprehensive income to interest expense related to the derivatives that no longer qualified for hedge accounting were $2 million for the three months ended March 31, 2018 and were immaterial for the three months ended March 31, 2017. We also entered into new interest rate swaps with offsetting terms that are not designated as hedging instruments. Adjustments to the fair value of interest rate swaps not designated as hedging instruments did not have a material impact to our consolidated results of operations for the three months ended March 31, 2018 and 2017.

In connection with the 2017 Term Facility Amendment, we entered into new forward starting interest rate swaps effective March 31, 2017 to hedge the interest payments associated with $750 million of the floating-rate 2017 Term Loan B. The total notional amount outstanding is $750 million in the remaining nine months of 2018 and the full year 2019. In September 2017, we entered into new forward starting interest rate swaps to hedge the interest payments associated with $750 million of the floating-rate Term Loan B. The total notional outstanding of $750 million becomes effective December 31, 2019 and extends through the full year 2020. We have designated these swaps as cash flow hedges. The effective portion of changes in the fair value of the interest rate swaps is reported as a component of other comprehensive income (loss) and reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings.

The estimated fair values of our derivatives designated as hedging instruments as of March 31, 2018 and December 31, 2017 are as follows (in thousands):

	Derivative Assets (Liabilities)		
		Fair Value as of	
Derivatives Designated as Hedging Instruments	Consolidated Balance Sheet Location	March 31, 2018	December 31, 2017
Foreign exchange contracts	Prepaid expenses and other current assets	$ 5,040	$ 6,213
Foreign exchange contracts	Other accrued liabilities	(163)	—
Interest rate swaps	Prepaid expenses and other current assets	2,854	856
Interest rate swaps	Other assets, net	8,571	3,093
		$ 16,302	$ 10,162

	Derivative Assets (Liabilities)		
		Fair Value as of	
Derivatives Not Designated as Hedging Instruments	Consolidated Balance Sheet Location	March 31, 2018	December 31, 2017
Interest rate swaps	Other accrued liabilities	$(5,403)	$ (7,119)
		$(5,403)	$ (7,119)

The effects of derivative instruments, net of taxes, on OCI for the three months ended March 31, 2018 and 2017 are as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in OCI on Derivative, Effective Portion Three Months Ended March 31, 2018	2017
Foreign exchange contracts	$2,363	$5,121
Interest rate swaps	5,548	(665)
Total	$7,911	$4,456

Derivatives in Cash Flow Hedging Relationships	Income Statement Location	Amount of (Gain) Loss Reclassified from Accumulated OCI into Income, Effective Portion Three Months Ended March 31, 2018	2017
Foreign exchange contracts	Cost of revenue	$(3,311)	$1,519
Interest rate swaps	Interest expense, net	1,562	1,352
Total		$(1,749)	$2,871

7. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or most advantageous market for that asset or liability. Guidance on fair value measurements and disclosures establishes a valuation hierarchy for disclosure of inputs used in measuring fair value defined as follows:

Level 1-Inputs are unadjusted quoted prices that are available in active markets for identical assets or liabilities.
Level 2-Inputs include quoted prices for similar assets and liabilities in active markets and quoted prices in non-active markets, inputs other than quoted prices that are observable, and inputs that are not directly observable, but are corroborated by observable market data.
Level 3-Inputs that are unobservable and are supported by little or no market activity and reflect the use of significant management judgment.
The classification of a financial asset or liability within the hierarchy is determined based on the least reliable level of input that is significant to the fair value measurement. In determining fair value, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. We also consider the counterparty and our own non-performance risk in our assessment of fair value.
Assets and Liabilities that are Measured at Fair Value on a Recurring Basis
Foreign Currency Forward Contracts—The fair value of the foreign currency forward contracts is estimated based upon pricing models that utilize Level 2 inputs derived from or corroborated by observable market data such as currency spot and forward rates.
Interest Rate Swaps—The fair value of our interest rate swaps are estimated using a combined income and market-based valuation methodology based upon Level 2 inputs, including credit ratings and forward interest rate yield curves obtained from independent pricing services reflecting broker market quotes.
The following tables present our assets (liabilities) that are required to be measured at fair value on a recurring basis as of March 31, 2018 and December 31, 2017 (in thousands):

		Fair Value at Reporting Date Using		
	March 31, 2018	Level 1	Level 2	Level 3
Derivatives:				
Foreign currency forward contracts	$ 4,877	$ —	$ 4,877	$ —
Interest rate swap contracts	6,022	—	6,022	—
Total	$ 10,899	$ —	$ 10,899	$ —

		Fair Value at Reporting Date Using		
	December 31, 2017	Level 1	Level 2	Level 3
Derivatives:				
Foreign currency forward contracts	$ 6,213	$ —	$ 6,213	$ —
Interest rate swap contracts	(3,170)	—	(3,170)	—
Total	$ 3,043	$ —	$ 3,043	$ —

There were no transfers between Levels 1 and 2 within the fair value hierarchy for the three months ended March 31, 2018.
Other Financial Instruments
The carrying value of our financial instruments including cash and cash equivalents, and accounts receivable approximates their fair values. The fair values of our senior secured notes due 2023 and term loans under our Amended and Restated Credit Agreement are determined based on quoted market prices for a similar liability when traded as an asset in an active market, a Level 2 input.
The following table presents the fair value and carrying value of our senior notes and borrowings under our senior secured credit facilities as of March 31, 2018 and December 31, 2017, (in thousands):

	Fair Value at	Carrying Value at (1)
Financial Instrument		

	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Term Loan A	$551,368	$ 559,223	$546,460	$ 553,444
Term Loan B	1,885,727	1,890,453	1,869,826	1,873,993
Revolver, $400 million	—	—	—	—
5.375% Senior secured notes due 2023	535,658	546,563	530,000	530,000
5.25% Senior secured notes due 2023	506,320	512,500	500,000	500,000

(1) Excludes net unamortized debt issuance costs.

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8. Accumulated Other Comprehensive Income (Loss)

As of March 31, 2018 and December 31, 2017, the components of accumulated other comprehensive income (loss), net of related deferred income taxes, are as follows (in thousands):

	March 31, 2018	December 31, 2017
Defined benefit pension and other post retirement benefit plans	$(101,504)	$ (102,623)
Unrealized foreign currency translation gain	14,592	11,488
Unrealized gain on foreign currency forward contracts and interest rate swaps	8,314	2,651
Total accumulated other comprehensive loss, net of tax	$(78,598)	$ (88,484)

The amortization of actuarial losses and periodic service credits associated with our retirement-related benefit plans is primarily included in other, net in the consolidated statements of operations. See Note 6. Derivatives, for information on the income statement line items affected as the result of reclassification adjustments associated with derivatives.

9. Earnings Per Share

The following table reconciles the numerators and denominators used in the computations of basic and diluted earnings per share from continuing operations (in thousands, except per share data):

	Three Months Ended March 31,	
	2018	2017
Numerator:		
Income from continuing operations	$90,449	$77,722
Less: Net income attributable to noncontrolling interests	1,362	1,306
Net income from continuing operations available to common stockholders, basic and diluted	$89,087	$76,416
Denominator:		
Basic weighted-average common shares outstanding	274,720	277,353
Add: Dilutive effect of stock options and restricted stock awards	2,124	2,206
Diluted weighted-average common shares outstanding	276,844	279,559
Earning per share from continuing operations:		
Basic	$0.32	$0.28
Diluted	$0.32	$0.27

Basic earnings per share are based on the weighted-average number of common shares outstanding during each period. Diluted earnings per share are based on the weighted-average number of common shares outstanding plus the effect of all dilutive common stock equivalents during each period. The calculation of diluted weighted-average shares excludes the impact of 3 million of anti-dilutive common stock equivalents for each of the three months ended March 31, 2018 and 2017.

10. Contingencies

Legal Proceedings

While certain legal proceedings and related indemnification obligations to which we are a party specify the amounts claimed, these claims may not represent reasonably possible losses. Given the inherent uncertainties of litigation, the ultimate outcome of these matters cannot be predicted at this time, nor can the amount of possible loss or range of loss, if any, be reasonably estimated, except in circumstances where an aggregate litigation accrual has been recorded for probable and reasonably estimable loss contingencies. A determination of the amount of accrual required, if any, for these contingencies is made after careful analysis of each matter. The required accrual may change in the future due to new information or developments in each matter or changes in approach such as a change in settlement strategy in dealing with these matters.

Antitrust Litigation and DOJ Investigation

US Airways Antitrust Litigation

In April 2011, US Airways filed suit against us in federal court in the Southern District of New York, alleging violations of the Sherman Act Section 1 (anticompetitive agreements) and Section 2 (monopolization). The complaint was filed fewer than two months after we entered into a new distribution agreement with US Airways. In September

2011, the court dismissed all claims relating to Section 2. The claims that were not dismissed are claims brought under Section 1 of the Sherman Act, relating to our contracts with US Airways, which US Airways claims contain anticompetitive provisions, and an alleged conspiracy with the other GDSs, allegedly to maintain the industry structure and not to compete for content. We strongly deny all of the allegations made by US Airways.

Sabre filed summary judgment motions in April 2014. In January 2015, the court issued an order granting Sabre's summary judgment motions in part, eliminating a majority of US Airways' alleged damages and rejecting its request for injunctive relief by which US Airways sought to bar Sabre from enforcing certain provisions in our contracts. In September 2015, the court also dismissed US Airways' claim for declaratory relief. In February 2017, US Airways sought reconsideration of the court's opinion dismissing the claim for declaratory relief, which the court denied in March 2017.

The trial on the remaining claims commenced in October 2016. In December 2016, the jury issued a verdict in favor of US Airways with respect to its claim under Section 1 of the Sherman Act regarding Sabre's contract with US Airways and awarded it $5 million in single damages. The jury rejected US Airways' claim alleging a conspiracy with the other GDSs. We continue to believe that our business practices and contract terms are lawful. In January 2017, we filed a motion seeking judgment as a matter of law in favor of Sabre on the one claim on which the jury found for US Airways, which the court denied in March 2017.

Based on the jury’s verdict, in March 2017 the court entered final judgment in favor of US Airways in the amount of $15 million, which is three times the jury’s award of $5 million as required by the Sherman Act.

In April 2017, we filed an appeal with the United States Court of Appeals for the Second Circuit seeking a reversal of the judgment. US Airways also filed a counter-appeal challenging earlier court orders, including the above-referenced orders dismissing and/or issuing summary judgment as to portions of its claims and damages. In connection with this appeal, we posted an appellate bond equal to the aggregate amount of the $15 million judgment entered plus interest, which stayed the judgment pending the appeal.

As a result of the jury's verdict, US Airways is also entitled to receive reasonable attorneys’ fees and costs under the Sherman Act. As such, it filed a motion seeking approximately $125 million in attorneys’ fees and costs, the amount of which we strongly dispute. In January 2018, the court denied US Airways' motion seeking attorneys' fees and costs, based on the fact that the appeal of the underlying judgment remains pending, as discussed above. The court's denial of the motion was without prejudice, and US Airways may refile the motion if it prevails on the appeal.

We have accrued a loss of $32 million, which represents the court's final judgment of $15 million, plus our estimate of $17 million for US Airways' reasonable attorneys’ fees, expenses and costs. We are unable to estimate the exact amount of the loss associated with the verdict, but we estimate that there is a range of outcomes between $32 million and $65 million, inclusive of the trebled damage award of approximately $15 million. No amount within the range is considered a better estimate than any other amount within the range and therefore, the minimum within the range was recorded in selling, general and administrative expense in the fourth quarter of 2016. As noted above, the amount of attorneys' fees and costs to be awarded is subject to conclusion of the appellate process and, if US Airways ultimately prevails on the appeal, final decision by the trial court, which may itself be appealed. The ultimate resolution of this matter may be greater or less than the amount recorded and, if greater, could adversely affect our results of operations.

We have and will incur significant fees, costs and expenses for as long as the lawsuit, including any appeal, is ongoing. In addition, litigation by its nature is highly uncertain and fraught with risk, and it is therefore difficult to predict the outcome of any particular matter, including any appeal or changes to our business that may be required as a result of the litigation. Depending on the outcome of the litigation, any of these consequences could have a material adverse effect on our business, financial condition and results of operations.

Putative Class Action Lawsuit on Antitrust Claims

In July 2015, a putative class action lawsuit was filed against us and two other GDSs, in the United States District Court for the Southern District of New York. The plaintiffs, who are asserting claims on behalf of a putative class of consumers in various states, are generally alleging that the GDSs conspired to negotiate for full content from the airlines, resulting in higher ticket prices for consumers, in violation of various federal and state laws. The plaintiffs sought an unspecified amount of damages in connection with their state law claims, and they requested injunctive relief in connection with their federal claim. In July 2016, the court granted, in part, our motion to dismiss the lawsuit, finding that plaintiffs’ state law claims are preempted by federal law, thereby precluding their claims for damages. The court declined to dismiss plaintiffs’ claim seeking an injunction under federal antitrust law. The plaintiffs may appeal the court’s dismissal of their state law claims upon a final judgment. We believe that the losses associated with this case are neither probable nor estimable and therefore have not accrued any losses as of March 31, 2018. We may incur significant fees, costs and expenses for as long as this litigation is ongoing. We intend to vigorously defend against the remaining claims.

Department of Justice Investigation

On May 19, 2011, we received a civil investigative demand ("CID") from the U.S. Department of Justice ("DOJ") investigating alleged anticompetitive acts related to the airline distribution component of our business. We are fully cooperating with the DOJ investigation and are unable to make any prediction regarding its outcome. The DOJ is also investigating other companies that own GDSs, and has sent CIDs to other companies in the travel industry. Based on its findings in the investigation, the DOJ may (i) close the file, (ii) seek a consent decree to remedy issues it believes violate the antitrust laws, or (iii) file suit against us for violating the antitrust laws, seeking injunctive relief. If injunctive relief were granted, depending on its scope, it could affect the manner in which our airline distribution business is operated and potentially force changes to the existing airline distribution business model. Any of these consequences would have a material adverse effect on our business, financial condition and results of operations. We have not received any communications from the DOJ regarding this matter for several years; however, we have not been notified that this matter is closed.

Indian Income Tax Litigation

We are currently a defendant in income tax litigation brought by the Indian Director of Income Tax ("DIT") in the Supreme Court of India. The dispute arose in 1999 when the DIT asserted that we have a permanent establishment within the meaning of the Income Tax Treaty between the United States and the Republic of India and accordingly issued tax assessments for assessment years ending March 1998 and March 1999, and later issued further tax assessments for assessment years ending March 2000 through March 2006. The DIT has continued to issue further tax assessments on a similar basis for subsequent years; however, the tax assessments for assessment years ending March 2007 and later are no longer material. We appealed the tax assessments for assessment years ending March 1998 through March 2006 and the Indian Commissioner of Income Tax Appeals returned a mixed verdict. We filed further appeals with the Income Tax Appellate Tribunal ("ITAT"). The ITAT ruled in our favor on June 19, 2009 and July 10, 2009, stating that no income would be chargeable to tax for assessment years ending March 1998 and March 1999, and from March 2000 through March 2006. The DIT appealed those decisions to the Delhi High Court, which found in our favor on July 19, 2010. The DIT has appealed the decision to the Supreme Court of India. Our case has been listed for hearing with the Supreme Court, and it has not yet been presented. We have appealed the tax assessments for the assessment years ended March 2013 and March 2015 with the ITAT and no trial date has been set for these subsequent years.

In addition, Sabre Asia Pacific Pte Ltd ("SAPPL") is currently a defendant in similar income tax litigation brought by the DIT. The dispute arose when the DIT asserted that SAPPL has a permanent establishment within the meaning of the Income Tax Treaty between Singapore and India and accordingly issued tax assessments for assessment years ending March 2000 through March 2005. SAPPL appealed the tax assessments, and the Indian Commissioner of Income Tax (Appeals) returned a mixed verdict. SAPPL filed further appeals with the ITAT. The ITAT ruled in SAPPL's favor, finding that no income would be chargeable to tax for assessment years ending March 2000 through March 2005. The DIT appealed those decisions to the Delhi High Court. No hearing date has been set. The DIT also assessed taxes on a similar basis for assessment years ending March 2006 through March 2014 and appeals for assessment years ending March 2006 through 2014 are pending before the ITAT.

If the DIT were to fully prevail on every claim against us, including SAPPL, we could be subject to taxes, interest and penalties of approximately $46 million as of March 31, 2018. We intend to continue to aggressively defend against each of the foregoing claims. Although we do not believe that the outcome of the proceedings will result in a material impact on our business or financial condition, litigation is by its nature uncertain. We do not believe this outcome is more likely than not and therefore have not made any provisions or recorded any liability for the potential resolution of any of these claims.

Indian Service Tax Litigation

SAPPL's Indian subsidiary is also subject to litigation by the India Director General (Service Tax) ("DGST"), which has assessed the subsidiary for multiple years related to its alleged failure to pay service tax on marketing fees and reimbursements of expenses. Indian courts have returned verdicts favorable to the Indian subsidiary. The DGST has appealed the verdict to the Indian Supreme Court. We do not believe that an adverse outcome is probable and therefore have not made any provisions or recorded any liability for the potential resolution of any of these claims.

Litigation Relating to Routine Proceedings

We are also engaged from time to time in other routine legal and tax proceedings incidental to our business. We do not believe that any of these routine proceedings will have a material impact on the business or our financial condition.

Other

In November 2017, in connection with Air Berlin's insolvency proceedings, we requested that Air Berlin make an election under the German Insolvency Act on whether to perform or terminate its contract with us. In January 2018, Air Berlin notified us by letter that it was exercising its right under the German Insolvency Act to terminate its contract with us. In addition, Air Berlin's letter alleged various breaches by us of the contract and asserted that it had suffered a significant amount of damages associated with its claims. Air Berlin has not commenced any formal action with respect to its claims. We believe that losses associated with these claims are neither probable nor estimable and therefore have not accrued any losses as of March 31, 2018. We may incur significant fees, costs and expenses for as long as this matter is ongoing. We intend to vigorously defend against these claims.

As previously disclosed, we became aware of an incident involving unauthorized access to payment information contained in a subset of hotel reservations processed through the Sabre Hospitality Solutions SynXis Central Reservation System (the “HS Central Reservation System”). Our investigation was supported by third party experts, including a leading cybersecurity firm. Our investigation determined that an unauthorized party: obtained access to account credentials that permitted access to a subset of hotel reservations processed through the HS Central Reservation System; used the account credentials to view a credit card summary page on the HS Central Reservation System and access payment card information (although we use encryption, this credential had the right to see unencrypted card data); and first obtained access to payment card information and some other reservation information on August 10, 2016. The last access to payment card information was on March 9, 2017. The unauthorized party was able to access information for certain hotel reservations, including cardholder name; payment card number; card expiration date; and, for a subset of reservations, card security code. The unauthorized party was also able, in some cases, to access certain information such as guest name(s), email, phone number, address, and other information if provided to the HS Central Reservation System. Information such as Social Security, passport, or driver’s license number was not accessed. The investigation did not uncover forensic evidence that the unauthorized party removed any information from the system, but it is a possibility. We took successful measures to ensure this unauthorized access to the HS Central Reservation System was stopped and is no longer possible. There is no indication that any of our systems beyond the HS Central Reservation System, such as Sabre’s Airline Solutions and Travel Network platforms, were affected or accessed by the unauthorized party. We notified law enforcement and the payment card brands, who engaged a payment card industry data ("PCI") forensic investigator to investigate this incident. We have notified customers and other companies that use or interact with, directly or indirectly, the HS Central Reservation System about the incident. We are also cooperating with various governmental authorities that are investigating this incident. Separately, in November 2017, Sabre Hospitality Solutions observed a pattern of activity that, after further investigation, led it to believe that an unauthorized party improperly obtained access to certain hotel user credentials for purposes of accessing the HS Central Reservation System. We deactivated the compromised accounts and notified law enforcement of this activity. We also notified the payment card brands, and at their request, we have engaged a PCI forensic investigator to investigate this incident. We have not found any evidence of a breach of the network security of the HS Central Reservation System, and we believe that the number of affected reservations represents only a fraction of 1% of the bookings in the HS Central Reservation System. Although the costs related to these incidents, including any associated penalties assessed by any governmental authority or payment card brand or indemnification obligations to our customers, as well as any other impacts or remediation related to this incident, may be material, it is not possible at this time to determine whether we will incur, or to reasonably estimate the amount of, any liabilities in connection with them. We maintain insurance that covers certain aspects of cyber risks, and we continue to work with our insurance carriers in these matters.

11. Segment Information

Our reportable segments are based upon our internal organizational structure; the manner in which our operations are managed; the criteria used by our Chief Executive Officer, who is our Chief Operating Decision Maker ("CODM"), to evaluate segment performance; the availability of separate financial information; and overall materiality considerations. Effective the first quarter of 2018, our business has three reportable segments: (i) Travel Network, (ii) Airline Solutions and (iii) Hospitality Solutions. Each segment now reflects a portion of our shared corporate costs that historically were not allocated to a business unit, based on relative consumption of shared technology infrastructure costs and defined revenue metrics. These changes have no impact on our consolidated results of operations, but result in a decrease of segment profitability only.

Our CODM utilizes Adjusted Gross Profit, Adjusted Operating Income and Adjusted EBITDA as the measures of profitability to evaluate performance of our segments and allocate resources. Corporate includes a technology organization that provides development and support activities to our segments. The majority of costs associated with our technology organization are allocated to the segments primarily based on the segments' usage of resources. Benefit expenses, facility costs and depreciation expense on the corporate headquarters building are allocated to the segments based on headcount. Unallocated corporate costs include certain expenses such as accounting, finance, human resources, legal, corporate systems, impairment and related charges, stock-based compensation, restructuring charges, legal reserves and other items not identifiable with one of our segments.

We account for significant intersegment transactions as if the transactions were with third parties, that is, at estimated current market prices. The majority of the intersegment revenues and cost of revenues are fees charged by Travel Network to Airline Solutions for airline trips booked through our GDS.

Our CODM does not review total assets by segment as operating evaluations and resource allocation decisions are not made on the basis of total assets by segment.

The performance of our segments is evaluated primarily on Adjusted Gross Profit, Adjusted Operating Income and Adjusted EBITDA which are not recognized terms under GAAP. Our uses of Adjusted Gross Profit, Adjusted Operating Income and Adjusted EBITDA have limitations as analytical tools, and should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP.

We define Adjusted Gross Profit as operating income adjusted for selling, general and administrative expenses, the cost of revenue portion of depreciation and amortization, amortization of upfront incentive consideration and stock-based compensation included in cost of revenue.

We define Adjusted Operating Income as operating income adjusted for joint venture equity income, acquisition-related amortization, litigation costs, net, and stock-based compensation.

We define Adjusted EBITDA as income from continuing operations adjusted for depreciation and amortization of property and equipment, amortization of capitalized implementation costs, acquisition-related amortization, amortization of upfront incentive consideration, interest expense, net, loss on extinguishment of debt, other, net, litigation costs, net, stock-based compensation and provision for income taxes.

Segment information for the three months ended March 31, 2018 and 2017 is as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Revenue		
Travel Network	$721,136	$663,477
Airline Solutions	206,603	193,613
Hospitality Solutions	68,128	64,363
Eliminations	(7,498)	(6,100)
Total revenue	$988,369	$915,353
Adjusted Gross Profit[(a)]		
Travel Network	$298,017	$307,067
Airline Solutions	89,764	74,530
Hospitality Solutions	20,243	18,815
Corporate	(3,444)	365
Total	$404,580	$400,777
Adjusted Operating Income[(b)]		
Travel Network	$211,845	$229,030
Airline Solutions	30,712	19,719
Hospitality Solutions	2,137	(322)
Corporate	(47,098)	(37,487)
Total	$197,596	$210,940
Adjusted EBITDA[(c)]		
Travel Network	$261,588	$271,514
Airline Solutions	74,419	56,834
Hospitality Solutions	11,759	7,022
Total segments	347,766	335,370
Corporate	(46,428)	(37,809)
Total	$301,338	$297,561
Depreciation and amortization		
Travel Network	$30,287	$26,352
Airline Solutions	43,707	37,115
Hospitality Solutions	9,622	7,344
Total segments	83,616	70,811
Corporate	18,260	34,859
Total	$101,876	$105,670
Capital Expenditures		
Travel Network	$14,295	$26,273
Airline Solutions	24,345	36,891
Hospitality Solutions	10,174	8,175
Total segments	48,814	71,339
Corporate	15,885	16,979
Total	$64,699	$88,318

(a) The following table sets forth the reconciliation of Adjusted Gross Profit to operating income in our statement of operations (in thousands):

	Three Months Ended March 31,	
	2018	2017
Adjusted Gross Profit	$404,580	$400,777
Less adjustments:		
Selling, general and administrative	130,111	144,441
Cost of revenue adjustments:		
Depreciation and amortization[(1)]	83,926	73,697
Amortization of upfront incentive consideration[(2)]	19,456	16,132
Stock-based compensation	5,686	3,181
Operating income	$165,401	$163,326

(b) The following table sets forth the reconciliation of Adjusted Operating Income to operating income in our statement of operations (in thousands):

	Three Months Ended March 31,	
	2018	2017
Adjusted Operating Income	$197,596	$210,940
Less adjustments:		
Joint venture equity income	1,171	898
Acquisition-related amortization[(1c)]	17,590	35,181
Litigation costs, net[(4)]	828	3,501
Stock-based compensation	12,606	8,034
Operating income	$165,401	$163,326

(c) The following table sets forth the reconciliation of Adjusted EBITDA to income from continuing operations in our statement of operations (in thousands):

	Three Months Ended March 31,	
	2018	2017
Adjusted EBITDA	$301,338	$297,561
Less adjustments:		
Depreciation and amortization of property and equipment[(1a)]	74,463	61,300
Amortization of capitalized implementation costs[(1b)]	9,823	9,189
Acquisition-related amortization[(1c)]	17,590	35,181
Amortization of upfront incentive consideration[(2)]	19,456	16,132
Interest expense, net	38,109	39,561
Loss on extinguishment of debt	633	—
Other, net[(3)]	1,106	15,234
Litigation costs, net[(4)]	828	3,501
Stock-based compensation	12,606	8,034
Provision for income taxes	36,275	31,707
Income from continuing operations	$90,449	$77,722

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(1) Depreciation and amortization expenses:

a. Depreciation and amortization of property and equipment includes software developed for internal use.

b. Amortization of capitalized implementation costs represents amortization of upfront costs to implement new customer contracts under our SaaS and hosted revenue model.

c.

Acquisition-related amortization represents amortization of intangible assets from the take-private transaction in 2007 as well as intangibles associated with acquisitions since that date and amortization of the excess basis in our underlying equity in joint ventures.

(2) Our Travel Network business at times makes upfront cash payments or other consideration to travel agency subscribers at the inception or modification of a service contract, which are capitalized and amortized over an average expected life of the service contract, generally over three years to five years. This consideration is made with the objective of increasing the number of clients or to ensure or improve customer loyalty. These service contract terms are established such that the supplier and other fees generated over the life of the contract will exceed the cost of the incentive consideration provided up front. These service contracts with travel agency subscribers require that the customer commit to achieving certain economic objectives and generally have terms requiring repayment of the upfront incentive consideration if those objectives are not met.

(3) In the first quarter of 2017, we recognized a $12 million loss related to debt modification costs associated with our debt refinancing. In addition, other, net includes foreign exchange gains and losses related to the remeasurement of foreign currency denominated balances included in our consolidated balance sheets into the relevant functional currency.

(4) Litigation costs, net represent charges associated with antitrust litigation. See Note 10. Contingencies.

12. Subsequent Events

As stated in Note 5. Debt, our outstanding senior secured credit facilities have variable interest rates. In April 2018, we entered into five interest rate swap arrangements totaling $1.35 billion, which effectively converted a portion of our variable-rate debt based on one-month LIBOR to a fixed rate. We have designated these swaps as cash flow hedges, and they have maturity dates ranging from December 31, 2019 to December 31, 2021. The objective of these hedges is to manage the variability of cash flows in the interest payments related to the portion of the variable-rate debt designated as being hedged.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including this "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part I, Item 2, contains information that may constitute forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts, such as statements regarding our future financial condition or results of operations, our prospects and strategies for future growth, the development and introduction of new products, and the implementation of our marketing and branding strategies. In many cases, you can identify forward-looking statements by terms such as "expects," "outlook," "believes," "may," "intends," "provisional," "plans," "will," "predicts," "potential," "anticipates," "estimates," "should," "plans" or the negative of these terms or other comparable terminology. The forward-looking statements are based on our current expectations and assumptions regarding our business, the economy and other future conditions and are subject to risks, uncertainties and changes in circumstances that may cause events or our actual activities or results to differ significantly from those expressed in any forward-looking statement. Certain of these risks, uncertainties and changes in circumstances are described in the "Risk Factors" section of this Quarterly Report on Form 10-Q and in the "Risk Factors" and "Forward-Looking Statements" sections included in our Annual Report on Form 10-K filed with the SEC on February 16, 2018. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future events, results, actions, levels of activity, performance or achievements. You are cautioned not to place undue reliance on these forward-looking statements. Unless required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect circumstances or events after the date they are made.

The following discussion and analysis should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K filed with the SEC on February 16, 2018.

Overview

We connect people and places with technology that reimagines the business of travel. Effective the first quarter of 2018, we operate through three business segments: (i) Travel Network, our global business-to-business travel marketplace for travel suppliers and travel buyers, (ii) Airline Solutions, a broad portfolio of software technology products and solutions primarily for airlines, and (iii) Hospitality Solutions, an extensive suite of leading software solutions for hoteliers. Collectively, these offerings enable travel suppliers to better serve their customers across the entire travel lifecycle, from route planning to post-trip business intelligence and analytics.

A significant portion of our revenue is generated through transaction-based fees that we charge to our customers. For Travel Network, this fee is in the form of a transaction fee for bookings on our GDS; for Airline Solutions and Hospitality Solutions, this fee is a recurring usage-based fee for the use of our SaaS and hosted systems, as well as upfront fees and professional service fees.="bottom" style="padding:0pt .7pt 0pt 0pt;width:2.58%;">

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(746

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(488

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(2,475

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(2,377

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Credit cards and related loans

(75

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(41

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(66

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(88

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(255

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Recoveries of loans previously charged off:

Real estate loans

34

41

45

24

149

Installment loans

70

111

96

196

186

Commercial loans

1,200

1,179

963

451

309

Credit cards and related loans

24

45

61

49

85

Total Allowances for Losses

$

13,657

$

15,582

$

18,004

$

19,141

$

20,659

Allocation of Allowance for Losses (in 000 s)					
Allowance for loan losses	$ 11,896	$ 13,799	$ 16,063	$ 17,370	$ 19,073
Allowance for losses unfunded commitments	1,761	1,783	1,941	1,771	1,586
Total Allowance for Losses	$ 13,657	$ 15,582	$ 18,004	$ 19,141	$ 20,659
Ratio of Net Loan Losses to Average Loans Outstanding	0.13 %	(0.03 %)	0.06 %	0.19 %	0.22 %

Allocation of the allowance for losses compared to loan type as a percent of total at December 31:

(dollars in 000 s) Balance applicable to:	**2005**	**Type as a % of Loans**	**2004**	**Type as a % of Loans**	**2003**	**Type as a % of Loans**	**2002**	**Type as a % of Loans**	**2001**	**Type as a % of Loans**
Construction and Land	$ 1,655	18.4 %	$ 5,120	16.1 %	$ 2,680	20.8 %	$ 2,636	19.7 %	$ 1,969	18.8 %
Real Estate	4,277	53.6 %	1,757	53.5 %	2,164	49.1 %	4,047	48.4 %	2,949	46.8 %
H.E.C.L.	735	12.0 %	308	11.2 %	250	7.8 %	295	6.8 %	443	6.0 %
Installment	226	1.2 %	160	1.3 %	244	2.2 %	254	2.5 %	780	3.1 %
Credit Card and Related	76	0.2 %	86	0.3 %	229	0.6 %	97	0.3 %	393	0.3 %
Commercial, Other	3,879	14.6 %	3,237	17.6 %	6,468	19.5 %	6,296	22.3 %	5,712	25.0 %
Unfunded commitments	1,761	N/A	1,783	N/A	1,941	N/A	1,771	N/A	1,586	N/A
Unallocated	1,048	N/A	3,131	N/A	4,028	N/A	3,745	N/A	6,827	N/A
Balance at End of Year	$ 13,657	100.0 %	$ 15,582	100.0 %	$ 18,004	100.0 %	$ 19,141	100.0 %	$ 20,659	100.0 %

During 2005, we enhanced our methodology for determining the appropriate level of allowance for loan and lease losses. While our methodology had always consisted of two key components, an individual loan impairment component and a pool loan analysis component, the enhancement made in 2005 introduced improved methodology incorporating increased analysis of loss exposure associated with both historical loss rates and known qualitative factors present in various major segments of the loan portfolio.

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The prior methodology relied on loss factors that provided results not significantly different from the results of our enhanced methodology. However, with this enhancement, there was a reallocation in the unallocated portion of the allowance for loan losses which was attributable, at least in part, to the enhanced calculation of loss exposure compared to prior years.

Non-accrual loans within the Bank s portfolio decreased from $10.7 million as of December 31, 2004, to $2.5 million, at the end of 2005. Loans 90 days or more past due, and still accruing, remained at zero for the periods ending December 31, 2004 and December 31, 2005. Additional information on non-accrual loans, past due loans and troubled debt restructurings can be found in Footnote 5 to the financial statements. Over half of the level of non-accrual loans at the end of 2005 is centered in one relationship (total $1.4 million). Management has established specific reserves that would offset potential losses, if any, arising from less than full recovery of the loan from the supporting collateral. Recoveries in 2005 of loans previously charged-off totaled $1.3 million compared to charge-offs of $3.2 million taken during the year resulting in net charge-offs of $1.9 million. This figure compares to net recoveries of $0.4 million and net charge-offs of $0.7 million in 2004 and 2003, respectively.

With the combination of the collateral securing the problem loans and the size of the allowance for losses, Management feels that the allowance is sufficient to cover inherent losses. Management reviews the adequacy of the allowance and also employs an independent third party loan review group quarterly to, among other things, review the reasonableness of individual asset classifications. Management, as necessary, adjusts the allowance on a regular basis. The allowance is also examined annually by one or more of the Bank s regulatory bodies including the FDIC and DFI. During 2004, Management took a benefit to the provision for loan losses of $2.7 million. No provision for loan losses was taken during 2005. These actions reflected strong credit quality standards, consistent performance of the loan portfolio in recent years, improving trends in classified loans, improving trends in delinquencies, modest levels of net charge-offs in recent years, a positive outlook for the collection of the Company s non accrual loans, and a positive outlook for economic activity in general. The need for additional provision for loan losses or for further benefit to the provision for loan losses in 2006 will be dependent upon Management s on-going analysis of the adequacy of the allowance for loan losses. While Management believes it to be adequate at the present time, the appropriate value can fluctuate over time in response to economic conditions and the subjective decisions which must be made in response to those conditions.

The allowance for losses consists of an allocated portion based on historical average loss experience adjusted for known expected loss factors and a specifically allocated portion. The total of these components is considered adequate to provide for losses, which can be reasonably anticipated. However, since these amounts are based on estimates, ultimate losses relating to these loans may vary and Management believes that qualitative factors make it prudent to carry a reasonable level of an additional portion to absorb losses in excess of the allocated portion. Qualitative factors considered include, but are not limited to, portfolio composition, concentrations, off balance sheet risks, delinquencies and non-accruals, criticized and classified loans, non performing loans, gross and net loan losses, changes in lending function, changes in management, the Bank s organizational structure, the special assets group, lending and credit approval authorities, loan officer training, the credit review function, and real estate appraisal policies.

Management continuously monitors residential real estate reports and markets, and is aware of a great deal of discussion surrounding a possible slow down and/or drop in value of residential real estate in the Bank s service area. While long term interest rates remain relatively low and the Bank s service area is marked by limited supply and healthy demand, residential projects financed by the Bank are underwritten with a requirement of a percentage of cash equity to the total cost of the project in addition to prudent exposures to current appraised values. To further mitigate this risk, individual projects financed are analyzed using direct, current and historical project trends with limitations to production unit starts ahead of sales using the projected absorption analysis contained in the appraisal of each project. The Bank believes, based upon past experience, that this process helps mitigate against the production of a supply of units that would exceed the current market demand.

Additionally, due to the popularity of our market area to urban retirees and others wanting to enjoy the environment and lifestyle it provides, we have seen and continue to see a migration of wealthier individuals and families absorb the residential housing production with greater cash equities than is typical of other areas throughout the country. This assumption is supported by the fact that the Bank s portfolio of residential mortgages have an average loan to value ratio of less than 60% along with average credit scores substantially exceeding industry standards with low delinquency ratios. Management does not see significant risk of a dramatic slowdown in real estate in 2006. However, Management would not be surprised to see flat housing prices in 2006 or even some modest downward pressure on prices, as a correction to the dramatic increases seen over the past several years.

A summary of maturities and sensitivities of loans to changes in interest rates at December 31, 2005 is shown in the table below. A more complete discussion of the Bank s exposure to changes in interest rates can be found in the MD&A under the section titled Net Interest Income and Interest Rate Risk .

Loan Portfolio as of 12/31/05

(dollars in 000 s) Fixed Rate Loans	3 Months or less	Over 3 through 12 Months	Due after After 1 to 3 Years	Due After After 3 to 5 Years	Due After 5 Years	Total
Construction/Land Development	22,210	22,693	12,792	914	3,921	62,530
Real estate	70	17,234	26,167	44,024	219,670	307,165
Home equity credit lines					289	289
Installment	259	661	3,306	6,832	5,719	16,777
Cash reserve	19					19
Agricultural production	147	2,283	4,726			7,156
Commercial, other	1,089	2,351	17,908	32,547	18,357	72,252
Total	**23,794**	**45,222**	**64,899**	**84,317**	**247,956**	**466,188**

Variable Rate Loans	3 Months or less	Over 3 through 12 Months	Due after After 1 to 3 Years	Due After After 3 to 5 Years	Due After 5 Years	Total
Construction/Land Development	185,907	13,144	11,515	3,592	2,728	216,886
Real estate	119,345	20,960	158,088	183,131	28,265	509,789
Home equity credit lines	181,768					181,768
Installment	1,255					1,255
Cash reserve	3,348					3,348
Agricultural production	28,742					28,742
Commercial, other	105,656		69	8,780		114,505
Total	**626,021**	**34,104**	**169,672**	**195,503**	**30,993**	**1,056,293**
Total loans, gross (excludes allowance for loan losses, net deferred loan fees and loans held for sale)						**1,522,481**

Investment Portfolio

The Bank s investment portfolio primarily consists of U.S. Treasury Notes and Bills, Federal Agency Notes, Mortgage Backed Securities, and Municipal Bonds. See Footnote No. 4 to the consolidated financial statements for a detailed composition of the investment portfolio. Overall, the portfolio showed a net reduction in outstanding balances over the course of 2005 as 1) the Bank redirected these earning assets into the loan portfolio and 2) to a lesser extent the market value relative to amortized cost of the investment portfolio declined. The Treasury and Agency portion of the portfolio decreased by $4.9 million from one year ago. Holdings in the Municipal Bond portfolio were reduced from $377.0 million at the end of 2004 to $356.7 million at the end of 2005. In total, the Bank decreased its investment portfolio from $644.8 million at the end of 2004 to $619.3 million at the end of 2005, a $25.5 million decrease.

The Bank may segregate its portfolio into three categories a Trading Portfolio (which is carried at market value, with changes in market value reflected in the income statement), a Held to Maturity portfolio (which is carried at amortized cost, with changes in market value having no impact on the financial statements) and an Available for Sale portfolio (which is carried at market value, with changes in market value reflected in comprehensive income). The Bank holds no securities that should be classified as Trading or Held to Maturity securities. The Bank has determined that since its securities may be sold prior to maturity because of interest rate changes, to meet liquidity needs, or to better match the re-pricing characteristics of funding sources, that the entire portfolio should be classified as Available for Sale.

Adjustments to the Available for Sale portfolio for changes in market values resulted in an unrealized gain of $0.4 million included in accumulated other comprehensive income as of December 31, 2005 compared to an unrealized gain of $6.9 million at December 31, 2004, net of related taxes. Maturities and sales over the full year exceeded purchases and the total investment portfolio decreased by $25.5 million from the end of 2004 to the end of 2005.

Shown below is a summary maturity distribution of the investment portfolio, by type and weighted taxable equivalent yield as of December 31, 2005. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Maturity information for Mortgage Backed securities shown below is based on contractual maturities.

(dollars in 000 s)	**One Year Or Less**	**After One Year to Five Years**	**After Five Years to Ten Years**	**After Ten Years**	**Total**
Maturity Distribution:					
U.S. Treasury Securities	$ 11,867	$ 10,279	$ 500	$	$ 22,646
U.S. Government Agencies	114,716	99,871			214,587
Mortgage Backed Securities	110	2,385	4,394	2,050	8,939
Municipal Bonds, Other	38,564	179,541	146,813	8,242	373,160
Total	$ 165,257	$ 292,076	$ 151,707	$ 10,292	$ 619,332

	One Year Or Less	**After One Year to Five Years**	**After Five Years to Ten Years**	**After Ten Years**	**Total**
Weighted Average Yield:					
U.S. Treasury Securities	2.42 %	4.03 %	4.22 %		3.10 %
U.S. Government Agencies	2.53 %	4.27 %			3.34 %
Mortgage Backed Securities	6.16 %	6.64 %	5.74 %	5.63 %	5.96 %
Municipal Bonds, Other	6.27 %	5.89 %	5.45 %	6.00 %	5.76 %
Total	3.40 %	4.45 %	5.46 %	5.93 %	4.44 %

Other Real Estate Owned (OREO)

The Company did not hold any OREO from foreclosure as of December 31, 2005 or 2004. Future OREO activity will depend, among other things, on how many borrowers the Bank may need to foreclose upon, and the strength of the real estate market and general economic activity.

Goodwill and Core Deposit Intangibles

Goodwill totaled $47.8 million at December 31, 2005 and 2004. Of this total, $14.4 million was the result of the acquisition of Ojai Valley Bank that was completed on October 31, 2003, $32.2 million was the result of the acquisition of American Commercial Bank that was completed on September 28, 2001 and $1.2 million relates to a May 3, 1996 acquisition of Citizens Bank of Paso Robles by BSM Bancorp which the Company acquired in 1998.

On an annual basis, the Company tests its Goodwill for impairment. The Goodwill is entirely attributable to the Company s community banking segment. Results of these tests have indicated that there was no impairment of Goodwill in any of the past four years (2002 through 2005) since the testing commenced.

Core deposit intangibles total $6.5 million at December 31, 2005 compared to $7.7 million one year earlier. Of the year-end 2005 amounts, $4.4 million represents the net un-amortized value of the core deposit intangible created with the American Commercial Bank acquisition and $2.1 million represents the net un-amortized value of the core deposit intangible created upon the acquisition of Ojai Valley Bank. In connection with these acquisitions, the Company recognizes core deposit intangibles that represent the fair value of long-term deposit relationships acquired. Such amounts are then amortized over expected useful remaining economic lives. During 2005, the Company adjusted the amortization rate of the Core Deposit Intangible associated with the American Commercial Bank acquisition due to a greater retention rate of the original core deposit base than was originally contemplated at the time of the acquisition in 2001. No adjustments to the Ojai Valley Bank related Core Deposit Intangible have been necessary. Absent adjustments to the amortization schedules in future periods, the core deposit intangibles are now scheduled to be fully amortized in September 2013 with respect to the American Commercial Bank acquisition and October 2012 with respect to the Ojai Valley Bank acquisition and the total amount of the amortization is projected to be $872 thousand in 2006. This charge to expense is carried under other operating expense on the consolidated statements of income.

Senior Housing Crime Prevention Foundation Investment

The Bank owns a $30 million holding of the Preferred Stock of Senior Housing Crime Prevention Foundation Investment Corporation (SHCPF-I) which is carried under a separate caption on the Consolidated Statement of Financial Positions. That investment is secured by a federal agency security issued by FNMA. The Bank has the right after five years on April 29, 2010 to require SHCPF to redeem all or a part of the shares of the Preferred Stock. Dividends are paid to the Bank on the Preferred Stock at a rate which is 1.875% below the interest earned on the underlying FNMA agency security. This 1.875% differential is used by SHCPF to fund the various programs of the Senior Housing Crime Prevention Foundation at 53 nursing home facilities in the Bank s tri-county service area. These include, among other things, the senior crime stoppers program which is reducing crimes against the elderly living in those facilities. The benefits to the Bank of this program include full Community Reinvestment Act (CRA) credit for our $30 million investment, positive public relations, and significant marketing opportunities with the operators of the facilities, their owners, Board of Directors, employees, family members and residents.

Deposits

While the Bank is competitive with major institutions in terms of its structure of interest rates on deposit products offered, Management was not aggressive during 2005 in terms of pricing to attract additional deposits, a decision which reflected the Bank s liquidity through the year. As discussed in the Income Statement Analysis, many of the Bank s deposit rates have risen in varying degrees in response to the general increase in rates. A comparison of the rates paid on the Bank s deposit products at December 31, 2005 and 2004 is as follows:

Selected Quoted Interest Rates	**2005**	**2004**	**Change**
Demand Deposits	0 %	0 %	0 %
NOW Account (50 & Better over $2,500)	0.25 %	0.10 %	0.15 %
Money Market Deposits (over $100,000)	1.15 %	0.80 %	0.35 %
Passbook Savings Account	0.50 %	0.25 %	0.25 %
Individual Retirement Account (2 Year term)	3.60 %	2.75 %	0.85 %
Time Deposit ($100,000 6 month term)	3.20 %	1.85 %	1.35 %
Wall Street Journal Prime Rate	7.25 %	5.25 %	2.00 %

Average deposits have risen steadily over the past three years reflecting growth at the Bank s existing offices and the acquisition of Ojai Valley Bank on October 31, 2003 which had deposits of approximately $78.8 million at the time of the acquisition. Below is a summary of the average deposits outstanding and the average rate paid by category over the last three years.

(dollars in 000 s)	**Average Balance**	**2005 Interest**	**Rate**	**Average Balance**	**2004 Interest**	**Rate**	**Average Balance**	**2003 Interest**	**Rate**
Interest Bearing Demand and Money Market Investment Accounts	$ 765,491	$ 3,271	0.43 %	$ 741,230	$ 1,712	0.23 %	$ 651,285	$ 1,527	0.23 %
Savings Accounts	317,370	1,502	0.47 %	322,665	853	0.26 %	287,435	1,077	0.37 %
Time Deposits	414,883	9,837	2.37 %	399,806	5,691	1.42 %	399,448	6,944	1.74 %
Total Interest Bearing Deposits	1,497,744	14,610	0.98 %	1,463,701	8,256	0.56 %	1,338,168	9,548	0.71 %
Non Interest Bearing Demand	551,536			506,547			425,047		
Total Deposits	$ 2,049,280	$ 14,610	0.71 %	$ 1,970,248	$ 8,256	0.42 %	$ 1,763,215	$ 9,548	0.54 %

The majority of the Bank s time deposits (approximately 53%) have balances that are under $100,000. While all time deposits are somewhat more rate sensitive than the Bank s other deposit categories, the smaller time deposit balances tend to be more stable and less sensitive to absolute rate levels than do time deposits of $100,000 or more. Approximately 90% of the Bank s time deposits mature within one year and would be potentially subject to a change in rate on their maturity date. The following table as of December 31, 2005, displays summary size and maturity information on the Bank s time deposits.

(dollars in 000 s) Balance by Size	**Three Months or Less**	**After Three Months to Six Months**	**After Six Months to One Year**	**After One Year**	**Total**
Under $100,000	$ 89,028	$ 64,935	$ 46,156	$ 32,156	$ 232,275
$100,000 or More	109,782	56,954	23,663	11,664	202,063
Total Time Deposits	$ 198,810	$ 121,889	$ 69,819	$ 43,820	$ 434,338

Other Borrowings

While not a significant component of the Bank s structure, other borrowings were $25.9 million, at the end of 2005 compared to $6.6 million at the end of 2004. These consist of borrowings under the U.S. Treasury Tax and Loan note account and Federal Home Loan Bank (FHLB) borrowings. The Bank had outstanding borrowings of $3.9 million and $4.6 million at December 31, 2005 and 2004, respectively, under the U.S. Treasury Tax and Loan note account program. The Bank had two borrowings from the FHLB totaling $22.0 million at December 31, 2005 and one for $2.0 million at December 31, 2004. The two borrowings at the end of 2005 were structured as follows:

Description	Issue Date	Rate	Maturity	Principal
Fixed Rate Credit Advance	06/25/01	6.16 %	06/27/11	$ 2,000,000
Fixed Rate Credit Advance	01/20/05	3.74 %	01/22/08	$ 20,000,000
Total				$ 22,000,000

While the $2.0 million borrowing above was specifically taken down to match fund a particular earning asset, the $20.0 million borrowing funded general earning asset growth.

The Company may increase its Other Borrowings during 2006 in an effort to diversify its funding sources and purchase earning assets which create a positive spread for the income statement, allowing it to more profitably leverage its strong capital base. Management had the ability at December 31, 2005 to borrow up to $110 million of mostly shorter term borrowings (up to five years) from sources such as the FHLB. Funds raised from these sources may be used to fund earning assets such as investment securities or generate additional loans at sufficiently positive spreads to justify the additional leverage. In January of 2006, the Company added $25.0 million of additional borrowings in the form of a five year fixed rate credit advance at 4.75%.

Liquidity and Capital Resources

The focus of the Bank s liquidity management is to ensure its ability to meet cash requirements. Sources of liquidity include cash, due from bank balances (net of Federal Reserve requirements to maintain reserves against deposit liabilities), fed funds sold, investment securities (net of pledging requirements), loan repayments, deposits and fed funds borrowing lines. Typical demands on liquidity are deposit run-off from demand deposits and savings accounts, maturing time deposits, which are not renewed, and anticipated funding under credit commitments to customers.

A review of liquidity provided by operating activities finds that this source has been relatively constant over the past three years at $52.3 million, $43.3 million and $49.8 million in 2005, 2004, and 2003, respectively. Net cash used in investing activities has declined from $174.7 million in 2003 to $149.3 million in 2004 and $122.5 million in 2005 reflecting a net drop over this period in new loans and investments made. Net cash provided by financing activities fell from $151.7 million in 2003 to $53.5 million in 2004 and $61.3 million in 2005. The Company experienced slower deposit growth over the last couple of years compared to 2003.

The Bank has adequate liquidity at the present time. Its loan to deposit ratio at year-end 2005 was 73.6% versus 71.3% one year earlier. The Bank normally strives for a loan to deposit ratio in the 65% to 75% range. The Bank s internally calculated liquidity ratio stands at 29.7% at December 31, 2005 compared to 34.2% one year earlier. These levels are above the Bank s minimum policy of 15%.

Management is not aware of any trend, demand, commitment or event that would result in a material change in the Bank s liquidity at the present time.

The Company is dependent on the Bank for dividend payments to conduct its stock repurchase program and to make dividends to its shareholders. The Company declared cash dividends during 2005 of

$14,995,000 and repurchased stock totaling $23,065,000. The California Financial Code provides that a bank may not make a cash distribution to its shareholders in excess of (1) the bank s undivided profits or (2) the bank s net income for its last three fiscal years less the amount of any distributions made by the bank during such period. Based on these restrictions in the California Financial Code, the Bank can make additional cash dividends totaling $15,827,000 at December 31, 2005 to the Company. The Bank can also apply to the (DFI) for the ability to pay additional dividends to the Company. The Bank and Company expects to make such application during 2006 given the Company s planned regular dividends and on-going stock repurchase program. Given the Bank s strong capital position, Management does not expect such approval to be withheld. Indeed, at the Bank s request, it received approval to pay $5,000,000 in dividends to the Holding Company in the fourth quarter of 2005 so that it would not risk violating the California Financial Code requirements noted above for 2005.

Capital ratios for commercial banks and their holding companies in the United States are generally calculated using three different formulas. These calculations are referred to as the Leverage Ratio and two risk based calculations known as Tier One Risk Based Capital Ratio and the Total Risk Based Capital Ratio. The Company and the Bank are subject to certain standards concerning these ratios. These standards were developed through the joint efforts of banking authorities from 12 different countries around the world. The standards essentially take into account the fact that different types of assets have different levels of risk associated with them. Further, they take into account the off-balance sheet exposures of banks when assessing capital adequacy.

The Leverage Ratio calculation simply divides common stockholders equity (reduced by goodwill and certain other intangibles that a bank may have) by the total assets of the bank. In the Tier One Risk Based Capital Ratio, the numerator is the same as the leverage ratio, but the denominator is the total risk-weighted assets of the bank. Risk-weighted assets are determined by segregating all the assets and off-balance sheet exposures into different risk categories and weighting them by a percentage ranging from 0% (lowest risk) to 100% (highest risk). The Total Risk Based Capital Ratio again uses risk-weighted assets in the denominator, but expands the numerator to include other capital items besides equity such as a limited amount of the allowance for loan losses, long-term capital debt, preferred stock and other instruments. Summarized below are the capital ratios at December 31, 2005 and 2004, for both Mid-State Bancshares and Mid-State Bank & Trust. Additionally, the standards for a well-capitalized institution, as defined by the federal banking agencies, are displayed.

	Minimum Regulatory Standard	**Well-Capitalized Regulatory Standard**	**Mid-State Bancshares 2005**	**2004**	**Mid-State Bank & Trust 2005**	**2004**
Leverage Ratio	4.0%	5.0%	9.2%	9.3%	8.9%	9.2%
Tier One Risk Based Capital Ratio	4.0%	6.0%	11.6%	12.1%	11.3%	12.0%
Total Risk Based Capital Ratio	8.0%	10.0%	12.3%	13.0%	12.0%	12.9%

While it is the intent of Management to continue to maintain strong capital ratios, the Board of Directors has initiated a stock repurchase program and increased the quarterly dividend payments in an effort to further leverage its equity and enhance shareholder value. The Company also may modestly increase its other borrowings as noted above under Other Borrowings and increase its capital leverage.

Without deducting for goodwill and other intangibles from equity, two other commonly followed ratios related to capital have trended as follows over the past three years.

	2005	**2004**	**2003**
Dividend Payout Ratio	40.0 %	38.6 %	35.3 %
Average Common Equity to Average Assets	11.7 %	12.2 %	12.8 %

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Capital Commitments

As of December 31, 2005, neither the Company nor the Bank had any material commitment for capital expenditures.

Contractual Obligations

As of December 31, 2005, the Bank had the following contractual obligations.

	Less Than One Year	One to Three Years	Three to Five Years	Over Five Years	Total
Long Term Debt	$	$ 20,000	$	$ 2,000	$ 22,000
Operating Leases	2,435	4,398	3,692	4,218	14,743
Total Contractual Obligations	$ 2,435	$ 24,398	$ 3,692	$ 6,218	$ 36,743

Off Balance Sheet and Other Related Party Transactions

As noted in Footnote 12 to the financial statements, the Company is contingently liable for letter of credit accommodations made to its customers in the ordinary course of business totaling $40.9 million at December 31, 2005, up from $30.2 million one year earlier. Additionally, the Company has un-disbursed loan commitments, also made in the ordinary course of business, totaling $658.0 million, which was up from the $626.4 million outstanding one year earlier. The Company has an allowance for losses-unfunded commitments totaling $1,761,000 and $1,783,000 at December 31, 2005 and 2004, respectively, to cover losses inherent in its letter of credit accommodations and un-disbursed loan commitments.

There are no Special Purpose Entity (SPE) trusts, corporations, or other legal entities established by the Company or the Bank which reside off-balance sheet. There are no other off-balance sheet items other than the aforementioned items related to letter of credit accommodations and un-disbursed loan commitments.

As noted in Footnote 5 to the financial statements, the Company does make loans and leases to related parties (directors and officers) in the ordinary course of business at prevailing rates and terms. These loans and leases totaled $14.1 million and $8.7 million at the end of 2005 and 2004, respectively. In addition, there were un-funded commitments to loan up to an additional $4,352,000 in extensions of credit to directors and executive officers at year-end 2005.

INCOME STATEMENT ANALYSIS

Net Interest Income and Interest Rate Risk

Net Interest Income is the difference between interest and fees earned on all earning assets and interest paid on interest bearing liabilities. Net Interest Income for 2005 was $112.8 million, up from $101.5 million recorded in 2004 and $95.5 million in 2003. The components of net interest income change in response to both changes in rate, average balance and mix of both earning assets and liabilities. The following tables present an analysis of yields/rates, interest income and expense, and average balances for 2005, 2004, and 2003.

ANALYSIS OF CHANGES IN INTEREST INCOME AND EXPENSE

	2005			**2004**			**2005 Compared to 2004 Composition of Change**		
(dollars in 000 s)	**Average Balance**	**Interest Income/ Expense**	**Average Yield / Rate**	**Average Balance**	**Interest Income/ Expense**	**Average Yield / Rate**	**Change Due To: Volume**	**Rate**	**Total Change**
EARNING ASSETS:									
Loans	$ 1,472,885	$ 104,401	7.09 %	$ 1,310,842	$ 85,127	6.49 %	$ 11,004	$ 8,270	$ 19,274
Investment Securities	611,130	22,747	3.72 %	701,996	24,329	3.47 %	(3,266)	1,684	(1,582)
Fed Funds, Other	36,108	1,178	3.26 %	37,380	480	1.28 %	(28)	726	698
TOTAL EARNING ASSETS	$ 2,120,123	$ 128,326	6.05 %	$ 2,050,218	$ 109,936	5.36 %	$ 7,710	$ 10,680	$ 18,390
INTEREST BEARING LIABILITIES									
NOW, Savings, and Money Market Accounts	$ 1,082,861	$ 4,773	0.44 %	$ 1,063,895	$ 2,565	0.24 %	$ 65	$ 2,143	$ 2,208
Time Deposits	414,883	9,837	2.37 %	399,806	5,691	1.42 %	286	3,860	4,146
Interest Bearing Deposits	1,497,744	14,610	0.98 %	1,463,701	8,256	0.56 %	351	6,003	6,354
Other Borrowings	23,117	893	3.86 %	4,401	194	4.41 %	774	(75)	699
TOTAL INTEREST BEARING LIABILITIES	1,520,861	15,503	1.02 %	1,468,102	8,450	0.58 %	1,125	5,928	7,053
NET INTEREST INCOME	$ 2,120,123	$ 112,823	5.32 %	$ 2,050,218	$ 101,486	4.95 %	$ 6,585	$ 4,752	$ 11,337

	2004			**2003**			**2004 Compared to 2003 Composition of Change**		
(dollars in 000 s)	**Average Balance**	**Interest Income/ Expense**	**Average Yield / Rate**	**Average Balance**	**Interest Income/ Expense**	**Average Yield / Rate**	**Change Due To: Volume**	**Rate**	**Total Change**
EARNING ASSETS:									
Loans	$ 1,310,842	$ 85,127	6.49 %	$ 1,131,932	$ 80,372	7.10 %	$ 12,161	$ (7,406)	$ 4,755
Investment Securities	701,996	24,329	3.47 %	640,888	24,040	3.75 %	2,205	(1,916)	289
Fed Funds, Other	37,380	480	1.28 %	84,421	828	0.98 %	(533)	185	(348)
TOTAL EARNING ASSETS	$ 2,050,218	$ 109,936	5.36 %	$ 1,857,241	$ 105,240	5.67 %	$ 13,833	$ (9,137)	$ 4,696
INTEREST BEARING LIABILITIES:									
NOW, Savings, and Money Market Accounts	$ 1,063,895	$ 2,565	0.24 %	$ 938,720	$ 2,604	0.28 %	$ 325	$ (364)	$ (39)
Time Deposits	399,806	5,691	1.42 %	399,448	6,944	1.74 %	5	(1,258)	(1,253)
Interest Bearing Deposits	1,463,701	8,256	0.56 %	1,338,168	9,548	0.71 %	330	(1,622)	(1,292)
Other Borrowings	4,401	194	4.41 %	4,423	151	3.41 %	(1)	44	43
TOTAL INTEREST BEARING LIABILITIES	1,468,102	8,450	0.58 %	1,342,591	9,699	0.72 %	329	(1,578)	(1,249)
NET INTEREST INCOME	$ 2,050,218	$ 101,486	4.95 %	$ 1,857,241	$ 95,541	5.14 %	$ 13,504	$ (7,559)	$ 5,945

During 2005 there was a $18.4 million increase in interest income along with an increase of $7.1 million in interest expense compared to 2004. The resulting $11.3 million increase in net interest income for 2005 was a result of a number of dynamics affecting both average balance and interest rate considerations. First, the Company experienced an increase in its average earning assets outstanding of

$69.9 million. The increase was primarily attributable to the net increase in higher yielding average loans, which were up by $162.0 million, offset by declines in investments outstanding of $90.9 million and fed funds sold of $1.3 million. Second, while the Company s average interest bearing liabilities increased by $52.8 million, earning assets increased by a larger $69.9 million. Third, earning asset yields were higher in 2005 compared to the average for 2004, and liability costs, while higher in 2005 also, did not increase as dramatically.

During 2004 there was a $4.7 million increase in interest income along with a decrease of $1.2 million in interest expense compared to 2003. The resulting $5.9 million increase in net interest income for 2004 was a result of a number of dynamics affecting both average balance and interest rate considerations. First, the Company experienced an increase in its average earning assets outstanding of $193.0 million. The increase was primarily attributable to the net increase in average loans, which were up by $178.9 million, and to a lesser extent to an increase in average investments of $61.1 million. These increases were partially offset by a decrease in average federal funds sold of $47.0 million. Second, while the Company s average interest bearing liabilities increased by $125.5 million, earning assets increased by a larger $193.0 million. Third, earning asset yields were somewhat lower in 2004 compared to the average for 2003 and liability costs did not drop as quickly.

The Bank expects its risk exposure to changes in interest rates during 2006 to remain manageable and well within acceptable policy ranges. A recent review as of the end of 2005 of the potential changes in the Bank s net interest income over a 12 month time horizon showed that it could fluctuate under extreme alternative rate scenarios from between +3.8% and -7.3% of the base case (rates unchanged) of $126.1 million. The Bank s policy is to maintain a structure of assets and liabilities which are such that net interest income will not vary more than plus or minus 15% of the base forecast over the next 12 months. Management expects that its exposure to interest rate risk is manageable and it will continue to strive for an optimal trade-off between risk and earnings.

The following table presents a summary of the Bank s net interest income forecasted for the coming 12 months under alternative interest rate scenarios.

	Change From Base
Rates Down Very Significant (Prime down from 7.25% to 4.25% over 11 months)	-7.3 %
Rates Down Significant (Prime down from 7.25% to 5.25% over 11 months)	-3.8 %
Rates Down Modestly (Prime down from 7.25% to 6.25% over 11 months)	-1.4 %
Base Case Rates Unchanged (Prime unchanged at 7.25% over 12 months)	
Rates Up Modestly (Prime up from 7.25% to 8.25% over 11 months)	+1.1 %
Rates Up Aggressive (Prime up from 7.25% to 9.25% over 11 months)	+1.8 %
Rates Up Very Aggressive (Prime up from 7.25% to 10.25% over 11 months)	+3.8 %

Net interest income under the above scenarios is influenced by the characteristics of the Bank s assets and liabilities. In the case of N.O.W., savings and money market deposits (total $1.067 billion) interest is based on rates set at the discretion of management ranging from 0.25% to 1.15%. In a downward rate environment, there is a limit to how far these deposit instruments can be re-priced and this behavior is similar to that of fixed rate instruments. In an upward rate environment, the magnitude and timing of changes in rates on these deposits is assumed to be more reflective of variable rate instruments.

It is important to note that the above table is a summary of several forecasts and actual results may vary. The forecasts are based on estimates and assumptions of management that may turn out to be different and may change over time. Factors affecting these estimates and assumptions include, but are not limited to competitors behavior, economic conditions both locally and nationally, actions taken by the Federal Reserve Board, customer behavior, and management s responses. Changes that vary significantly from the assumptions and estimates may have significant effects on the Bank s net interest income. Therefore the results of this analysis should not be relied upon as indicative of actual future results. Historically, the Bank has been able to manage its Net Interest Income in a fairly narrow range reflecting the Bank s relative insensitivity to interest rate changes. The impact of prepayment behavior on mortgages, real estate loans, mortgage backed securities, securities with call features, etc. is not considered material to the sensitivity analysis. Over the last 5 years, the Bank s net interest margin (which is net interest income divided by average earning assets of the Bank) has ranged from a low of 4.95% to a high of 6.06% (not taxable equivalent). The Bank s net interest margin in 2005 of 5.32% was just below the middle of this range by historical standards, coming off the low levels experienced in 2004 and 2003 of 4.95% and 5.14%, respectively. The improvement in the net interest margin in 2005 is a result of both the higher level of interest rates and the change in mix of earning assets (the Bank now has a higher portion in loans vis-à-vis investment securities compared to 2004 when the margin was at its lowest level). The net interest margin under the alternative scenarios ranges from 5.09% to 5.69%. Management feels this range of scenarios is consistent with current experience and interest rate levels, but no assurances can be given that actual future experience will fall within this range.

The Bank s exposure with respect to interest rate derivatives, exchange rate fluctuations, and/or commodity price movements is nil. The Bank does not own any instruments within these markets.

Provision for Loan Losses

The Company did not make a provision to the allowance for loan losses during 2005. In 2004 and 2003 however, it reduced the allowance for loan losses by $2.7 million and $969 thousand, respectively, through a benefit to the provision for loan losses. These actions over the past three years reflected strong credit quality standards, consistent performance of the loan portfolio in recent years, improving trends in classified loans, improving trends in delinquencies, an improved outlook for the collection of the Company s non accrual loans, the reduced absolute level of non accrual loans and the outlook for economic activity in general. The need for additional provision for loan losses or for further benefit to the provision for loan losses in 2006 will be dependent upon Management s on-going analysis of the adequacy of the allowance for loan losses. While Management believes the allowance to be adequate at the present time, the appropriate value can fluctuate over time in response to economic conditions and the subjective decisions which must be made in response to those conditions.

Non-Interest Income

Non-Interest Income for 2005 totaled $21.4 million compared to $27.8 million in 2004 and $29.1 million in 2003. Service charges on deposit accounts decreased $0.8 million to $9.4 million in 2005 compared to 2004 following an increase of $0.9 million to $10.2 million in 2004 versus 2003. The decrease in 2005 compared to 2004 reflects primarily a decline in account analysis charges collected in the face of higher earnings credits for compensating balances posted to customer accounts in the higher rate environment compared to the prior year. The increase in 2004 compared to 2003 primarily reflects the implementation of a new decision plan module for handling non-sufficient fund and overdraft accounts and the merger with Ojai Valley Bank.

Commissions, fees and other service charges decreased by $4.0 million in 2005 to $8.6 million. This followed a decrease of $0.5 million in 2004 over 2003. The decrease in 2005 is a result of outsourcing its merchant credit card processing functions (approximately $5.2 million) offset by improvements to other categories, especially debit card fees ($0.4 million), letter of credit commissions ($0.3 million) and trust department income ($0.3 million). The Company now receives a payment for merchant credit card processing which is net of expenses, so a similar decline was experienced in the non interest expense section of the income statement. The decrease in 2004 compared to 2003 also related primarily to a drop in merchant credit card processing income as a result of outsourcing this activity late in the year.

Gains on sales of securities decreased to $88 thousand in 2005 following $475 thousand and $40 thousand gains in 2004 and 2003, respectively. The net gains in 2005 were recognized primarily in the second quarter as the Company liquidated certain securities to help fund loan growth during the year. The gain in 2004 reflected the acceptance of a tender offer for a $1.0 million block of corporate bonds held by the Bank resulting in a $352 thousand gain in the first quarter and the sale of an additional security (the put feature of which was no longer applicable) at a gain of $93 thousand in the third quarter.

The Gain on Sale of loans held for sale (single family mortgages) was $549 thousand in 2005 compared to $607 thousand in 2004 and $3.4 million in 2003. The modest decline in 2005 compared to 2004 reflected a lower volume of jumbo adjustable rate mortgage loans sold as the Company kept a larger amount of these in its regular loan portfolio. The higher levels in 2003 compared to 2004 reflected the large amount of mortgage refinance activity experienced as a result of the historically low mortgage interest rate levels in that year.

All other sources of income were $2.8 million in 2005, compared to $3.9 million in 2004 and $3.3 million in 2003. The decline in 2005 compared to 2004 related to a $1.1 million gain on the sale of OREO in 2004 which did not recur in 2005. The increase in 2004 over 2003 was a result of the $1.1 million gain on sale of OREO in 2004, partially offset by declines in miscellaneous recoveries from the prior year.

Non-Interest Expense

Total non-interest expense for 2005 was $77.7 million, following $79.3 million in 2004, and $74.7 million in 2003. Salaries and employee benefits increased to $44.6 million in 2005 compared to $41.8 million in 2004 and $39.2 million in 2003. The increase in 2005 compared to 2004 reflects: 1) a $1.7 million increase in expense for the Company s bonus program due to exceeding goals established at the start of the year by a greater degree in 2005 than in 2004, 2) increases in payroll taxes and other benefits of $0.4 million and 3) salary expense increases of $0.7 million. The increase in 2004 compared to 2003 was a result of including: 1) the addition of employees from the acquisition of Ojai Valley Bank resulting in approximately $0.9 million more salaries and benefits expense, 2) increases in the Company cost of health care coverage for employees and workers compensation premiums of approximately 198 thousand, and 3) the balance being regular salary increases. Salary and Benefit levels were higher in the fourth quarter of the year ($11.9 million compared to $11.1 million in the third quarter) reflecting higher rates on the bonus payout, the filling of a number of open positions throughout the Bank and the hiring of individuals in anticipation of its expansion efforts to establish a branch and commercial lending office in Westlake Village in the Spring of 2006. Additionally, beginning in late 2005, the Company expanded its compliance efforts and anticipates the possible hiring of additional staff members in 2006 to meet the increasing level of compliance legislation and rule making. Management considers containment of salaries and benefits costs in 2006 and beyond to be one of its top challenges. A number of factors are continuing to create unusually strong upward pressure on these costs, especially in the areas of medical benefits, workers compensation costs and competitive wages. Also, during the first quarter of 2006, the Company will implement a change in accounting for stock options which will require it to take a charge to compensation expense based on the grant date fair value of its stock option awards and the estimated number of awards that are expected to vest. The cost will be recognized over the period during which the employees are required to provide service in exchange for the awards usually the vesting period. Initial estimates for 2006 put the impact at approximately $1.0 million pre-tax or $0.03 per share. See Note 1 and Note 15 of the Notes to the Consolidated Financial Statements which follows in item 8 of this report. The Company is addressing these cost pressures by focusing on ways of becoming more efficient in its processes and using technology wherever possible to hold down staffing requirements.

Occupancy expense was virtually unchanged in 2005 and 2004 at $12.5 million, having increased from $11.6 million in 2003. The increase in 2004 over 2003 reflects a $533 thousand dollar increase in depreciation expense resulting from new fixed assets put in service, a $123 thousand increase in rental expense (largely because of the new Ojai facilities) and other miscellaneous increases in maintenance, repairs and utilities. Occupancy expense is expected to increase in 2006 as the result of opening a new bank branch and commercial banking office in Westlake Village in the Spring, an upgrade planned to the Bank s computer mainframe, certain branch renovations and normal rent increases. Management expects these increases in cost to be approximately $0.9 million for 2006.

Advertising and promotion expenditures were $4.4 million in 2005 following charges of $4.0 million in 2004 and $2.9 million in 2003. The increase in 2005 over 2004 reflected increased business development expenditures of $269 thousand, increased donations of $115 thousand and various other smaller increases in individual line items. The increase in 2004 over 2003 reflected a planned increase of $1.0 million in the Company s marketing budget in support of 1) an expanded awareness campaign in the relatively new Ventura County market and 2) increased consumer loan sales efforts. The Company does not expect any major increases in its 2006 expenditures and anticipates they will show only modest increases over 2005 levels.

General office expenditures were $3.8 million in 2005 following levels of $4.0 million in 2004 and $3.8 million in 2003. While this category of expenditure has been relatively flat in recent years, the small increase in 2004 reflects the recent Ojai acquisition. This category includes primarily charges for stationery and supplies, telephone expenses, and postage. Management does not expect any significant changes to this category in 2006.

Merchant processing and data processing charges were $0.9 million in 2005, $5.2 million in 2004, and $6.2 million in 2003. The decline reflects the outsourcing of this function to an outside vendor late in 2004. Management s expectation for 2006 is that this category of expense will be little changed.

Professional services were $5.0 million in 2005 following $5.5 million in 2004 and $4.3 million in 2003. The decrease in 2005 compared to 2004 reflects primarily lower costs incurred with complying with the Sarbanes-Oxley Act, Section 404 requirements pertaining to the effectiveness of internal control over financial reporting. The increase in 2004 over 2003 reflects increased costs of $913 thousand for the Company s outside accounting firm and its outsourced internal audit firm to comply with the 404 requirements. Management expects costs in 2006 for professional services to be little changed from 2005 levels.

Regulatory assessments (charges for FDIC assessments and DFI fees) have been little changed over the past three years at $0.4 million, $0.5 million and $0.4 million in 2005, 2004, and 2003, respectively. Management does not anticipate any significant increases in these charges in 2006.

Other operating expenses continue to be relatively stable in 2005 at $6.0 million compared to $5.8 million in 2004 and $6.2 million in 2003. The increase in 2005 compared to 2004 reflects especially a decrease in the total credit to the provision for losses on unfunded commitments of $136 thousand. The decrease in 2004 reflects a $328 thousand change in the provision for losses on unfunded commitments from a debit position in 2003 to a credit in 2004.

Taxes

Book tax expense amounted to $19.1 million in 2005, $17.5 million in 2004, and $15.9 million in 2002. While the statutory tax rate of the Company is 42.05%, the actual rate accrued was 33.7%, 33.3%, and 34.8% in 2005, 2004, and 2003, respectively. The primary reason for the difference compared to the statutory rate relates to the tax exempt income generated by the Company s municipal bond portfolio.

While the 2005 tax rate was little changed from 2004, the small decline in the accrued rate in 2004 from 2003 reflected a modest increase in municipal tax exempt income.

As described in Footnote No. 10 to the financial statements, the Company has deferred tax assets primarily related to the timing difference associated with charge-offs and provisions for losses on certain loans and with the timing difference on deferred compensation.

SUBSIDIARY ACTIVITY

Mid-Coast Land Company

Mid-Coast Land Company recorded a profit of $409 thousand in 2005, $379 thousand in 2004 and $322 thousand in net income in 2003. The gains in each of these years primarily relate to the on-going commissions on the sale of property formerly owned by Mid-Coast Land Company. Management expects earnings to continue for several years as there are 86 lots remaining to be sold at the start of 2006 (down from 97 one year earlier) which are subject to the payment of these commissions. Mid-Coast Land Company is no longer engaged in real estate development activity, having sold its final property which closed during the first quarter of 2003. It currently records residual activity resulting from prior years operations.

MSB Properties, Inc.

This wholly owned subsidiary was formed to engage in the specific business of acquiring, owning, and improving real property and tangible personal property which may be necessary or convenient for the operation or housing of the administrative departments and branch offices of the Bank. Incorporated under the laws of the State of California in May of 1968, it also allows for the ownership of property which may be reasonably necessary for future expansion of the Bank s business, or which is otherwise reasonably related to the conduct of the Bank s business, pursuant to Section 752 of the Financial Code of the State of California.

Earnings for this subsidiary consist primarily of rental income from the Bank s offices and administrative center coupled with a minor amount of rental income from non-bank tenants and interest earnings on its cash assets. Leases are written with market terms and at market rates. Expenses are principally rental expense, depreciation of leasehold improvements, general maintenance and utilities expense. The affairs of the subsidiary are managed by Bank employees and as such this subsidiary has no paid staff members.

Earnings for MSB Properties, Inc. have remained relatively unchanged over the years with net earnings after-tax of $1.2 million, $1.2 million, and $1.4 million, in 2005, 2004 and 2003, respectively. The subsidiary benefited from a one-time pre-tax gain of $273 thousand in 2003 from the sale of a property.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

This Management s Discussion and Analysis of Financial Condition and Results of Operations, as well as, disclosures included elsewhere in this Form 10-K, are based upon the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements require Management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingencies. Management believes that the most significant subjective judgements that it is required to make include the following:

- *Allowance for losses.* Management reviews the adequacy of the allowance and also employs an independent third party loan review group to, among other things, review the adequacy of the allowance and make recommendations. Management, as necessary, adjusts the allowance for loan losses and the allowance for losses unfunded commitments. These adjustments are made through

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a charge to expense or a benefit in the provision for loan losses on the income statement. The allowance is also examined annually by one or more of the Bank s regulatory bodies including the FDIC and DFI. The need for additional provision for loan losses in 2006, or a benefit to the provision for loan losses, will be dependent upon Management s on-going analysis of the adequacy of the allowance for losses. While Management believes it to be adequate at the present time, the appropriate value can fluctuate over time in response to economic conditions and the subjective decisions which must be made in response to those conditions.

- *Fair Value.* Where applicable, the Company is required by Generally Accepted Accounting Principles (GAAP) to disclose the fair value of financial instruments and the methods and significant assumptions used to estimate those fair values. Also, the fair value calculated on collateral supporting the Bank s extensions of credit (e.g. appraisals on the property securing real estate loans) can have a significant effect on the determination of the adequacy of the allowance for losses noted above. Wherever possible, fair value used by the Company equals quoted market price, as for example with its investment securities portfolio, if available. If it is not available, fair value is estimated by the Company using quoted market prices for similar assets. Fair value of other instruments involves discounting future cash flows using current market rates for instruments with similar maturity and credit characteristics. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers 1) the length of time and the extent to which the fair value has been less than cost, 2) the financial condition and near-term prospects of the issuer, and 3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Management is also required to calculate the fair value of its options issued under its Equity Based Compensation Plan. See Note 15 to the Consolidated Financial Statements for a description of the calculation of pro forma compensation expense based on the fair value of options issued at the grant date.

- *Taxes.* The Company estimates its quarterly effective income tax rate based upon a variety of factors, including, but not limited to, the expected revenues for the year and the product mix of revenue, and the ratio of permanent differences to total revenue. Any changes to the estimated rate are made prospectively in accordance with APB 28 Interim Financial Reporting . Additionally, a valuation allowance, which was zero at December 31, 2005 and 2004, provides for deferred taxes that are not anticipated to be offset by taxable income projected for the next 12 months. A valuation allowance is based on estimates by Management which can change over time.

- *Goodwill and Core Deposit Intangibles.* The Company is required by GAAP to perform an annual impairment analysis of the amount of Goodwill showing on its Consolidated Statement of Financial Position. Additional information can be found under Goodwill and Core Deposit Intangibles earlier in this Managements Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Certain information concerning market risk is contained in the Notes to the Consolidated Financial Statements which are included in Item 8 of this Report and in Management s Discussion and Analysis of Financial Condition and Results of Operations which is included in Item 7 of this Report.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Management s Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting of the Company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting also includes controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to comply with the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act.

The Company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, Management concluded that the Company s internal control over financial reporting was effective as of December 31, 2005 and 2004. Management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2005 and 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

/s/ JAMES W. LOKEY	/s/ JAMES G. STATHOS
James W. Lokey	James G. Stathos
President	*Executive Vice President*
Chief Executive Officer	*Chief Financial Officer*

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Mid-State Bancshares:

We have completed integrated audits of Mid-State Bancshares   2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Mid-State Bancshares and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. 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 of these statements 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 of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005 and 2004, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting 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 effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Management s assessment and our audit of Mid-State Bancshares   internal control over financial reporting also included controls over the preparation of financial statements in accordance with the instructions to the Consolidated

Financial Statements for Bank Holding Companies (Form FR Y-9C) to comply with the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Los Angeles, California
March 15, 2006

Consolidated Statements of Financial Position
(amounts in 000 s except share amounts)

	December 31, 2005	2004
Assets		
CASH AND DUE FROM BANKS	**$ 109,791**	$ 112,669
FEDERAL FUNDS SOLD		6,000
SECURITIES AVAILABLE FOR SALE	**619,332**	644,817
LOANS HELD FOR SALE	**10,176**	12,988
LOANS, net	**1,507,118**	1,408,095
PREMISES AND EQUIPMENT, net	**24,772**	24,946
ACCRUED INTEREST RECEIVABLE	**13,947**	11,918
GOODWILL	**47,840**	47,840
CORE DEPOSIT INTANGIBLES, net	**6,483**	7,732
SENIOR HOUSING CRIME PREVENTION FOUNDATION INVESTMENT	**30,000**	
OTHER ASSETS	**22,040**	19,082
TOTAL ASSETS	**$ 2,391,499**	$ 2,296,087
Liabilities		
DEPOSITS:		
Demand deposits	**$ 567,782**	$ 517,139
Savings, money market and NOW accounts	**1,067,486**	1,083,139
Time deposits $100,000 or more	**202,063**	166,295
Time deposits Under $100,000	**232,275**	227,972
Total Deposits	**2,069,606**	1,994,545
OTHER BORROWINGS	**25,903**	6,582
ALLOWANCE FOR LOSSES UNFUNDED COMMITMENTS	**1,761**	1,783
ACCRUED INTEREST PAYABLE & OTHER LIABILITIES	**21,667**	18,550
TOTAL LIABILITIES	**2,118,937**	2,021,460
Commitments and Contingencies (Note 12)		
Capital Accounts		
CAPITAL STOCK, NO PAR VALUE:		
Authorized 100,000,000 shares		
Outstanding 22,520,434 shares in 2005 and 23,099,159 in 2004	**42,343**	61,439
UNDIVIDED PROFITS	**229,824**	206,328
ACCUMULATED OTHER COMPREHENSIVE INCOME, NET OF TAXES OF $264 IN 2005 AND $4,573 IN 2004	**395**	6,860
TOTAL CAPITAL ACCOUNTS	**272,562**	274,627
TOTAL LIABILITIES & CAPITAL ACCOUNTS	**$ 2,391,499**	$ 2,296,087

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

Consolidated Statements of Income
(amounts in 000 s except per share amounts)

	Year Ended December 31, 2005	2004	2003
Interest Income:			
Interest and fees on loans and leases	**$ 104,401**	$ 85,127	$ 80,372
Interest on securities:			
U.S. Treasury securities	**679**	974	1,012
U.S. Government agencies and corporations	**6,492**	8,553	8,809
Obligations of states and political subdivisions, other	**15,576**	14,802	14,219
Interest on federal funds sold	**1,178**	480	828
TOTAL INTEREST INCOME	**128,326**	109,936	105,240
Interest Expense:			
Interest on deposits	**14,610**	8,256	9,548
Interest on other borrowings	**893**	194	151
TOTAL INTEREST EXPENSE	**15,503**	8,450	9,699
Net Interest Income	**112,823**	101,486	95,541
(Benefit)/Provision for loan losses		(2,700)	(969)
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	**112,823**	104,186	96,510
Other Income:			
Service charges on deposit accounts	**9,384**	10,164	9,254
Commissions, fees and other service charges	**8,620**	12,577	13,064
Gains on sale of securities	**88**	475	40
Gain on sale of loans held for sale	**549**	607	3,385
Other income	**2,800**	3,941	3,316
TOTAL OTHER INCOME	**21,441**	27,764	29,059
Other Expenses:			
Salaries & employee benefits	**44,635**	41,779	39,156
Occupancy expenses	**12,534**	12,509	11,572
Advertising & promotion	**4,439**	3,955	2,938
General office	**3,809**	4,017	3,832
Merchant processing and data processing fees	**900**	5,197	6,207
Professional services	**4,955**	5,525	4,342
Regulatory assessments	**445**	498	407
Other operating expenses	**5,957**	5,814	6,237
TOTAL OTHER EXPENSES	**77,674**	79,294	74,691
Income before taxes	**56,590**	52,656	50,878
Tax expense	**19,099**	17,547	17,714
NET INCOME	**$ 37,491**	**$ 35,109**	$ 33,164
Earnings per share:			
Basic	**$ 1.65**	$ 1.50	$ 1.41
Diluted	**$ 1.61**	$ 1.47	$ 1.40
Average shares used in earnings per share calculation:			
Basic	**22,788**	23,422	23,443
Diluted	**23,300**	23,897	23,762

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

Consolidated Statements of Comprehensive Income
(amounts in 000 s)

	Year Ended December 31, 2005	2004	2003
NET INCOME	**$ 37,491**	**$ 35,109**	$ 33,164
Other Comprehensive Income Before Taxes:			
Unrealized (losses) gains on securities available for sale:			
Unrealized holding losses arising during year	**(10,687)**	(8,568)	(1,547)
Reclassification adjustment for gains included in net income	**(88)**	(475)	(40)
Other comprehensive loss, before tax	**(10,775)**	(9,043)	(1,587)
Income tax benefit	**(4,310)**	(3,626)	(626)
OTHER COMPREHENSIVE LOSS, NET OF TAXES	**(6,465)**	(5,417)	(961)
TOTAL COMPREHENSIVE INCOME	**$ 31,026**	$ 29,692	$ 32,203

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

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Consolidated Statements of
Changes in Capital Accounts
(amounts in 000 s except share amounts)

	Number of Shares	Capital Stock	Undivided Profits	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, December 31, 2002	23,697,235	77,588	163,309	13,238	254,135
Cash dividend $0.50 per share			(11,702)		(11,702)
Exercise of stock options	172,096	2,284			2,284
Shares issued in connection with Merger	498,153	11,846			11,846
Net income			33,164		33,164
Change in net unrealized gain on available for sale securities, net of taxes of $(626)				(961)	(961)
Stock repurchased	(800,006)	(16,212)			(16,212)
BALANCE, December 31, 2003	23,567,478	$ 75,506	$ 184,771	$ 12,277	$ 272,554
Cash dividend $0.58 per share			(13,552)		(13,552)
Exercise of stock options	190,548	2,579			2,579
Net income			35,109		35,109
Change in net unrealized gain on available for sale securities, net of taxes of $(3,626)				(5,417)	(5,417)
Stock repurchased	(658,867)	(16,646)			(16,646)
BALANCE, December 31, 2004	23,099,159	$ 61,439	$ 206,328	$ 6,860	$ 274,627
Cash dividend $0.66 per share			(14,995)		(14,995)
Exercise of stock options	266,330	3,969			3,969
Tax Benefit from exercise of options			1,000		1,000
Net income			37,491		37,491
Change in net unrealized gain on available for sale securities, net of taxes of ($4,310)				(6,465)	(6,465)
Stock repurchased	(845,055)	(23,065)			(23,065)
BALANCE, December 31, 2005	**22,520,434**	**$ 42,343**	**$ 229,824**	**$ 395**	**$ 272,562**

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

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Consolidated Statements of Cash Flows
(amounts in 000 s)

	Year Ended December 31, 2005	2004	2003
Operating Activities:			
Net Income	**$ 37,491**	$ 35,109	$ 33,164
Adjustments to reconcile net income to net cash provided by operating activities:			
(Benefit)/Provision for credit losses		(2,700)	(969)
Provision for depreciation and amortization	**5,249**	5,044	4,511
Amortization of originated mortgage servicing rights	**458**	459	804
Amortization of net investment security premiums	**3,743**	5,120	4,204
Amortization of deferred loan (costs) fees	**(525)**	(163)	687
Amortization of core deposit intangible assets	**1,249**	1,375	1,121
Gain on sale of investments	**(88)**	(475)	(40)
Originations of loans held for sale	**(70,517)**	(77,218)	(222,486)
Proceeds from sales of loans held for sale	**73,878**	78,247	235,021
Gain on sale of other real estate owned		(1,084)	
Gain on sale of loans held for sale	**(549)**	(607)	(3,385)
Deferred tax charge (benefit)	**33**	(765)	1,814
(Increase) decrease in accrued interest	**(2,029)**	256	(485)
Decrease (increase) in other assets	**860**	(4,176)	(2,938)
Increase (decrease) in accrued interest payable and other liabilities	**3,095**	4,882	(1,257)
Net cash provided by operating activities	**52,348**	43,304	49,766
Investing Activities:			
Proceeds from sales and maturities of securities	**140,159**	160,631	137,567
Purchases of securities	**(159,104)**	(44,463)	(275,591)
Net increase in loans	**(98,498)**	(266,363)	(41,427)
Receipts from real estate investments, net of advances		4,512	
Cash acquired in acquisition, net of cash used			9,959
Purchases of premises and equipment	**(5,071)**	(3,670)	(5,265)
Net (loss) gain from proceeds on sales of premises and equipment	**(4)**	5	10
Net cash used in investing activities	**(122,518)**	(149,348)	(174,747)
Financing Activities:			
Net increase in deposits	**75,061**	82,114	180,684
Increase in other borrowings Federal Home Loan Bank	**20,000**		
Net decrease in other borrowings revolving T.T. & L. note	**(679)**	(1,045)	(3,346)
Cash dividend paid	**(14,995)**	(13,552)	(11,702)
Proceeds from exercise of stock options	**4,970**	2,579	2,284
Purchase of bank stock for retirement	**(23,065)**	(16,646)	(16,212)
Net cash provided by financing activities	**61,292**	53,450	151,708
(DECREASE) INCREASE IN CASH & CASH EQUIVALENTS	**(8,878)**	(52,594)	26,727
CASH AND CASH EQUIVALENTS, beginning of year	**118,669**	171,263	144,536
CASH AND CASH EQUIVALENTS, end of year	**$ 109,791**	$ 118,669	$ 171,263

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Consolidated Statements of Cash Flows (Continued)
(amounts in 000 s)

	Year Ended December 31, 2005	2004	2003
Supplemental disclosure of cash flow information			
Cash paid during the year for:			
Interest	**$ 15,112**	$ 8,237	$ 9,424
Taxes on income	**19,057**	15,006	19,136
Transfers from loans to other real estate owned			3,279
Supplemental disclosure of non-cash investing activities:			
Transfer of security investment for senior housing crime prevention foundation investment	**30,000**		
ACQUISITIONS			
Fair value of tangible assets acquired	**$**	$	$ 87,484
Fair value of core deposit intangible acquired			2,727
Goodwill created in acquisition			14,392
Liabilities assumed			(79,592)
Acquisition price, including direct costs			25,011
Less:			
Common stock issued			(11,846)
Amounts payable to shareholders and other accruals			(203)
Cash paid			(12,962)
Cash acquired			22,921
Cash acquired, net of cash paid	**$**	$	$ 9,959

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies

The accounting and reporting policies of Mid-State Bancshares and subsidiary (the Company) conform with accounting principles generally accepted in the United States (GAAP) and general practice within the banking industry. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The following are descriptions of the more significant accounting policies of the Company.

Consolidation: The consolidated financial statements include the accounts of Mid-State Bancshares and its wholly owned subsidiary, Mid-State Bank & Trust, (the Bank) which includes Mid-State Bank & Trust s wholly owned subsidiaries, Mid-Coast Land Company and MSB Properties, Inc. All inter-company accounts and transactions have been eliminated in the consolidated financial statements.

Significant Group Concentrations of Credit Risk: Most of the Company s activities are with customers located within the three counties of San Luis Obispo, Santa Barbara and Ventura in California. Note 4 below reviews the types of securities that the Company invests in. Note 5 reviews the types of lending that the Company engages in. The Company does not have any significant concentrations to any one industry or customer, but does have a significant portion of its loan portfolio (approximately 84%) secured by real estate.

Cash and Cash Equivalents: For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold and securities purchased under agreements to resell, all of which mature within ninety days.

Securities: Securities for which the Company has the positive intent and ability to hold until maturity would be classified as held-to-maturity securities. Securities which are purchased principally for the purpose of selling them in the near term for a gain would be classified as trading securities. Securities not classified as held-to-maturity or trading are classified as available for sale. The Company holds no securities that should be classified as trading securities or held-to-maturity securities. Securities classified as available for sale are reported on the consolidated statements of financial position as of December 31, 2005 and 2004, at their market value. The net unrealized gains or losses for these securities are reported, net of related taxes, in the statements of comprehensive income for the years ended December 31, 2005, 2004 and 2003 and as a separate component of the capital accounts for the years ended December 31, 2005 and 2004.

In connection with the merger with Ojai Valley Bank (see Note 2 below), Mid-State Bancshares classified approximately $28.7 million of securities as available for sale which were previously categorized as held to maturity on Ojai Valley Bank s Statement of Financial Position. These actions were taken in conformance with Mid-State Bancshares overall asset/liability and investment management policy and are permitted under Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

Interest income from the securities portfolio is accrued as earned including the accretion of discounts and the amortization of premiums based on the original cost of each security owned. The accretion of discounts and the amortization of premiums are on a straight-line basis to the expected maturity date of the bond. The gain or loss recognized on any security sold prior to maturity is based on the difference

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies (Continued)

between principal proceeds and this amortized cost. Related income taxes are calculated at current federal and state statutory rates.

Loans Held for Sale: Loans held for sale are carried at the lower of cost or market, which is determined on an aggregate basis. They are stated at the amount of unpaid principal, reduced by market valuation adjustments and increased or reduced by net deferred loan origination fees and costs. Interest on loans is recognized over the terms of the loans and is calculated on principal amounts outstanding. Direct loan origination fees and costs are deferred until the related loan is sold.

Loans: Loans are stated at face amount, less payments collected and net deferred loan fees. Income is accrued daily as earned. Loan origination costs are netted against loan fees collected and the net amount is deferred in accordance with SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* and amortized into income over the expected life of the loan. The allowance for loan losses, which is based on estimates, is maintained at a level considered adequate to provide for losses that are considered to be inherent in the portfolio. Ultimate losses may vary from the current estimates. Management reviews these estimates periodically, considers the borrower s financial status, current economic conditions, historical loan loss experience and other factors. As adjustments become necessary, they are reported in earnings in the periods in which they become known. The allowance is increased by provisions charged to operating expense and reduced by net charge--offs.

In determining income recognition on loans, generally no interest is recognized with respect to loans on which a default of interest or principal has occurred for a period of 90 days or more. Consumer loans are typically charged-off when they are 90 days or more past due. Other types of loans are placed on non-accrual status when management believes that the borrower s financial condition, after giving consideration to economic and business conditions and collection efforts, is such that the presumption of collectibility of interest no longer is prudent. When a loan is placed on non-accrual status, previously accrued and uncollected interest is reversed from income. Loans on non-accrual are charged off, or partially charged off, when collection of all, or a portion of, principal is considered doubtful. Payments received on non accrual loans are applied to principal unless the loan has had a partial charge off in which case payment is applied as a recovery to the allowance for loan losses. Once a loan is on non-accrual, it is generally not returned to accrual status until 1) all past due principal and interest payments have been paid, 2) there has been a demonstrated ability to make payments for 6 to 12 months, and 3) there is sufficient collateral supporting the loan.

Premises and Equipment: Premises and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed principally on the straight-line method over the lesser of the estimated useful life of each type of asset or the lease term.

Other Real Estate Owned: Other Real Estate Owned (OREO) is comprised of real estate acquired through foreclosure. It is carried at the lower of cost or estimated fair value less estimated costs of disposal.

Goodwill: The amounts presented on the Company s consolidated statements of financial position represents the excess of acquisition prices paid over and above the fair market value of net assets acquired. In accordance with the terms of SFAS No. 142, on an annual basis, the Company tests its Goodwill for impairment. Goodwill is entirely attributable to the Company s community banking segment, and because the fair market value of Mid-State Bancshares equity is a safe proxy for the fair market value of the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies (Continued)

community banking segment, the Company compares its fair market value of equity to its book value. This difference is compared to Goodwill. Provided the excess of fair market value to book value is above the Goodwill amount, there is no impairment of Goodwill.

Core Deposit Intangible: The fair market value of core deposits acquired are carried at cost, less accumulated amortization. The amounts carried are included in Core Deposit Intangibles, net, on the consolidated statements of financial position. The amortization of the Core Deposit Intangible (CDI) is computed principally on a straight-line basis over its expected useful life. On an annual basis, the Company tests it CDI for impairment. The amortized CDI is compared to the original amount of CDI booked at the time of the acquisition. This percentage is then compared to the percentage of customers acquired in the acquisition who are still banking with the Bank. Provided the percentage of the CDI does not exceed the percentage of customers who are still banking with the Bank, there is no impairment. The amortization of the CDI may be adjusted from time to time based on the results of this test.

Allowance for losses unfunded commitments: The allowance for loan losses unfunded commitments, which is based on estimates, is maintained at a level considered adequate to provide for losses that are considered to be inherent in commitments and contingencies which the Company is obligated under. Ultimate losses may vary from the current estimates. Management reviews these estimates periodically, considers the financial status of the commitment or contingency, current economic conditions, historical experience and other factors. As adjustments become necessary, they are reported in earnings in the periods in which they become known. The allowance is increased by provisions charged to other operating expense and reduced by credits to other operating expense.

Accounting for Income Taxes: Deferred income tax assets or liabilities are computed based on the difference between the financial statement and income tax basis of assets and liabilities using the enacted marginal tax rate. Deferred income tax expenses or benefits are based on the changes in the deferred asset or liability from period to period. The Company estimates its quarterly effective income tax rate based upon a variety of factors, including, but not limited to, the expected revenues for the year and the product mix of revenue, and the ratio of permanent differences to total revenue. Any changes to the estimated rate are made prospectively in accordance with APB 28 Interim Financial Reporting . Additionally, Management makes estimates as to the amount of reserves, if any, that are necessary for known tax exposures.

Stock Option Plan: The Company applies Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations in accounting for its Plan. Accordingly, no compensation expense has been recognized for grants under the Plan. Consistent with the methods of SFAS No. 123, pro-forma compensation expense for the Plan is determined based on the fair value at the grant date. Fair values were estimated using the Black-Scholes option-pricing model and pro forma disclosures of net income and earnings per share, as if the fair value based method of accounting had been applied, are disclosed in Note 15.

Recent Accounting Pronouncements: In January of 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 46, Consolidation of Variable Interest Entities . FIN No. 46 addresses consolidation by business enterprises of variable interest entities, which have one or both of the following characteristics: i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity; and ii) the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies (Continued)

equity investors lack an essential characteristic of a controlling financial interest. FIN No. 46 was initially effective for all financial statements issued on or after February 1, 2003, but subsequently the adoption date was deferred to January 1, 2004. The adoption of FIN No. 46 did not have a material impact on the Company s results of operations and financial position.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS 149 was effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. The adoption of SFAS 149 did not have a material impact on the Company s results of operations and financial position.

The FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity in May of 2003. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material impact on the Company s results of operations and financial position.

The FASB issued SFAS No. 132 (revised 2003), Employers Disclosures about Pensions and Postretirement Benefits in December of 2003. SFAS No. 132 requires additional disclosures about the assets, obligations and cash flows of defined benefit pension and postretirement plans, as well as the expense recorded for such plans. As of December 31, 2003, the Company has disclosed the required elements related to its defined benefit pension plan in Note 16 to these consolidated financial statements.

In December 2003, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. The SOP was effective for loans acquired in fiscal years beginning after December 15, 2004. The SOP addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an Investor s initial investment in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. The adoption of SOP 03-3 did not have a material impact on the Company s results of operations and financial position.

In June 2004, the Emerging Issues Task Force of the Financial Accounting Standards Board (FASB) issued guidance on its Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The guidance made recommendations regarding unrealized losses on available-for-sale debt and equity securities accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, and No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations. The guidance for evaluating whether an investment is other-than-temporarily impaired was to be applied in other-than-temporary impairment evaluations made in reporting periods beginning after June 15, 2004. The disclosures were to be effective in annual financial statements for fiscal years ending after December 15, 2003, for investments accounted for under Statements 115 and 124. On September 30, 2004, the FASB

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies (Continued)

Board directed the issuance of FASB Staff Position (FSP) EITF Issue 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1. The proposed FSP would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under paragraph 16 of issue 03-1. The FASB asked constituents to comment on whether the application guidance with respect to minor impairments should also be applied to securities analyzed for impairment under paragraphs 10-15 of Issue 03-1. At the June 29, 2005 meeting, the Board decided not to provide additional guidance on the meaning of other-than-temporary impairment and directed the staff to finalize proposed FASB Staff Position (FSP) EITF 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1. The final FSP, retitled as FSP FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, would:

1. Replace the guidance in paragraphs 10-18 of EITF Issue 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, and refer to existing other-than-temporary impairment guidance for example, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities

2. Supersede Issue 03-1 and EITF Topic No. D-44, Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value

3. Codify the guidance set forth in Topic D-44 and clarify that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made

4. Be effective for other-than-temporary impairment analyses conducted in periods beginning after September 15, 2005.

At the September 7, 2005 meeting, the Board directed the staff to consider transition guidance for the proposed FSP. At the September 14, 2005 meeting, the Board decided to retain the paragraph in the proposed FSP pertaining to the accounting for debt securities subsequent to an other-than-temporary impairment and add a footnote to clarify that the proposed FSP does not address when a debt security should be designated as nonaccrual or how to subsequently report income on a nonaccrual debt security. In addition, the Board decided that (1) transition would be applied prospectively and (2) the effective date would be reporting periods beginning after December 15, 2005. Adoption of EITF Issue 03-1-a is not expected to have a material impact on the Company s results of operations and its financial position.

The FASB issued a revision to SFAS No. 123, Accounting for Stock-Based Compensation in December 2004. The revised Statement is SFAS No. 123R (revised 2004), Share-Based Payment and it will supercede APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. It is to be effective for the Company as of the beginning of the first annual reporting period that begins after June 15, 2005. The Statement requires that the Company measures the cost of employee services received in exchange for an award of equity instruments (share based payment awards) based on the grant date fair value of the award and the estimated number of awards that are expected to vest. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award usually the vesting period. Compensation cost for awards that

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

1. Summary of Significant Accounting Policies (Continued)

vest would not be reversed if the awards expire without being exercised. The Company currently applies APB Opinion No. 25, in accounting for its Plan. Accordingly, no compensation expense has been recognized for grants under the Plan. Pro forma disclosures of net income and earnings per share are however disclosed in Note 15 of the Company s Annual Report on Form 10K. The Company expects to adopt the revised Statement for the first quarter of 2006. The Company expects that adoption of SFAS No. 123R would have a significant effect on its Consolidated Statements of Income, Comprehensive Income and Changes in Capital Accounts in future years. Initial estimates for 2006 put the impact at approximately $1.0 million pre-tax, or $0.03 per share.

FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* on June 1, 2005, a replacement of APB No. 20 and SFAS No. 3. The Statement applies to all voluntary changes in accounting principle, and changes the requirements for accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 improves financial reporting because its requirements enhance the consistency of financial information between periods. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company expects to adopt the Statement for the first quarter of 2006 and expects it will not have a material effect on its consolidated financial statements.

FASB issued SFAS No. 155, *Accounting for Certain Hybrid Instruments,* on February 16, 2006 as an amendment of FASB Statements No. 133 and 140. The standard allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. The standard also a) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, b) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, c) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and d) amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

2. Merger

Ojai Valley Bank

On October 31, 2003, Mid-State Bancshares and its wholly owned subsidiary Mid-State Bank & Trust acquired 100 percent of the outstanding common stock of Ojai Valley Bank. The results of Ojai Valley Bank s operations have been included in the consolidated financial statements since that date. Ojai Valley Bank was a community bank that served the communities of Ojai and Oak View in Ventura County. The merger expanded Mid-State Bank & Trust s Ventura County presence with these two additional offices.

The aggregate purchase price was $25.0 million, including $11.8 million in cash paid to Ojai Valley Bank shareholders, $11.8 million in Mid-State Bancshares common stock issued and $1.3 million for other merger related expenses. The value of the 498,153 shares issued was determined based on the average closing market price of Mid-State Bancshares common stock over the twenty consecutive trading days that

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

2. Merger (Continued)

Mid-State Bancshares stock traded ending October 24, 2003. The average price of Mid-State Bancshares stock over that period was $23.78. The merger was accounted for utilizing the purchase method of accounting.

A pro forma summary of revenue, net income and earnings per share, as if the merger was in effect at the beginning of each period, is presented below. This summary specifically excludes any expense savings achieved as a result of the merger. Adjustments have been made to reflect the amortization of the core deposit intangible and the loss of interest on cash utilized to complete the merger. These results are not included in the financial statements included herein. Figures are in thousands.

	(Unaudited) For the Year Ended December 31, 2003
Pro Forma Interest and Non Interest Income:	
Combined Mid-State Bancshares and Ojai Valley Bank	$ 138,789
Pro Forma Net Income:	
Combined Mid-State Bancshares and Ojai Valley Bank	$ 32,728
Pro Forma Earnings Per Share Basic	$ 1.37
Pro Forma Earnings Per Share Diluted	$ 1.35

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition, October 31, 2003 (in 000 s).

Cash and Due From Banks	$ 4,731
Federal Funds Sold	18,190
Securities, net	33,423
Loans, Net	30,407
Goodwill(A)	14,392
Other Intangibles(B)	2,727
Other Assets	733
Total Assets Acquired	104,603
Total Deposits	(78,800)
Other Liabilities	(792)
Total Liabilities Assumed	(79,592)
Net Assets Acquired	$ 25,011

(A) Goodwill is completely attributable to the Community Banking segment of the Company and is not deductible for tax purposes.

The entire amount displayed is attributable to a Core Deposit Intangible which is being amortized over its expected useful life of 9.00 years, i.e. through October 31, 2012.

3. Cash Reserves

The average reserve balances required to be maintained by the Federal Reserve Bank were approximately $22.3 million and $24.8 million at December 31, 2005 and 2004, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

4. Securities

A summary of investment securities owned is as follows:

December 31, 2005

(amounts in 000 s) Securities Available For Sale	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury securities	**$ 22,868**	**$**	**$ (222)**	**$ 22,646**
Securities of U.S. government agencies and corporations	**216,218**	**171**	**(1,802)**	**214,587**
Mortgage backed securities	**8,672**	**313**	**(46)**	**8,939**
Obligations of states and political subdivisions	**354,356**	**4,342**	**(2,047)**	**356,651**
Other investments	**16,559**	**22**	**(72)**	**16,509**
TOTAL	**$ 618,673**	**$ 4,848**	**$ (4,189)**	**$ 619,332**

December 31, 2004

(amounts in 000 s) Securities Available For Sale	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U.S. Treasury securities	$ 25,630	$ 5	$ (148)	$ 25,487
Securities of U.S. government agencies and corporations	217,028	796	(1,170)	216,654
Mortgage backed securities	8,824	650	(57)	9,417
Obligations of states and political subdivisions	365,821	11,604	(387)	377,038
Other investments	16,081	141	(1)	16,221
TOTAL	$ 633,384	$ 13,196	$ (1,763)	$ 644,817

The following table shows those investments with gross unrealized losses and their market value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2005:

	Less than 12 months		12 months or more		Total	
(amounts in 000 s)	Market Value	Unrealized Losses	Market Value	Unrealized Losses	Market Value	Unrealized Losses
U.S. Treasury securities	$ 10,778	$ (77)	$ 11,868	$ (145)	$ 22,646	$ (222)
Securities of U.S. government agencies and corporations	84,827	(787)	109,604	(1,015)	194,431	(1,802)
Mortgage backed securities	2,501	(35)	599	(11)	3,100	(46)
Obligations of states and political subdivisions	134,943	(1,508)	20,176	(539)	155,119	(2,047)
Other investments	1,973	(25)	1,962	(47)	3,935	(72)
TOTAL	$ 235,022	$ (2,432)	$ 144,209	$ (1,757)	$ 379,231	$ (4,189)

All of the unrealized losses identified in the table above are attributable to changes in general interest rate levels and are not considered to be other than temporary impairment. The unrealized losses are not

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

4. Securities (Continued)

the result of any deteriorating financial conditions or near term prospects of the underlying issuers and Management believes that it has the intent and ability to either retain these investment securities to allow for the eventual recovery in market value or to hold them until maturity.

Securities having a fair value of $109,959,000 and $106,354,000 at December 31, 2005 and 2004, respectively, were pledged to secure public deposits and for other purposes as required by law.

Proceeds from maturities, calls, partial pay-downs and/or sales of securities were $140,159,000, $160,631,000, and $137,567,000 for the years ended 2005, 2004, and 2003, respectively. Gross gains of $145,000, $485,000, and $46,000 and gross losses of $57,000, $10,000, and $6,000 were realized on that activity for the years ended 2005, 2004, and 2003, respectively.

The amortized cost and market value of securities at December 31, 2005 and 2004, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Included in the due after ten years category below is common stock held in the Federal Home Loan Bank, Federal National Mortgage Association and Federal Agricultural Mortgage Association. Management believes this maturity category most closely matches the non maturity characteristics of these equity investments totaling $8.2 million.

	Available For Sale	
(dollars in 000 s)	**Cost**	**Market**
December 31, 2005*	**Basis**	**Value**
Due in one year or less	**$ 166,103**	**$ 165,257**
Due after one year to five years	**289,849**	**292,076**
Due after five years to ten years	**152,383**	**151,675**
Due after ten years	**2,096**	**2,082**
Equity securities	**8,242**	**8,242**
Total	**$ 618,673**	**$ 619,332**
	Cost	**Market**
December 31, 2004*	**Basis**	**Value**
Due in one year or less	$ 127,629	$ 128,025
Due after one year to five years	304,579	310,386
Due after five years to ten years	191,278	196,500
Due after ten years	2,155	2,163
Equity securities	7,743	7,743
Total	$ 633,384	$ 644,817

* Mortgage back securities are shown at contractual maturity, however, the average life of these securities may differ due to principal prepayments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

5. Loans

The loan portfolio consists of the following:

(dollars in 000 s)	**December 31, 2005**	**2004**
Construction and development loans	**$ 279,417**	$ 229,569
Real estate loans	**816,953**	761,947
Home equity credit lines	**182,057**	160,050
Installment loans	**18,032**	19,206
Cash reserve	**3,367**	3,607
Agricultural production	**35,898**	40,256
Commercial, other	**186,757**	211,251
	1,522,481	1,425,886
Less allowance for loan losses	**(11,896)**	(13,799)
Less deferred loan fees, net	**(3,467)**	(3,992)
TOTAL LOAN PORTFOLIO	**$ 1,507,118**	$ 1,408,095

At December 31, 2005, $1,278,427,000 of the Bank s portfolio was collateralized by various forms of real estate. The Company attempts to reduce its concentration of credit risk by making loans, which are diversified by project type and geographic locations throughout the Central Coast of California. While management of the Company believes that the collateral presently securing this portfolio is adequate, there can be no assurances that a deterioration in the California real estate market would not expose the Bank to significantly greater credit risk.

Loans on non-accrual status totaled $2,463,000 and $10,700,000 at December 31, 2005 and 2004, respectively. The bank had no loans past due 90 days or more and still accruing interest at December 31, 2005 and 2004. If interest income on non-accrual loans had been recorded as originally scheduled, approximately $1,008,140, $1,308,710, and $1,731,761 of additional interest income would have been recorded for the years ended December 31, 2005, 2004 and 2003, respectively. Additionally, there was no interest income which was recognized for loans on non-accrual during 2005, 2004, or 2003.

A loan is identified as impaired when it is probable that interest and principal will not be collected according to the contractual terms of the loan agreement. Because this definition is very similar to that used by bank regulators to determine on which loans interest should not be accrued, the Company expects that most impaired loans will be on non-accrual status. Therefore, in general, the accrual of interest on impaired loans is discontinued, and any uncollected interest is written off against interest from other loans in the current period. No further income is recognized until all recorded amounts of principal are recovered in full or until circumstances have changed such that the loan is no longer regarded as impaired. Certain impaired loans are both fully secured by collateral and are current in their interest and principal payments. These impaired loans are not classified as non-accrual and $37,930, $73,102 and $629,093 in interest was recognized from these loans during 2005, 2004 and 2003, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

5. Loans (Continued)

The amount of the valuation allowance for impaired loans is determined by comparing the recorded investment in each loan with its value measured by one of three methods: (1) the expected future cash flows discounted at the effective interest rate; (2) the loan s observable market price, if available from a secondary market; or (3) by valuing the underlying collateral if the loan is collateral dependent. A valuation allowance is computed as any amount by which the recorded investment exceeds the value of the impaired loan. If the value of the loan, as determined by one of the above methods, exceeds the recorded investment in the loan, a valuation allowance for the loan is not established. The following table discloses information about impaired loans and their related allowance.

	December 31,	
(dollars in 000 s)	**2005**	**2004**
Loans identified as impaired at year end	**$ 2,528**	$ 10,778
Impaired loans for which a valuation allowance has been determined	**1,972**	9,381
Amount of valuation allowance	**592**	4,462
Impaired loans for which no valuation allowance was determined necessary	**556**	1,397

The average amount of the recorded investment in impaired loans during the years ended December 31, 2005, 2004 and 2003 was approximately $6,629,000, $12,914,000 and $19,304,000, respectively. The valuation allowance reported above is determined on a loan-by-loan basis.

The Company also provides an allowance for losses for (1) loans that, while not individually identified as being currently impaired, are internally evaluated as having a relatively higher level of credit risk and (2) losses inherent in the balance of the loan portfolio which have not been specifically identified as of the year-end. The allowance is based on review of individual loans, historical trends, current economic conditions, and other factors. The allowance for loan losses consists of an amount allocated to loans which are impaired, a statistically allocated portion and an unallocated portion. The total of these components is considered adequate to provide for losses which can be reasonably anticipated.

The allowance for loan losses is netted against loans on the Statements of Financial Position for December 31, 2005 and 2004. A summary of the changes in the allowance for loan losses account and the allowance for losses unfunded commitments which shows on the liability side of the Consolidated Statements of Financial Position is as follows:

	December 31,		
(dollars in 000 s)	**2005**	**2004**	**2003**
Balance at beginning of year:			
Allowance for loan losses	**$ 13,799**	$ 16,063	$ 17,370
Allowance for losses unfunded commitments	**1,783**	1,941	1,771
Total allowance for losses at beginning of year	**15,582**	18,004	$ 19,141
(Reductions in) additions to the allowance for loan losses (credited to) charged to expense		(2,700)	(969)
Provision for losses unfunded commitments charged to expense	**(22)**	(158)	170
Loans charged off	**(3,231)**	(940)	(1,894)
Recoveries of loans previously charged off	**1,328**	1,376	1,165
Adjustment Acquired through Merger			391
TOTAL ALLOWANCE FOR LOSSES END OF YEAR	**$ 13,657**	$ 15,582	$ 18,004

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

5. Loans (Continued)

(dollars in 000 s)	December 31, 2005	2004	2003
Allowance for loan losses	**$ 11,896**	$ 13,799	$ 16,063
Allowance for losses unfunded commitments	**1,761**	1,783	1,941
TOTAL ALLOWANCE FOR LOSSES END OF YEAR	**$ 13,657**	$ 15,582	$ 18,004

An analysis of loans and leases to directors and executive officers is as follows:

(dollars in 000 s)	December 31, 2005	2004
Balance, at beginning of year	**$ 8,744**	$ 1,246
Additional loans and leases made	**8,758**	7,817
Payments received and other adjustments	**(3,374)**	(319)
BALANCE AT END OF YEAR	**$ 14,128**	$ 8,744

These loans were made in the ordinary course of the Bank s business and, in management s opinion, were made at prevailing rates and terms. In addition, there were un-funded commitments to loan up to an additional $4,352,000 in extensions of credit to directors and executive officers at year-end.

6. Premises and Equipment

Premises and equipment consisted of the following:

(dollars in 000 s)	December 31, 2005	2004
Land	**$ 7,595**	$ 7,595
Buildings	**32,694**	31,307
Furniture and equipment	**28,345**	26,890
Construction and equipment purchases in progress	**1,828**	444
	70,462	66,236
Less Accumulated depreciation and amortization	**(45,690)**	(41,290)
TOTAL PREMISES AND EQUIPMENT	**$ 24,772**	$ 24,946

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

6. Premises and Equipment (Continued)

Depreciation and amortization included in occupancy expenses was $5,249,000, $5,044,000, and $4,511,000 in 2005, 2004 and 2003, respectively, based on the following estimated useful lives:

Buildings	20-40 years
Furniture and equipment	3-20 years

Total rental expense for banking premises was $2,042,000, $1,985,000, and $1,864,000, in 2005, 2004 and 2003, respectively. As of December 31, 2005 the approximate minimum future lease rentals payable under non-cancelable lease contracts for bank premises were as follows (dollars in 000 s):

Year	
2006	$ 2,351
2007	2,282
2008	2,002
2009	1,887
2010	1,749
Thereafter	4,446
TOTAL LEASE COMMITMENTS	$ 14,717

7. Goodwill and Core Deposit Intangible Assets

The following table presents net income and basic and diluted earnings per common share, adjusted to reflect results as if the non-amortization provisions of SFAS 142 had not been in effect for the periods presented (dollars in 000 s).

	2005	**2004**	**2003**
Net Income:			
Reported net income	**$ 37,491**	$ 35,109	$ 33,164
Less: Amortization of Goodwill, net of taxes	**(3,189)**	(3,189)	(2,390)
Adjusted Net Income	**$ 34,302**	$ 31,920	30,774
Basic earnings per share:			
Reported basic earnings per share	**$ 1.65**	$ 1.50	$ 1.41
Less: Amortization of Goodwill, net of taxes	**(0.14)**	(0.14)	(0.10)
Adjusted basic earnings per share	**$ 1.51**	$ 1.36	$ 1.31
Diluted earnings per share:			
Reported diluted earnings per share	**$ 1.61**	$ 1.47	$ 1.40
Less: Amortization of Goodwill, net of taxes	**(0.14)**	(0.13)	(0.10)
Adjusted diluted earnings per share	**$ 1.47**	$ 1.34	$ 1.30

The following is a summary of the Company s core deposit intangible assets. Figures are in thousands.

	Dec. 31, 2005			**Dec. 31, 2004**		
	Gross Amount	**Accumulated Amortization**	**Net Carrying Amount**	**Gross Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Core Deposit Intangible	**$ 11,597**	**$(5,114)**	**$ 6,483**	$ 11,597	$(3,865)	$ 7,732

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

7. Goodwill and Core Deposit Intangible Assets (Continued)

The aggregate amount of amortization expense of the core deposit intangible assets is as follows ($ in 000 s):

	2005	2004	2003
Amortization of Core Deposit Intangible	**$ 1,249**	$ 1,375	$ 1,122

The decline in the amortization rate in 2005 compared to 2004 is related to an adjustment made necessary by a stronger retention of core deposits from one of the Company s acquisitions than originally anticipated. The projected amortization expense for the core deposit intangible assets, assuming no further acquisitions or dispositions or adjustments to current amortization rates, is approximately $872 thousand per year over the next six years. Amortization of core deposit intangible premiums from prior mergers are currently scheduled to be completed by dates ranging from October 2012 to September 2013 which represent original lives ranging from 9.0 years to 12.0 years.

8. Disclosures about Fair Value of Financial Instruments

Where applicable, the Company is required by GAAP to disclose the fair value of financial instruments and the methods and significant assumptions used to estimate those fair values. In the case of financial instruments for which it is not practicable to estimate the fair value, the Company is required to disclose information pertinent to estimating the fair value such as interest rates and maturity, and also state the reasons why it is not practicable to estimate fair value.

Fair values of financial instruments depict the market s assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market s assessment of the risk that the cash flows will not occur. The information about fair value is said to better enable investors, creditors, and other users to assess the consequences of an entity s investment and financing strategies, that is, to assess its performance.

There are several factors which users of these financial statements should consider. First, there are uncertainties inherent in the process of estimating the fair value of financial instruments. Secondly, the statement covers financial instruments only, not other assets like premises and equipment, the fair value of which might differ significantly from the amounts at which they are carried in an entity s financial statements. Thirdly, the Company must exclude from its estimate of the fair value of deposit liabilities any consideration of its ongoing customer relationships which provide stable sources of investable funds. Lastly, these disclosures do not address means of evaluating an entity s performance in areas other than the management of financial instruments; for example, the ability to generate non-interest income and the control of non-interest expense. For these reasons, users are advised not to regard the disclosure of the fair market value of financial instruments as in any way equivalent to a valuation of the Company as a whole.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and Due from Banks and Fed Funds Sold

For those short-term instruments, the carrying amount is a reasonable estimate of fair value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

8. Disclosures about Fair Value of Financial Instruments (Continued)

Investment Securities

For securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Held for Sale and Loans, net

For certain homogeneous categories of loans, such as some residential mortgages, credit card receivables, and other consumer loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics.

The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Accrued Interest Receivable

For accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

Deposits

The fair value of demand deposits is the amount payable on demand. The fair value of fixed-maturity certificates of deposit, savings accounts and money market deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

Other Borrowings

Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

Commitments to Extend Credit and Letters of Credit

Commitments to extend credit and letters of credit are written at current market rates. The Company does not anticipate any interest rate or credit factors that would affect the fair value of commitments or letters of credit outstanding at December 31, 2005.

Accrued Interest Payable

For accrued interest payable, the carrying amount is a reasonable estimate of fair value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

8. Disclosures about Fair Value of Financial Instruments (Continued)

The estimated fair values of the Company s financial instruments are as follows:

(dollars in 000 s)	2005 Carrying Amount	Fair Value	2004 Carrying Amount	Fair Value
Financial assets:				
Cash and due from banks	**$ 109,791**	**$ 109,791**	$ 112,669	$ 112,669
Fed funds sold			6,000	6,000
Investment securities	**619,332**	**619,332**	644,817	644,817
Loans held for sale	**10,177**	**10,278**	12,988	13,118
Loans, net	**1,507,118**	**1,499,709**	1,408,095	1,366,160
Accrued interest receivable	**13,947**	**13,947**	11,918	11,918
Financial liabilities:				
Deposits	**2,069,606**	**2,063,188**	1,994,545	1,991,371
Other borrowings	**25,903**	**25,638**	6,582	6,582
Accrued interest payable	**685**	**685**	293	293

9. Deposits

Deposits are insured up to $100,000 per member by the Federal Deposit Insurance Corporation (FDIC). The following is a breakdown by type and maturity at year-end of the Bank s deposits:

December 31, 2005

(dollars in 000 s)	No Contractual Maturity	Three Months or Less	After 3 Months to 12 Months	After One Year	Total
Demand Deposits	**$ 567,782**	**$**	**$**	**$**	**$ 567,782**
Savings, Money Market and NOW Accounts	**1,067,486**				**1,067,486**
Time Deposits $100,000 or more		**109,782**	**80,617**	**11,664**	**202,063**
Time Deposits Under $100,000		**89,028**	**111,091**	**32,156**	**232,275**
Total	**$ 1,635,268**	**$ 198,810**	**$ 191,708**	**$ 43,820**	**$ 2,069,606**

December 31, 2004

(dollars in 000 s)	No Contractual Maturity	Three Months or Less	After 3 Months to 12 Months	After One Year	Total
Demand Deposits	$ 517,139	$	$	$	$ 517,139
Savings, Money Market and NOW Accounts	1,083,139				1,083,139
Time Deposits $100,000 or more		83,331	69,017	13,947	166,295
Time Deposits Under $100,000		84,477	103,005	40,490	227,972
Total	$ 1,600,278	$ 167,808	$ 172,022	$ 54,437	$ 1,994,545

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

10. Income Taxes

The current and deferred amounts of the provision for taxes in the years ended December 31, were:

(dollars in 000 s)	**2005**	**2004**	**2003**
Federal:			
Current	**$ 13,081**	$ 12,395	$ 10,942
Deferred	**(116)**	(553)	1,285
Total Federal Taxes	**12,965**	11,842	12,227
State:			
Current	**5,985**	5,917	4,958
Deferred	**149**	(212)	529
Total State Taxes	**6,134**	5,705	5,487
TOTAL FEDERAL AND STATE TAX EXPENSE	**$ 19,099**	$ 17,547	$ 17,714

The provision for taxes on income differed from the amounts computed using the federal statutory rate of 35 percent as follows:

(dollars in 000 s)	**2005**	**2004**	**2003**
Tax expense at federal statutory tax rate	**$ 19,807**	$ 18,429	$ 17,807
State income tax expense, net of state benefit on federal return	**3,986**	3,709	3,567
Tax savings from exempt investment and loan income)	**(4,681)**	(4,542)	(3,880)
Other, net	**(13)**	(49)	220
TOTAL TAX EXPENSE	**$ 19,099**	$ 17,547	$ 17,714

The principal items giving rise to changes in deferred taxes were:

(dollars in 000 s)	**2005**	**2004**	**2003**
Allowance for loan losses	**$ 861**	$ 826	$ 409
Real estate joint ventures	**40**	(56)	(53)
Deferred compensation	**(65)**	(61)	5
State income taxes	**(100)**	(256)	91
Depreciation	**(607)**	(1,608)	1,011
Securities discount accretion	**(3)**	(170)	(153)
Accrued liabilities and other, net	**(120)**	296	279
Accrued compensation	**(9)**	167	(9)
Credit carryovers	**96**	97	128
Lease income	**(243)**		
Purchase accounting adjustments	**183**		2,077
TOTAL DEFERRED TAXES	**$ 33**	$ (765)	$ 3,785

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

10. Income Taxes (Continued)

As of December 31, the deferred tax assets and liabilities, which include the deferred tax asset acquired in the Americorp transaction, are as follows:

(dollars in 000 s)	2005	2004	2003
Assets:			
Allowance for loan losses	**$ 5,738**	$ 6,618	$ 7,444
Gain on loan workouts		167	167
Deferred compensation	**2,379**	2,314	2,253
Merger related expenses	**226**	226	226
State income taxes	**1,719**	1,613	1,357
Depreciation and amortization	**1,007**	381	
Securities discount accretion	**473**	470	299
Accrued compensation			115
Lease rental	**277**		
Credit carryovers	**835**	930	1,027
Total Assets	**12,654**	12,719	12,888
Liabilities:			
Real estate joint ventures	**(603)**	(563)	(619)
Depreciation and amortization			(1,227)
Accrued Compensation	**(84)**	(52)	
Mark-to-market adjustment	**(293)**	(293)	(293)
Accrued liabilities and other, net	**(705)**	(993)	(696)
Purchase accounting adjustments	**(2,260)**	(2,077)	(2,077)
Total Liabilities	**(3,945)**	(3,978)	(4,912)
Valuation Allowance			
Net deferred tax asset before tax effect of unrealized gain on securities available for sale	**8,709**	8,741	7,976
Tax effect of unrealized gain on securities available for sale	**(264)**	(4,573)	(8,200)
DEFERRED TAX ASSET, NET	**$ 8,445**	$ 4,168	$ (224)

The net deferred tax asset above is included in Other Assets on the Consolidated Statements of Financial Position. As of December 31, 2005, the Company has State tax credit carryforwards of $835,000 for financial reporting purposes. There are no alternative minimum tax credit carryforwards for tax purposes. As of December 31, 2005, Management of the Company has determined that the net deferred tax asset meets the realizability standards of SFAS No. 109 and as such, no valuation allowance is required as of that date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

11. Other Borrowings

The Company had other borrowings under the Treasury Tax and Loan note account of $3,903,000 and $4,582,000 at December 31, 2005 and 2004, respectively. Federal Home Loan Bank borrowings were at $22,000,000 and $2,000,000 at December 31, 2005 and 2004, respectively. A summary of borrowings from the Federal Home Loan Bank are as follows:

Description	Issue Date	Rate	Maturity	Carrying Amount
Fixed Rate Credit Advance	06/25/01	6.16 %	06/27/11	$ 2,000,000
Fixed Rate Credit Advance	01/20/05	3.74 %	01/22/08	$ 20,000,000
Total				$ 22,000,000

The Company has unused commitments to borrow Federal Funds from certain correspondent banks and unused borrowing lines from the Federal Home Loan Bank. As of December 31, 2005 and 2004, these combined unused lines amounted to $109,685,000 and $109,791,000, respectively.

12. Commitments and Contingencies

At December 31, 2005 and 2004, the Company was contingently liable for letter of credit accommodations made to its customers totaling $40,914,000 and $30,176,000, respectively. At December 31, 2005 and 2004, the Company also had undisbursed loan commitments in the amount of $657,687,000 and $626,353,000, respectively.

Letters of credit are issued in connection with agreements made by customers to counterparties. Terms of these letters of credit are generally for one year and may or may not be collateralized by receivables or other assets. If the customer fails to comply with the agreement, the counterparty may enforce the letter of credit as a remedy. Credit risk arises from the possibility that the customer may not be able to repay the Company. The notional amount of the letter of credit accommodations represents the maximum amount of future cash payments.

Many of the commitments are expected to expire without being drawn upon. Accordingly, the total outstanding commitment amount does not necessarily represent future cash requirements. The Company does not anticipate any significant losses as a result of these transactions. Provision has been made for losses which may be sustained in the fulfillment of, or from an inability to fulfill, any commitments. This provision is included in the Allowance for Losses Unfunded Commitments on the Consolidated Statements of Financial Position through a charge to other operating expenses on the Consolidated Statements of Income.

The Company is involved in litigation of a routine nature which is being handled and defended in the ordinary course of the Company s business. In the opinion of management, based in part on the advice of legal counsel, the resolution of this litigation will not have a material impact on the Company s financial condition or results of operations.

13. Earnings Per Share

Earnings per share (EPS) have been computed in 2005, 2004 and 2003, based on the weighted average number of shares outstanding each year of 22,788,000, 23,422,000, and 23,443,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

13. Earnings Per Share (Continued)

The following is a reconciliation of the numerators and denominators used in the calculation of basic EPS and diluted EPS for the years ended December 31.

(figures in 000 s except per share data)	Earnings	Weighted Average Shares Outstanding	EPS
2005			
Basic Earnings Per Share:			
Net Income available to Common Stockholders	**$ 37,491**	**22,788**	**$ 1.65**
Effect of Dilutive Securities:			
Stock Options		**512**	
Diluted Earnings Per Share:			
Net Income available to Common Stockholders and assumed conversions	**$ 37,491**	**23,300**	**$ 1.61**
2004			
Basic Earnings Per Share:			
Net Income available to Common Stockholders	$ 35,109	23,422	$ 1.50
Effect of Dilutive Securities:			
Stock Options		475	
Diluted Earnings Per Share:			
Net Income available to Common Stockholders and assumed conversions	$ 35,109	23,897	$ 1.47
2003			
Basic Earnings Per Share:			
Net Income available to Common Stockholders	$ 33,164	23,443	$ 1.41
Effect of Dilutive Securities:			
Stock Options		319	
Diluted Earnings Per Share:			
Net Income available to Common Stockholders and assumed conversions	$ 33,164	23,762	$ 1.40

14. Capital Accounts

The Company declared cash dividends during 2005 of $14,995,000. The California Financial Code provides that a bank may not make a cash distribution to its shareholders in excess of (1) the bank s undivided profits or (2) the bank s net income for its last three fiscal years less the amount of any distributions made by the bank during such period. Based on these restrictions in the California Financial Code, the Bank can make additional cash dividends totaling $15,827,000 at December 31, 2005 to the Company. The Bank can also apply to the State of California s Department of Financial Institutions (DFI) for the ability to pay additional dividends to the Company. The Bank and Company expects to make such application during 2006 given the Company s planned regular dividends and on-going stock repurchase program. Given the Bank s strong capital position, Management does not expect such approval to be withheld.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

15. Stock Options

On May 17, 2005, shareholders of the Company approved a new equity based compensation plan, the Mid-State Bancshares 2005 Equity Based Compensation Plan (the 2005 Plan) which reserves an additional 1,000,000 common shares for issuance in accordance with the terms of the Plan. The 2005 Plan provides for the grant of stock options, stock appreciation rights, restricted shares, restricted share units, performance based cash only awards, or any combination thereof. It replaces the 1996 Stock Option Plan which was limited in scope to the issuance of Stock Options. Shares available for issuance under the 1996 Plan are now included in the 2005 Plan, resulting in 1,027,372 shares currently being available to be issued (4.56% of current and issued outstanding common stock) as of December 31, 2005. All Options under both the 1996 and 2005 Plans have been granted at a price not less than the fair market value of the stock at the grant date. While options are exercisable and expire as determined by the Board of Directors, generally options expire no later than ten years from the date of grant and vest at the rate of 20% per year following the date of grant. As of December 31, 2005, 2,000,958 shares are currently under option. The shares are exercisable at prices ranging from $5.375 to $30.61. There were 266,330 shares exercised in 2005 and 190,548 and 172,096 exercised in 2004 and 2003, respectively.

The Bank applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations in accounting for its Plan. Accordingly, no compensation expense has been recognized for grants under the Plan. Consistent with the methods of SFAS No. 123, pro-forma compensation expense for the Plan is determined based on the fair value at the grant date. Fair values were estimated using the Black-Scholes option-pricing model with the following assumptions in 2005: dividend yields ranging from 2.12% to 2.68%, expected volatility of 34.85%, risk-free interest rates ranging from 3.83% to 4.44% and expected lives of 6.29 years. Assumptions utilized in prior years for estimating fair values were not materially different. The Bank s net income and earnings per share for the years ended December 31, 2005, 2004 and 2003 would have been reduced to pro forma amounts indicated below:

(dollars in 000 s except per share data)	**2005**	**2004**	**2003**
Net income to common shareholders:			
As reported	**$ 37,492**	$ 35,109	$ 33,164
Pro forma compensation cost	**$ (2,406)**	$ (2,099)	$ (1,618)
Pro forma	**$ 35,086**	$ 33,010	$ 31,546
Net income per common and common share equivalent:			
Basic earnings per share:			
As reported	**$ 1.65**	$ 1.50	$ 1.41
Pro forma	**$ 1.54**	$ 1.41	$ 1.35
Diluted earnings per share:			
As reported	**$ 1.61**	$ 1.47	$ 1.40
Pro forma	**$ 1.51**	$ 1.38	$ 1.33

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

15. Stock Options (Continued)

A summary of the Company s stock options as of December 31, 2005, 2004 and 2003, and changes during the periods then ended, is presented below:

	Options	Weighted Average Exercise Price	Per Share Ranges
2005			
Outstanding at Beginning of Year	**2,086,917**	**$ 17.81**	**$ 5.375-$30.61**
Granted during Year	**216,371**	**$ 27.73**	**$ 26.67-$30.24**
Exercised/Forfeited during Year	**(302,330)**	**$ 15.75**	**$ 5.375-$27.60**
Outstanding at End of Year	**2,000,958**	**$ 19.20**	**$ 5.375-$30.61**
Exercisable at End of Year	**1,207,218**	**$ 16.30**	**$ 5.375-$30.61**
Range of Expiration Dates	**7/10/2008 to 12/21/2015**		
Shares Available for Future Grant	**1,027,372**		
2004			
Outstanding at Beginning of Year	1,900,267	$ 15.65	$ 5.375-$25.79
Granted during Year	423,652	$ 25.87	$ 21.73-$30.61
Exercised/Forfeited during Year	(237,002)	$ 14.91	$ 5.375-$25.71
Outstanding at End of Year	2,086,917	$ 17.81	$ 5.375-$30.61
Exercisable at End of Year	1,191,986	$ 15.36	$ 5.375-$25.79
2003			
Outstanding at Beginning of Year	1,877,866	$ 15.03	$ 5.375-$20.05
Granted during Year	257,413	$ 18.61	$ 16.90-$25.79
Exercised/Forfeited during Year	(235,012)	$ 13.94	$ 5.375-$18.21
Outstanding at End of Year	1,900,267	$ 15.65	$ 5.375-$25.79
Exercisable at End of Year	1,120,705	$ 14.82	$ 5.375-$20.05

A summary of the Company s stock options outstanding and exercisable as of December 31, 2005 by price range is presented below:

Range of Exercise Prices	Total Amount Outstanding	Weighted Average Remaining Contractual Years	Weighted Average Exercise Price	Amount Exercisable	Weighted Average Exercise Price
$3.061 - $6.122	33,488	0.5	$ 5.375	33,488	$ 5.375
$6.123 - $9.183					
$9.184 - $12.244	12,000	4.3	$ 12.125	12,000	$ 12.125
$12.245 - $15.305	473,543	3.8	$ 14.540	455,101	$ 14.542
$15.306 - $18.366	820,350	5.0	$ 16.882	606,189	$ 16.845
$18.367 - $21.427	18,000	6.7	$ 19.372	10,000	$ 19.322
$21.428 - $24.488	75,200	8.3	$ 22.816	16,800	$ 22.959
$24.489 - $27.549	329,006	8.5	$ 25.871	62,840	$ 25.825
$27.550 - $30.610	239,371	9.1	$ 28.320	10,800	$ 29.873
Total	2,000,958	5.8	$ 19.198	1,207,218	$ 16.301

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

16. Employee Benefits

The Company offers a combination qualified profit sharing plan (the Profit Sharing Plan) and a savings and retirement plan designed to comply with Internal Revenue Service Code Section 401(k) (the 401(k) Plan) to substantially all employees. The Company s contributions to the Profit Sharing and 401(k) Plans for the years ended December 31, 2005, 2004, and 2003 were $2,985,000, $2,842,000, and $2,665,000, respectively.

A bonus is paid to selected employees who exceed certain goals under formulas established at the start of the year. Included in employee benefits expense for 2005, 2004 and 2003 was a charge of $4,050,000, $2,400,000, and $3,400,000, respectively, which was accrued during those years and paid in the following year under the Incentive Reward System. Employees receiving bonuses under this program in 2005 ranged from 2.2% of their salary to as much as 95.8% of their salary.

The Company has postretirement obligations to certain of the former employees of acquired institutions. The liability for these obligations is included within Other Liabilities on the consolidated statement of financial position and amounted to $1,450,000 and $1,371,000 at December 31, 2005 and 2004, respectively. The amount of employee benefit expense accrued under these obligations amounted to $145,000, $145,000 and $61,000 in 2005, 2004, and 2003, respectively. Generally, these obligations amount to a fixed payment to these individuals for 10 to 15 years upon reaching their defined retirement age.

17. Regulatory Matters

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. 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 Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company s assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company s capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

17. Regulatory Matters (Continued)

As of December 31, 2005, the latest regulatory examinations indicated that, Mid-State Bancshares and Mid-State Bank & Trust were categorized as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, Mid-State Bancshares and Mid-State Bank & Trust must maintain minimum total risk-based, Tier One risk-based and Tier One Leverage ratios as set forth in the following table. There are no conditions or events that Management believes have changed Mid-State Bancshares and Mid-State Bank & Trust s category. The actual capital amounts and ratios as of December 31, 2005 and 2004 are also presented in the following table:

(dollars in 000 s)	Actual		To be Considered Adequately Capitalized For Capital Adequacy Purposes		To be Considered Well Capitalized For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Mid-State Bancshares Consolidated:						
As of December 31, 2005:						
Total Capital (to Risk Weighted Assets)	**$ 231,264**	**12.3 %**	**$ 149,824**	**8.0 %**	**$ 187,280**	**10.0 %**
Tier One Capital (to Risk Weighted Assets)	**$ 217,607**	**11.6 %**	**$ 74,912**	**4.0 %**	**$ 112,368**	**6.0 %**
Tier One Capital (to Average Assets)	**$ 217,607**	**9.2 %**	**$ 94,666**	**4.0 %**	**$ 118,333**	**5.0 %**
As of December 31, 2004:						
Total Capital (to Risk Weighted Assets)	$ 227,549	13.0 %	$ 140,209	8.0 %	$ 175,261	10.0 %
Tier One Capital (to Risk Weighted Assets)	$ 211,967	12.1 %	$ 70,105	4.0 %	$ 105,157	6.0 %
Tier One Capital (to Average Assets)	$ 211,967	9.3 %	$ 90,983	4.0 %	$ 113,728	5.0 %
Mid-State Bank & Trust Only:						
As of December 31, 2005:						
Total Capital (to Risk Weighted Assets)	**$ 224,459**	**12.0 %**	**$ 149,824**	**8.0 %**	**$ 187,280**	**10.0 %**
Tier One Capital (to Risk Weighted Assets)	**$ 210,802**	**11.3 %**	**$ 74,912**	**4.0 %**	**$ 112,368**	**6.0 %**
Tier One Capital (to Average Assets)	**$ 210,802**	**8.9 %**	**$ 94,690**	**4.0 %**	**$ 118,363**	**5.0 %**
As of December 31, 2004:						
Total Capital (to Risk Weighted Assets)	$ 225,921	12.9 %	$ 140,209	8.0 %	$ 175,261	10.0 %
Tier One Capital (to Risk Weighted Assets)	$ 210,339	12.0 %	$ 70,104	4.0 %	$ 105,157	6.0 %
Tier One Capital (to Average Assets)	$ 210,339	9.2 %	$ 91,018	4.0 %	$ 113,772	5.0 %

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

18. Reportable Business Segments

Reportable business segments are determined using the management approach and are intended to present reportable segments consistent with how the chief operating decision maker organizes segments within the company for making operating decisions and assessing performance. Presently, the Company is segregated into three reportable business segments, Community Banking, Mid-Coast Land Company and Trust Services.

The Community Banking business segment consists of commercial and retail banking. This segment is managed as a single strategic unit that derives its revenues from a wide range of banking services, including lending and investing activities, acceptance of demand, savings, and time deposits, and mortgage servicing. As previously noted, Mid-Coast Land Company engages in real estate investment activities. Trust Services provides custody services, investment management and trust-related services such as trustee for trust accounts, estate settlement services, guardianships and conservatorships.

Below is a summary statement of income and certain selected financial data for each of the three years ended December 31, 2005. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies. Certain assumptions are made concerning the allocations of costs between segments which may influence relative results, most notably, allocations of various types of overhead and administrative costs. Management believes that the allocations utilized below are reasonable and consistent with the way it manages the business.

	Community Banking			Mid-Coast Land Company			Trust Services		
(dollars in 000 s)	**2005**	**2004**	**2003**	**2005**	**2004**	**2003**	**2005**	**2004**	**2003**
Interest Income	$ 128,326	$ 109,936	$ 105,239	$	$	$ 1	$	$	$
Interest Expense	15,503	8,450	9,699						
Net Interest Income	112,823	101,486	95,540			1			
(Benefit) Provision		(2,700)	(969)						
Non Interest Income	19,512	26,153	27,715	717	682	678	1,212	929	666
Non Interest Expense	76,692	78,391	73,735	12	27	123	970	876	833
Pre-Tax Income	$ 55,643	$ 51,948	$ 50,489	$ 705	$ 655	$ 556	$ 242	$ 53	$ (167)
Ending Total Assets (in millions)	$ 2,380	$ 2,285	$ 2,199	$ 11	$ 11	$ 10	$	$	$

	Mid-State Bancshares		
(dollars in 000 s)	**2005**	**2004**	**2003**
Interest Income	$ 128,326	$ 109,936	$ 105,240
Interest Expense	15,503	8,450	9,699
Net Interest Income	112,823	101,486	95,541
(Benefit) Provision		(2,700)	(969)
Non Interest Income	21,441	27,764	29,059
Non Interest Expense	77,674	79,294	74,691
Pre-Tax Income	$ 56,590	$ 52,656	$ 50,878
Ending Assets (in millions)	$ 2,391	$ 2,296	$ 2,209

There were no significant capital expenditures made in 2005 in any of the above business segments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

19. Quarterly Financial Data

The following table presents condensed consolidated statements of income for each of the quarters covering the past two years (unaudited in 000 s):

	2005 **1st Quarter**	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Full Year**
Interest Income	**$ 29,482**	**$ 31,654**	**$ 32,923**	**$ 34,267**	**$ 128,326**
Interest Expense	**2,713**	**3,694**	**4,324**	**4,772**	**15,503**
Net Interest Income	**26,769**	**27,960**	**28,599**	**29,495**	**112,823**
Provision for loan losses					
Non-interest income	**5,395**	**5,378**	**5,271**	**5,397**	**21,441**
Non-interest expense	**18,335**	**19,211**	**19,473**	**20,655**	**77,674**
Income before taxes	**13,829**	**14,127**	**14,397**	**14,237**	**56,590**
Taxes	**4,739**	**4,615**	**4,905**	**4,840**	**19,099**
Net Income	**$ 9,090**	**$ 9,512**	**$ 9,492**	**$ 9,397**	**$ 37,491**
Earnings Per Share:					
Basic	**$ 0.39**	**$ 0.42**	**$ 0.42**	**$ 0.42**	**$ 1.65**
Diluted	**$ 0.39**	**$ 0.41**	**$ 0.41**	**$ 0.41**	**$ 1.61**

	2004 **1st Quarter**	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Full Year**
Interest Income	$ 26,237	$ 26,620	$ 28,236	$ 28,843	$ 109,936
Interest Expense	2,076	1,990	2,083	2,301	8,450
Net Interest Income	24,161	24,630	26,153	26,542	101,486
Provision for loan losses		(2,700)			(2,700)
Non-interest income	7,000	7,910	7,250	5,604	27,764
Non-interest expense	19,694	20,877	20,265	18,458	79,294
Income before taxes	11,467	14,363	13,138	13,688	52,656
Taxes	3,802	4,990	4,465	4,290	17,547
Net Income	$ 7,665	$ 9,373	$ 8,673	$ 9,398	$ 35,109
Earnings Per Share:					
Basic	$ 0.33	$ 0.40	$ 0.37	$ 0.41	$ 1.50
Diluted	$ 0.32	$ 0.39	$ 0.36	$ 0.40	$ 1.47

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

20. Parent Company Financial Information

Condensed financial information of Mid-State Bancshares (parent only) follows:

Condensed Balance Sheets

(dollars in 000 s)	**December 31, 2005**	**2004**
ASSETS		
Cash	**$ 4,946**	$ 1,292
Investment in Mid-State Bank & Trust	**269,811**	276,694
Other Assets	**1**	*5*
Total Assets	**$ 274,758**	$ 277,991
LIABILITIES AND STOCKHOLDERS EQUITY		
Dividend Payable	**$ 4,054**	$ 3,695
Accrued Liabilities	**(1,858)**	(331)
Total Liabilities	**2,196**	3,364
Stockholders Equity	**272,562**	274,627
Total Liabilities and Stockholders Equity	**$ 274,758**	$ 277,991

Condensed Income Statements

	December 31, 2005	**2004**	**2003**
Equity in earnings of subsidiaries:			
Undistributed	**$ (418)**	$ 10,345	$ 7,348
Dividends	**38,637**	25,222	26,245
Operating Expenses	**(1,254)**	(789)	(739)
Income Tax Benefit	**526**	331	310
Net Income	**$ 37,491**	$ 35,109	$ 33,164

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2005

20. Parent Company Financial Information (Continued)

Condensed Statements of Cash Flows

	December 31, 2005	2004	2003
Cash flows from operation activities:			
Net Income	**$ 37,491**	$ 35,109	$ 33,164
Adjustments to reconcile net income to net cash provided by operating activities:			
Net undistributed earnings of Bank	**418**	(10,345)	(7,348)
Net change in accrued liabilities	**(1,527)**	201	(310)
Net change in other assets	**4**	(5)	
Net cash provided by operating activities	**36,386**	24,960	25,506
Net Cash Flow from Investing Activities			
Net Cash Flows from Financing Activities:			
Proceeds from stock options	**3,969**	2,579	2,284
Payment to purchase common stock	**(23,065)**	(16,646)	(16,212)
Dividends paid by parent	**(14,636)**	(12,918)	(11,246)
Other non cash item related to tax benefit on stock options	**1,000**		
Net cash used in financing activities	**(32,732)**	(26,985)	(25,174)
Net Increase (Decrease) in Cash	**3,654**	(2,025)	332
Cash, beginning of year	**1,292**	3,317	2,985
Cash, at end of year	**$ 4,946**	$ 1,292	$ 3,317

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

In accordance with Rule 13a-15(b) of the Exchange Act, as of the end of the year ended December 31, 2005, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15 (e) and 15d-15(e) under the Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

During the quarter ended December 31, 2005, there have been no changes in our internal controls over financial reporting that has materially affected, or are reasonably likely to materially affect, these controls.

There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control system may vary over time.

In connection with our SOX 404 compliance efforts, we have invested significant resources in documenting, analyzing and testing our internal controls. As necessary, we have taken, and currently continue to take actions to remediate control gaps identified including additional information technology controls, improved segregation of duties (predominantly in our smaller departments), further formalization of our controllership guide, extensive training on generally accepted accounting principles (including internal controls) and enhanced monitoring controls. We are committed to ongoing assessments of our controls and their effectiveness, the results of which will be reported to our shareholders.

Additionally, under the supervision and with the participation of management, including the Company s Chief Executive Officer and Chief Financial Officer, the Company conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2005 based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon that evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2005. Management s report on internal control over financial reporting is set forth in Item 8 of this report on Form 10-K, and is incorporated herein by reference. Management s assessment of the effectiveness of the Company s internal control over financial reporting has been audited by PricewaterhouseCoopers LLP, an independent, registered public accounting firm, as stated in its report, which is also set forth in Item 8 of this Form 10-K and is also incorporated herein by reference.

ITEM 9B. OTHER INFORMATION

Not Applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by Item 10 of Form 10-K is incorporated by reference from the information contained in the Bank s Proxy Statement for the 2006 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A.

Code of Conduct

The Board has adopted a comprehensive code of conduct reflecting its policies. Our code of conduct is published on the Investor Information section of our website at www.midstatebank.com. Any change to or waiver of the code of conduct (other than technical, administrative, and other non-substantive changes) will be posted on our website or reported on a Form 8-K filed with the SEC. While the Board may consider a waiver for an executive officer or director, we do not expect to grant such waivers.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 of Form 10-K is incorporated by reference from the information contained in the Bank s Proxy Statement for the 2006 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K is incorporated by reference from the information contained in the Bank s Proxy Statement for the 2006 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Item 13 of Form 10-K is incorporated by reference from the information contained in the Bank s Proxy Statement for the 2006 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated by reference from the information contained in the Bank s Proxy Statement for the 2006 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this Report

(1) Management Statement, Report of Independent Registered Public Accounting Firm, Consolidated Statements of Financial Position, Income, Comprehensive Income, Changes in Capital Accounts, and Cash Flows, and the Notes to the Consolidated Financial Statements.

(2) Schedules: None

(3) Exhibits: See Page 99.

(b) Exhibits:

Exhibit Number	Index to Exhibits	Sequentially Numbered Pages
3.1	Articles of Incorporation, as amended(1)	
3.2	Bylaws of Registrant(2)	
4.1	Specimen Certificate evidencing shares of Mid-State Bancshares Common Stock(3)	
10.1	Mid-State Bancshares 1996 Stock Option Plan, form of Stock Option Agreement and form of Substitute Stock Option Agreement, as amended(4)	
10.2	Deferred Compensation Plan, and as further amended on January 9, 2002(6)	
10.3	Profit Sharing and Salary Deferral 401(K) Plan(5)	
10.4	Change in Control Agreement for Carrol R. Pruett, as amended(6)	
10.5	Change in Control Agreement for James G. Stathos(6)	
10.6	Change in Control Agreement for James W. Lokey(6)	
10.7	2001 Deferred Compensation Plan(6)	
10.8	Change in Control Agreement for Harry H. Sackrider(7)	
10.9	Mid-State Bancshares 2005 Equity Based Compensation Plan(8)	
21	Subsidiary of Mid-State Bancshares Mid-State Bank & Trust is the only subsidiary	
23.1	Consent of Accountants PricewaterhouseCoopers LLP	
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)	
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)	
32	Certification Pursuant to Section 906 of Sarbanes-Oxley Act of 2002	

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(1) Filed as part of the Registrant s Form 10-K for the year ended December 31, 1998.

(2) Filed as an exhibit to Registrant s Registration Statement (File No. 333-16952) filed on November 27, 1996.

(3) Filed as part of the Registrant s Registration Statement on Form S-4 (File No. 333-48181) filed on March 18, 1998.

(4) As filed by Registrant on Form S-8 (File No. 333-38584) filed on June 5, 2000.

(5) Filed as part of the Registrant s Form 10-K for the year ended December 31, 1998.

(6) Filed as part of the Registrant s Form 10-K for the year ended December 31, 2001.

(7) Filed as part of the Registrant s Form 10-K for the year ended December 31, 2002.

(8) Filed as part of the Registrant s Registration Statement on Form S-8 (File No. 333-126880) filed on July 26, 2005.

(c) Schedules:

Not Applicable

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SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Bank has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MID-STATE BANCSHARES	
By:	/s/ JAMES W. LOKEY JAMES W. LOKEY *President and Chief Executive Officer* *[Principal Executive Officer]*
Dated: March 15, 2006	
By	/s/ JAMES G. STATHOS JAMES G. STATHOS *Executive Vice President* *and Chief Financial Officer* *[Principal Financial and Accounting Officer]*
Dated: March 15, 2006	

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SIGNATURES

In accordance with the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Bank and in the capacities and on the dates indicated.

		Dated:
/s/ CARROL R. PRUETT CARROL R. PRUETT	Chairman of the Board	March 15, 2006
/s/ GEORGE H. ANDREWS GEORGE H. ANDREWS	Director	March 15, 2006
/s/ TRUDI CAREY TRUDI CAREY	Director	March 15, 2006
/s/ DARYL L. FLOOD DARYL L. FLOOD	Director	March 15, 2006
/s/H. EDWARD HERON H. EDWARD HERON	Director	March 15, 2006
/s/ JAMES W. LOKEY JAMES W. LOKEY	Director	March 15, 2006
/s/ STEPHEN P. MAGUIRE STEPHEN P. MAGUIRE	Director	March 15, 2006
/s/ MICHAEL L. MINER MICHAEL L. MINER	Director	March 15, 2006
/s/ GREGORY R. MORRIS GREGORY R. MORRIS	Director	March 15, 2006
/s/ ALAN RAINS ALAN RAINS	Director	March 15, 2006

EXHIBIT INDEX

Exhibit Number	**Description**
23.1	Consent of Accountants PricewaterhouseCoopers LLP
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)
32	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002