THERMAGE INC
Form 10-K
March 30, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For fiscal year ended December 31, 2006

Commission File Number: 001-33123

THERMAGE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**68-0373593**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

25881 Industrial Boulevard,

Hayward, California 94545

(510) 782-2286

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.001 par value per share	**The NASDAQ Stock Market, Inc.**

Securities Registered Pursuant to Section 12(g) of the Act: None

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

* The Registrant has not been subject to the filing requirements for the past 90 days as it commenced trading following its initial public offering on November 9, 2006, but has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 since such time.

The number of shares of Registrant s common stock issued and outstanding as of February 28, 2007 was 23,011,374.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the registrant s definitive proxy statement for the 2007 Annual Meeting of Shareholders.

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THERMAGE, INC.

ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. ***Business***

Overview

We design, develop, manufacture and market medical devices for the non-invasive treatment of wrinkles. Our Thermage® procedure can be performed on any part of the body where treatment of wrinkles is desired. Our ThermaCool® system uses patented monopolar radiofrequency, or RF, energy to heat and shrink collagen and tighten dermis and subcutaneous tissue while simultaneously cooling and protecting the surface of the skin. The heating and shrinking of the collagen can cause a healing process to begin, which may further tighten the skin and reduce wrinkles over the next two to six months. The Thermage procedure is normally performed in a medical office setting as a single treatment that takes from 20 minutes to two hours, depending on the treatment area. The Thermage procedure provides patients seeking wrinkle reduction as a non-invasive alternative to surgical procedures that cost up to tens of thousands of dollars and can involve weeks of recovery. We offer, and are continuing to develop, a variety of ThermaTips designed to optimize the Thermage procedure for new conditions and different parts of the body.

We received FDA clearance and commercially launched our ThermaCool system in 2002. We market the ThermaCool system, including our single-use ThermaTips, in the United States to physicians through a direct sales force and internationally in 77 countries through a network of distributors. Our sales force trains physicians on the proper use of the ThermaCool system and maintains frequent interaction with these customers to promote repeat sales of our ThermaTips. As of December 31, 2006, we had an installed base of over 2,000 ThermaCool RF generators and had sold over 350,000 ThermaTips, which we estimate represent an approximately equal number of Thermage procedures performed.

The Structure of Skin and Connective Tissue

The skin is comprised of the epidermis, dermis and the hypodermis, or subcutaneous fat layer. The top two layers of skin, the epidermis and dermis, together are known as the cutis and on most areas of the body are approximately two to three millimeters thick. The dermis contains blood vessels, hair follicles and other skin components. The deepest layer of the skin, the hypodermis, contains 50% of the body s fat cells. The hypodermis also contains collagen strands, or fibrous septae, that connect the dermis to the underlying bone and muscle. Collagen has been shown to be a very flexible and stretchable protein with high tensile strength. With advancing age and exposure to damaging environmental factors, collagen deteriorates and loses its elasticity, resulting in the formation of rhytids, or a wrinkling of the epidermis. The following diagram illustrates the basic anatomy of the skin:

Electromagnetic radiation, specifically light and heat, applied to the different layers of the skin can have an effect on the skin s appearance. Epidermis exposure to sunlight can tan the skin, while overexposure can lead to burns or blisters. Devices, such as aesthetic lasers, have been designed to generate light waves to deliver heat

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through the epidermis, into the dermis, for removal of hair, vein treatment and other aesthetic applications. Gels, coolants and other means are used to protect the epidermis from burning during this process. Delivery of heat below the dermis, into the subcutaneous fat layer, has been accomplished using other forms of energy, including RF energy, for aesthetic effect.

The Market for Aesthetic Procedures to Treat the Skin

The American Society for Aesthetic Plastic Surgery reports that in 2006, total expenditures for aesthetic procedures were approximately $12.2 billion. From 2000 to 2006 the total number of aesthetic procedures increased from approximately 5.7 million to over 11.5 million procedures, representing a 12% compounded annual growth rate. Non-invasive aesthetic procedures were primarily responsible for the overall increase, rising from approximately 4.3 million to approximately 9.5 million procedures over the same period, representing a 14% compounded annual growth rate. We believe there are several factors contributing to the rapid growth of non-invasive aesthetic procedures, including:

Aging of the U.S. Population. The baby boomer demographic segment, defined by the U.S. Census as those Americans born between 1946 and 1964, represented over 26% of the U.S. population during 2005. Baby boomers control approximately $2 trillion in spending power and 50% of all discretionary income. The size and wealth of this aging segment and its desire to retain a youthful appearance have driven the growth for aesthetic procedures.

Emergence of Non-Traditional Practitioners. The traditional providers of aesthetic procedures include dermatologists and plastic surgeons. In 2006, there were approximately 17,000 physicians within the specialties of dermatology and plastic surgery according to the American Board of Medical Specialties. Manufacturers of aesthetic systems have placed an increasingly important focus on sales to other physician groups including approximately 71,000 family practitioners, 41,000 obstetricians and gynecologists, and 41,000 general surgeons. Additionally, physician directed medi-spas and non-medical day spas have entered the aesthetics market.

Broader Range of and Accessibility to Safe and Effective Treatments. Technological developments have made non-invasive treatment alternatives increasingly safe and effective. These technological developments have also reduced the required treatment and recovery time from invasive surgical procedures, which in turn have led to greater patient demand. These factors, along with the easy-to-use and low-cost nature of these products, have attracted both traditional and non-traditional practitioners to aesthetic procedures.

Market Shift Towards Less Invasive Procedures. Market trends confirm that patients are moving away from invasive procedures towards minimally-invasive or non-invasive treatments. Notably, the American Society for Aesthetic Plastic Surgery reports that from 2000 to 2006 the total number of laser skin resurfacing procedures increased from approximately 117,000 to 577,000 procedures, representing a 30% compounded annual growth rate, and the total number of Botox injection procedures increased from 1.1 million to 3.2 million injections over the same period, representing a 19% compounded annual growth rate. Patients are seeking treatment for wrinkles in larger numbers. For example, skin tightening, which represents the fastest growing segment of the aesthetic laser market, is projected to grow at a 31% compounded annual rate over the next five years, according to the Millennium Research Group.

Changing Practitioner Economics. Managed care and government payor reimbursement restrictions in the United States, and similar payment-related constraints outside the United States, are motivating practitioners to establish or expand their elective aesthetic practices with procedures that are paid for directly by patients. We expect this trend to continue as physicians look for ways to expand their practices.

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Increasing Acceptance of Aesthetic Procedures. Mass-market television shows like *Extreme Makeover* and *The Swan* reflect the mainstream acceptance of aesthetic procedures. Additionally, features in many popular television and print media have the effect of widely advertising the aesthetic procedures undertaken by celebrities, enhancing the glamour associated with and demand for self-improving treatments.

Similar market trends also exist outside the United States, where demand for non-invasive aesthetic procedures has also experienced strong growth. Manufacturers of non-invasive aesthetic devices typically derive one-third to one-half of their revenue from international sales.

Aesthetic Procedures for Skin and Their Limitations

Many medical treatments are available to treat wrinkles, rejuvenate the skin and give a patient a more youthful appearance. The most popular treatments include invasive surgical procedures, minimally-invasive needle injections and non-invasive energy-based procedures.

Surgical Procedures

Of the various aesthetic alternatives for reducing wrinkles and rejuvenating appearance, invasive surgical procedures, such as cosmetic eyelid surgery, tummy tucks and facelifts, can create the most pronounced and long-lasting changes in appearance. They are performed by plastic surgeons with the patient under general anesthesia.

Market Data. Approximately 210,000 eyelid procedures, 172,000 tummy tucks and 138,000 facelifts were performed in the United States in 2006, according to the American Society for Aesthetic Plastic Surgery.

Limitations. Compared to alternative treatments, invasive surgical procedures are expensive, costing thousands of dollars, and can involve weeks of post-surgical recovery and time away from work. They carry risk of hematoma, or accumulation of blood under the skin that may require removal, infection and adverse reactions to anesthesia.

Injections

Popular alternatives for temporarily improving appearance and reducing wrinkles include Botox and soft tissue fillers, such as Restylane, that are injected into the skin. These injections are typically administered by dermatologists at a cost of several hundred dollars. In most instances, they involve little or no restricted recovery time for the patients.

Market Data. Approximately 3.2 million Botox and 1.9 million soft tissue filler injections were administered in 2006, according to the American Society for Aesthetic Plastic Surgery.

Limitations. The effects of these procedures are temporary and require repeat treatment, with Botox lasting from three to four months and injectable fillers typically lasting from three to six months.

Laser Treatments

Lasers and other light-based devices are used to perform skin rejuvenation, to temporarily reduce wrinkles and to perform other aesthetic procedures, such as hair removal and vein treatment. Light-based skin

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rejuvenation, or resurfacing, procedures can be either ablative or non-ablative. Ablative treatments, also known as laser peels, intentionally burn away the epidermis to heat the dermis and to stimulate collagen growth. Non-ablative rejuvenation treatments typically use less energy and employ gels or other substances in order to insulate the epidermis from damage during the treatment. Because they are less intense than ablative lasers, non-ablative procedures typically involve little downtime or recovery.

Market Data. According to the American Society for Aesthetic Plastic Surgery, there were over 577,000 laser skin resurfacing procedures performed in 2006 and 93% of these treatments were non-ablative.

Limitations. Ablative treatments, or laser peels, like surgery, are performed under general anesthesia and can involve weeks of post-surgical recovery and time away from work. Non-ablative light-based procedures are often effective in hair removal and other procedures targeting the epidermis. However, the nature of light makes it challenging to reach the depth of the subcutaneous fat layer. Penetration of light, and consequently the ability to produce heat, is physically limited by the wavelength of the light, the light s natural tendency to scatter within tissue and the absorption of this energy by specific chromophores within the body, such as water, blood and pigmentation. Non-ablative wrinkle treatments typically require multiple sessions, from four to six treatments spread two to four weeks apart per treatment.

These widely-adopted treatment options for wrinkle reduction fall generally into one of two categories: either a single invasive procedure involving significant recovery time, but with a long-lasting, pronounced effect; or a procedure that is either minimally-invasive or non-invasive involving minimal recovery time, but requiring frequent repeat treatments for a modest effect. We believe that the ideal treatment option falls between these two extremes, providing lasting, noticeable effect from a single procedure that involves little or no downtime.

The Thermage Solution

We believe that our Thermage procedure provides a compelling treatment alternative to treat wrinkles that fills a need not met by currently available surgical procedures and minimally and non-invasive treatments. Our ThermaCool system consists of an RF generator with cooling capability through the delivery of a coolant to protect the outer layer of the skin from over-heating and a handpiece that, in conjunction with a single-use ThermaTip, regulates epidermis cooling and monitors treatment data. Our system also includes a variety of single-use ThermaTips that attach to the handpiece and are selected by physicians based on the procedure to be performed and the size of the area to be treated. The Thermage procedure is typically performed in a medical office setting by, or under the supervision of, trained and qualified physicians, including not only plastic surgeons and dermatologists, but also physicians who do not traditionally perform cosmetic procedures, such as general and family practitioners, obstetricians and gynecologists, and general and vascular surgeons.

Benefits of the Thermage Solution

Our solution provides a number of benefits for physicians and patients:

Controlled Heating of Collagen. Because RF energy delivery depends on tissue resistance and not on optical light absorption, it can penetrate to a much greater depth than conventional lasers. Delivery of heat into the subcutaneous fat layer of the skin shrinks and shortens collagen strands. Over time, new collagen strands may grow and add strength and reduce the prominence of folds, lines and other wrinkles. Our monopolar RF heating approach delivers energy into the subcutaneous fat layer of the skin where an electrical current can travel along the collagen fibrous septae and cause the heating and contraction of these collagen strands in order to reduce wrinkles. Our own clinical experience demonstrates, and published independent, along with affiliated,

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scientific data corroborates, the Thermage procedure s tissue-tightening effect. This body of data provides potential physician customers with objective evidence that they can evaluate when considering a purchase of our system.

Non-Invasive, Non-Ablative Alternative to Surgery. The Thermage procedure is non-invasive, involving no surgery or injections, and offers an alternative to surgery at a lower price with little or no downtime from patients normal routines. It is also a non-ablative procedure that causes minimal temporary surface tissue damage. If desired, the Thermage procedure can be used in a complementary fashion in conjunction with invasive therapies such as liposuction, facelift and thread implants, as well as injectable fillers and other minimally-invasive and non-invasive aesthetic procedures.

Single Procedure Treatment. The Thermage procedure is normally performed in a medical office setting as a single treatment that takes from 20 minutes to two hours, depending on the treatment area. Studies have shown clinical effect from a Thermage procedure that is both immediate and that can improve over a measurement period of six months following treatment. In addition, Thermage procedures have been used effectively on all skin types and tones and on various areas of the body where wrinkle reduction is desired.

Compelling Physician Economics. We believe physicians are compensated more per hour by performing Thermage treatments than other non-invasive aesthetic device treatments. The ThermaCool system currently requires lower capital costs than competing laser and RF systems, while average procedure fees for Thermage treatments generally exceed our competitors. We continue to design new ThermaTips to address new applications without requiring additional equipment purchase.

Ease of Use. The ThermaCool system incorporates a straightforward user interface that allows a trained physician to easily perform procedures across various parts of the body. Different treatment sites may use different tips, each of which is pre-customized by size, pulse counts, pulse durations and heating profile to the intended procedure. The system provides real-time feedback and can be adjusted during the procedure as needed. The handpiece is designed with a small profile for accurate placement during treatment, comfort and ease of use.

Our Technology

Our ThermaCool system uses our patented method of delivering monopolar RF energy for heating collagen.

Monopolar Radiofrequency. Monopolar RF delivery uses two electrodes, with one active electrode being held in the device handpiece by the physician and the second, a passive return electrode, typically attached to the patient s back. Monopolar delivery allows for precise administration of energy because the electrical current is concentrated where the active electrode touches the body and disperses quickly as it travels towards the return electrode. The monopolar RF process is distinct from bipolar RF-based technology, which is superficial, relying on current passing through tissue located between two probes placed close together on the surface of the skin. We believe that monopolar technology delivers energy effectively to a greater tissue depth than bipolar technology.

The ThermaTip Capacitive Coupling Mechanism of Action for Collagen Heating. The single-use ThermaTip device contains our patented technology that uses monopolar RF energy as a controlled tissue heating source through the use of a non-conducting material, known as a

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dielectric. Capacitive coupling is the use of the dielectric to create an electric field in the area where our ThermaTip touches the body. The electric field induces a current within the surrounding tissue, resulting in volumetric heating of the tissue due to the tissue s natural resistance to electrical current flow. The heating depth is based upon the size and geometry of the ThermaTip and can be controlled from a few hundred microns to several millimeters in depth, depending upon the particular ThermaTip selected for various treatment areas. Collagen is a more efficient conductor of electricity than fat tissue and therefore acts as a pathway for the electric current. This process results in preferential heating of the fibrous septae, the strands of collagen fibers that permeate the dermis and hypodermis and connect skin to the underlying bone and muscle. Delivery of heat to the fibrous septae located in deeper layers of the skin shrinks and shortens them, resulting in tightening of the dermis and subcutaneous tissue. Over time, new collagen strands may grow as part of the body s natural healing process. These new strands may add strength and produce additional skin tightening over the next two to six months. This tightening of the skin has the ability to reduce the prominence of folds, lines and other deep wrinkles. To achieve this deep heating with simultaneous surface cooling, the surface of the ThermaTip transmits RF energy to the skin while serving as a dynamic contact cooling membrane for the cryogen spray. The contact membrane continually monitors skin surface temperature to help protect the epidermis.

Comfort and Safety. Since the initial launch of our ThermaCool system in 2002, we have monitored and revised our procedure guidelines to safely and effectively deliver RF energy and cryogen cooling to the treatment site with minimal discomfort to the patient. An energy-based aesthetic treatment, if not used according to the manufacturer s protocol, has the potential to cause patient discomfort, irritation or surface tissue burning. We have designed our ThermaCool system to minimize the risk of these types of occurrences through stringent built-in safety precautions in addition to extensive user training. Our system regulates a combination of inputs to precisely and uniformly distribute RF energy over the treatment site, including temperature and pressure sensors at each corner of the ThermaTip and pre-programmed power levels and times for specific treatments. In April 2004, we introduced new procedure guidelines that we believe improved patient comfort.

Our ThermaCool System

Our ThermaCool system includes three major components: the RF generator, the reusable handpiece and a single-use ThermaTip, as well as several consumable accessories. Physicians attach a single-use ThermaTip to the handpiece, which is connected to the ThermaCool RF generator. The ThermaCool generator authenticates the ThermaTip device and programs the ThermaCool system for the desired treatment without physician intervention.

Radiofrequency Generator. The ThermaCool RF generator produces a six-megahertz signal and is simple and efficient to operate. Controls are within easy reach, and important user information is clearly displayed on the built-in display, including energy delivered, tissue impedance, duration and feedback on procedure technique. Cooling is achieved in conjunction with the generator to deliver a coolant that cools and helps to protect the epidermal surface during a Thermage procedure. As of December 31, 2006, we had an installed base of over 2,000 ThermaCool RF generators.

Handpiece. The reusable handpiece holds the ThermaTip in place for the treatment and processes information about skin temperature and contact, treatment force against the skin, cooling system function and other important data. A precision control valve within the handpiece meters the delivery of cryogen, which cools and protects the epidermal surface.

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ThermaTip. The ThermaTip device is available in four sizes with several configurations of pulse counts, pulse durations and two heating profiles for efficient implementation of treatment guidelines, based on the size and nature of the treatment area. Physicians currently can order pre-sterilized ThermaTips in sizes of 0.25 cm^2, 1.0 cm^2, 1.5 cm^2 and 3.0 cm^2. Each ThermaTip contains a proprietary internal EPROM, or programmable memory chip, which stores treatment parameters and safety limits in order to optimize performance and safety in the selected treatment. To enhance procedural safety, we have also programmed the EPROM contained in ThermaTips for single-use treatments. Using the same ThermaTip to perform multiple treatments could result in injury, as a result of the eventual breakdown of the ThermaTip s dielectric coating. Therefore, the EPROM ensures that the ThermaTip is not reused following a particular procedure. Since the introduction of our ThermaCool system in 2002 and through December 31, 2006, we had sold over 350,000 ThermaTips, which we estimate represent an approximately equal number of Thermage procedures performed.

Our system also includes other consumable components in addition to ThermaTips. The system houses a canister of coolant that can be used for an average of three to six procedures, depending on the total skin surface area treated and the ThermaTip device used. Each patient procedure also requires a return pad, which is typically adhered to the patient s lower back to allow a path of travel for the RF current through the body and back to the generator. We also sell proprietary coupling fluid, a viscous liquid that helps ensure electrical and thermal contact with the ThermaTip device.

In February 2007, we introduced and began shipment of the ThermaCool® NXT, our next generation system. The ThermaCool NXT has been redesigned to save time, reduce procedure cost, simplify the treatment experience and improve clinician comfort. Advances to the technology include a streamlined operating system which speeds treatment times; a lighter, more ergonomic handpiece with remote controls; and a sleek new design with a smaller footprint that takes up 50 percent less floor space than its predecessor.

Our Thermage Procedure

In order to perform our Thermage procedure, the physician selects a single-use ThermaTip based on the procedure to be performed and the size of the area to be treated. We currently offer four treatment tip sizes with a combination of pulse counts, pulse durations and heating profiles for a variety of uses:

Body by Thermage, which involves the use of a larger tip, such as the 3.0 cm^2 tip, designed for the treatment of large areas;

Eyes by Thermage, which involves the use of a small, 0.25 cm^2 tip, designed for the treatment of eyelids;

Face by Thermage, which involves the use of 3.0 cm^2, 1.5 cm^2 or 1.0 cm^2 tip sizes, designed for the treatment of the face and neck;

Tummy by Thermage, which involves the use of 3.0 cm^2 tip size, designed for the treatment of the abdomen; and

Hands by Thermage, which involves the use of 1.5 cm^2 tip size, designed for the treatment of the hands.

After choosing the tip and attaching it to the handpiece, the physician marks the treatment area with a temporary grid pattern tattoo, corresponding to the size of the ThermaTip, which is easily wiped away post-procedure. The return pad is then adhered to the patient s lower back to allow a path of travel for the RF current back to the generator. After the application of a conductive fluid, each square of the grid is treated.

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For each grid square, the physician places the tip against the patient s skin and depresses the handpiece button. The handpiece processes information from the tip about skin temperature and contact, treatment force against the skin, cooling system function and other important data. The information from the handpiece is sent to the console in order to generate the proper RF signal. A precision control valve within the handpiece also regulates the delivery of cryogen, which cools and protects the skin s surface. The ThermaTip device transmits RF energy to the skin while serving as a contact cooling membrane for the cryogen spray. Our system monitors a combination of inputs, such as temperatures, power levels and delivery duration, to precisely and safely control the RF energy and cooling delivery to each treatment site.

Patients feel alternating sensations of cold and heat during the procedure and some physicians elect to use a topical anesthetic or an oral pain medication. Procedure times vary with the size of the treatment area; a procedure for a full face typically requires multiple passes and takes approximately 60 minutes. Patients may notice immediate improvement in the appearance of wrinkles and are typically able to resume normal activities immediately after having the procedure. Over the subsequent two to six months, patients may experience further reduction of wrinkles at the site of the treated skin as new collagen strands grow and reinforce the strands shrunk by the treatment.

As with other non-invasive energy-based devices, the duration and the extent of beneficial effect of the Thermage procedure varies from patient-to-patient and can be influenced by a number of factors, including the area of the body being treated, the age and skin laxity of the patient and operator technique.

Thermage patients may experience temporary swelling and reddening of the skin and, in rare instances, patients may experience burns, blisters, skin discoloration or skin depressions. Burns and blisters may occur either as a result of improper use of the device or as a result of a breakdown in the dielectric material within the ThermaTip.

Prior to April 2004, we trained physicians to follow a procedure protocol, or treatment guidelines, of fewer energy pulses on the skin at higher energy levels. This initial protocol, along with instances of poor operator technique, resulted in reported patient comfort challenges. We modified our procedure protocol in April 2004, and we retrained and recertified our physician customers on the new procedure protocol. The new procedure protocol involves lower energy levels with an increased number of pulses at the treatment site. We believe these modifications have generally increased patient comfort.

Our clinical studies of the Thermage procedure have been performed primarily on the face, using a single treatment. These studies included patients that experienced a range in effect from no improvement to significant improvement. Most experienced modest improvement from a single treatment. When comparing results of a single treatment with results of multiple treatments over time, we have not found a material difference between the two. Our studies typically follow patients over six months, though we have studied patients for up to a year. Generally, results have found improvement in the effect of the treatment increasing up to six months following treatment. Our study results going out one year indicate that if a patient has improvement at six months, the patient will likely have lasting improvement at 12 months. There are no published peer reviewed studies regarding the safety or effectiveness of our new 3.0 cm^2 ThermaTip, which has essentially replaced our 1.0 cm^2 and 1.5 cm^2 ThermaTips, or our current procedure protocol, which involves use of more energy pulses at a lower power. However, based upon our own research and unpublished clinical studies, we have demonstrated that the Thermage procedure using our new ThermaTips and protocol are at least as safe and effective.

Our Customers

To date, we have focused on physician customers who have a demonstrated commitment to building a high-volume, non-invasive, aesthetic skin-tightening business within their practice. We have found physicians with an active aesthetics practice tend to perform more Thermage procedures after purchasing our machine than

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physicians who are new to aesthetic medicine. We encourage our sales force to work closely with our target physician customers to accelerate growth in their aesthetics practices, which, in turn, generates more ThermaTip sales for our company. As a broader group of physicians are adding non-invasive aesthetic procedures to their practices, our target physician base is expanding to include not only plastic surgeons and dermatologists, but also obstetricians, gynecologists and general practitioners. Plastic surgeons and dermatologists currently represent the majority of our existing customers. Many of these physicians are seeking a less expensive alternative to the invasive procedures that they offer in order to augment their customer base and establish a relationship with those patients that do not desire, or cannot afford, an invasive procedure.

Business Strategy

Our goal is to become a leading provider of non-ablative medical devices to the aesthetics market by:

Driving Increased ThermaTip Usage. Unlike the capital equipment model of the traditional laser business, because of the disposable nature of our ThermaTips, we maintain an active, continuous relationship with our customer base. We work collaboratively with our customer base to increase ThermaTip usage by expanding clinical applications and augmenting and facilitating the marketing efforts of our physician customers. We believe that our customers interests are closely aligned with our own, and we monitor the market to foster continued procedure growth for our customers and ThermaTip sales for us. With innovative marketing programs, such as our PatientBuilder.com resource, our sales force works with physician customers to develop a profitable Thermage procedure practice.

Developing New Applications and Treatment Tips. We intend to expand our line of ThermaTips for additional applications and conditions. We recently received FDA clearance to market the TherMassager, an accessory to our ThermaCool system, for the temporary improvement in the appearance of cellulite and for therapeutic massage, which we currently intend to commercially launch in 2007. We are in the process of seeking, and intend to continue to seek, clearances from the FDA to strengthen our marketing efforts with regard to specific areas of the body, such as arms, the abdomen, hands and other locations on the body where wrinkle reduction is desired.

Investing in Intellectual Property and Patent Protection. We will continue to invest in expanding our intellectual property portfolio in the aesthetics market, and we intend to file for additional patents to strengthen our intellectual property rights. We believe that our intellectual property rights protect our position as the exclusive provider of wrinkle treatment using monopolar RF technology in the United States. Because our technology is RF-based and not light-based, we believe we are less exposed to the litigation, licenses and royalties that have been common in the aesthetic laser market. In June 2005, we settled a lawsuit with Syneron, which admitted the validity of six of our patents. As of December 31, 2006, we had 28 issued U.S. patents primarily covering our ThermaCool system and methods of use, the earliest of which will not expire until 2015, 13 pending U.S. patent applications, 15 issued foreign patents and 41 pending foreign patent applications, some of which foreign applications preserve an opportunity to pursue patent rights in multiple countries.

Broadening our Physician Customer Base. We intend to continue to penetrate the traditional aesthetic practitioner specialties, which include dermatologists and plastic surgeons. We are also seeking to selectively expand our direct sales efforts in non-core physician specialties and physician-directed medi-spas with track records of safe and successful aesthetic treatments.

Expanding our International Presence. We believe the size of the international market is comparable to the U.S. market, and we are focused on increasing our market penetration overseas

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and building global brand-recognition. In 2006, approximately 48% of our revenue originated outside of the United States. We intend to add distributors and sales support staff to increase sales and strengthen physician relationships in international markets.

Seeking Growth Opportunities via Complementary Products, Technologies or Businesses. We intend to pursue opportunities to expand our core business by identifying opportunities to offer complementary products for the aesthetics market.

Sales and Marketing

We sell our ThermaCool system to physicians in the United States through a direct sales force of trained sales consultants. As of December 31, 2006, we had a 31-person U.S. direct sales force, including three regional sales managers, a vice-president and a practice management specialist. Outside of the United States, we sell our ThermaCool system to physicians in 77 countries through 31 independent distributors.

United States Sales

Our strategy to increase sales in the United States is to:

continue to position the Thermage procedure as an attractive alternative to other aesthetic treatments for wrinkle reduction;

work closely with our physician customers to increase product usage and enhance the marketing of Thermage procedures in their practices;

leverage direct-to-consumer marketing campaigns; and

selectively expand our sales efforts to reach physicians outside of the traditional specialties for aesthetic procedures.

Further, we actively engage in promotional opportunities through participation in industry tradeshows, clinical workshops and company-sponsored conferences with expert panelists, as well as through trade journals, brochures and our website. We actively seek opportunities to obtain positive media exposure, have engaged in direct-to-consumer marketing, and have been highlighted on such national broadcasts as *Oprah*, *Good Morning America*, and *E! Live from the Red Carpet*, as well as numerous local news programs.

Consultative Sales Process. Through our consultative sales process, we form strong relationships with our customers through frequent interactions. Beyond performing initial system installation and on-site training and certification, which can occur within two weeks of a physician s purchase decision, our sales consultants provide consultation to physicians on how to integrate our system into their practices and market procedures to their patients. Our sales consultants compensation structure emphasizes treatment tip sales and customer service over capital equipment sales, although our sales force also has incentives to generate new accounts through system sales. We require our sales consultants to invest substantial time in training and servicing our physician customers, and therefore we discourage sales to physicians who do not show the potential to drive aesthetic procedure volume.

Physician Training and Certification. We provide comprehensive training and education to each physician before we deliver the ThermaCool system. We require this initial training to assist physicians in safely and effectively performing the Thermage procedure. The majority of physicians operating our installed base of ThermaCool systems have pursued and met the

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advanced training criteria that we establish. To signify their achievement, we award a Certificate of Training to these physicians and identify them within the physician locator on our website with a small certificate icon next to their names. We do not identify physicians within our physician locator unless they have met these training requirements.

PatientBuilder.com. To enhance the consultative sales process, we provide access to easily implemented marketing tools and materials through an exclusive arrangement with PatientBuilder.com. Accessed through our website, PatientBuilder.com enables physicians to create professional marketing campaigns for their own Thermage services, while protecting our brand. Using PatientBuilder.com, physicians can create direct mail pieces and a selective mailing list based on targeted patient demographics in their local areas, print ads for magazines and newspapers, printed brochures and an individually tailored website. We have also produced television commercials that physicians can use in the event that they would like to purchase local airtime.

Direct-to-Consumer Marketing. In 2005, we launched direct-to-consumer, or DTC, marketing campaigns designed to build brand awareness and recognition, demonstrate our commitment to supporting our physician customers and distributors and increase demand for Thermage procedures. Currently, our DTC marketing efforts are focused primarily on paid Internet search results, through search engines such as Google and Yahoo!, and banner ads placed strategically on websites targeting people who may be seeking aesthetic procedures. Also, our website at www.thermage.com has a separate patient area that includes information on our ThermaCool system, the underlying technology and potential treatment outcomes, as well as short films and listings of local physicians who offer Thermage procedures. We have observed our website traffic increase significantly following national television appearances and their periodic re-broadcasts and following our DTC efforts.

Expansion into Non-Traditional Specialties. The majority of our systems sales to date in the United States have been made to dermatologists and plastic surgeons. These physicians constitute the traditional specialties focused on aesthetic procedures. However, by broadening our direct sales efforts to selectively target non-traditional practitioners within the gynecology, primary care, ophthalmology and ear, nose and throat specialties whose practices may be complemented by our aesthetic procedures we hope to increase sales of our systems and consumable products. Also, we hope to generate additional revenue by increasing our penetration into the growing medi-spa market, which is comprised of physicians offering aesthetic treatments in a spa setting.

International Sales

As of December 31, 2006, we had an international sales team of 12 employees supporting 31 independent distributors who market our ThermaCool system in 77 countries. We require our distributors to provide customer training, to invest in equipment and marketing and to attend certain exhibitions and industry meetings. The percentage of our revenue from customers located outside the United States was approximately 48%, 44% and 28% in fiscal 2006, 2005 and 2004, respectively.

Our strategy to grow sales outside the United States is to:

increase penetration of our ThermaCool system in international markets in which our ThermaCool system is currently sold;

expand into attractive new international markets by identifying and training qualified distributors; and

expand our marketing efforts into select international markets.

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Competition

Our industry is characterized by intense competition and rapid innovation. For example, laser devices have advanced rapidly over the past decade, with a variety of technologies available for a wide range of applications. Most recently, other types of devices have been developed that are competitive in the area of wrinkle reduction, such as those based upon filtered light, bipolar RF energy and ultrasound. We compete directly against laser and other energy-delivery devices offered by public companies, including Candela, Cutera, Cynosure, Lumenis, Palomar Medical Technologies and Syneron, as well as by many private companies. Our ThermaCool system also competes with other wrinkle reduction solutions, including Botox and collagen injections, soft tissue fillers, chemical peels, microdermabrasion and liposuction, as well as cosmetic surgical procedures such as face lifts, blepharoplasty and abdominoplasty. Additionally, less invasive surgical solutions, such as implanted sutures, have been developed that may offer a compelling alternative to facelifts.

Competition among providers of medical devices and other treatments for the aesthetics market is characterized by extensive research efforts and rapid technological progress. While we attempt to protect our ThermaCool system through patents and other intellectual property rights, there are few barriers to entry that would prevent new entrants or existing competitors from developing products that would compete directly with ours. In addition, we have encountered and expect to continue to encounter physicians who, due to relationships with our competitors or the nature of their practice, will not purchase our ThermaCool system.

Research and Development

Our research and development efforts currently focus on:

- designing new treatment tips optimally designed for new clinical applications, such as cellulite, as well as specific areas of the body, such as arms, the abdomen and hands;
- identifying and incorporating new or modified dielectric materials and processes to mitigate the risk of dielectric breakdown;
- increasing security against the use of devices designed to enable re-use of treatment tips, resulting in procedure efficacy and safety concerns; and
- developing a new cooling system that integrates a substitute for hydroflurocarbon, to maintain compliance with changes in international environmental regulations.

As of December 31, 2006, we had a staff of 12 technical professionals focused on product development projects and a research staff of two. We have also formed strategic relationships with outside contractors for assistance on specialized projects, and we work closely with experts in the medical community to supplement our internal research and development resources. Research and development expenses for 2006, 2005 and 2004 were $9.6 million, $8.9 million and $8.5 million, respectively. In the future, we expect to pursue further research and development initiatives to improve and extend our technological capabilities and to foster an environment of innovation and quality.

Patents and Proprietary Technology

We rely on a combination of patent, copyright, trademark and trade secret laws and confidentiality and invention assignment agreements to protect our intellectual property rights. As of December 31, 2006, we had 28 issued U.S. patents primarily covering our ThermaCool TC system and methods of use, the earliest of which expire in 2015; 13 pending U.S. patent applications, 15 issued foreign patents and 41 pending foreign patent applications, some of which foreign applications preserve an opportunity to pursue patent rights in multiple countries. We intend to file for additional patents to strengthen our intellectual property rights.

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In addition to the use of RF-based energy, our patent portfolio covers use of other non-ablative energy modalities, including, but not limited to, microwaves, ultrasound and optical wavelengths. Our patent applications may not result in issued patents, and we cannot assure you that any patents that issue will protect our intellectual property rights. Third parties may challenge any patents issued to us as invalid, may independently develop similar or competing technology or may design around any of our patents. We cannot be certain that the steps we have taken will prevent the misappropriation of our intellectual property, particularly in foreign countries where the laws may not protect our proprietary rights in these foreign countries as fully as in the United States.

As a result of a settlement of litigation reached in June 2005, Syneron and we have granted each other a non-exclusive paid-up license under the patents asserted in the lawsuit and related patents under the parties control. We excluded from this license any rights to utilize monopolar RF technologies and capacitive electrical coupling, which we believe in combination allow the Thermage procedure to create a reverse thermal gradient and deep, near uniform, volumetric heating to achieve tissue tightening effects. Syneron excluded from its license any patents related to its proprietary Electro-Optical Synergy technology. Both parties admitted the validity of all patents in the litigation, but neither admitted any wrongdoing or liability.

In addition, we have notified certain competitors of our belief that they may be infringing or may need a license under one or more of our issued patents. These notices may result in litigation in the future. Patent litigation is very expensive and could divert management s attention from our core business. We have in the past and may in the future offer certain of our intellectual property rights for license to our competitors. As of December 31, 2006, we have not entered into any such licenses with our competitors other than our license with Syneron. We granted Edward Knowlton, one of our founders and inventor of our original patents, an exclusive license under those original patents and related patents for certain non-cosmetic applications.

Thermage, ThermaCool and ThermaCool TC are registered trademarks in the United States and several foreign countries. As of December 31, 2006, we have 56 pending and registered trademark filings worldwide, some of which apply to multiple countries, providing coverage in 48 countries. We intend to file for additional trademarks to strengthen our trademark rights, but we cannot be certain that our trademark applications will issue or that our trademarks will be enforceable.

All employees and technical consultants are required to execute confidentiality agreements in connection with their employment and consulting relationships with us. We also require them to agree to disclose and assign to us all inventions conceived or made in connection with the employment or consulting relationship. We cannot provide any assurance that employees and consultants will abide by the confidentiality or invention assignment terms of their agreements. Despite measures taken to protect our intellectual property, unauthorized parties may copy aspects of our products or obtain and use information that we regard as proprietary.

Clinical Research

Our clinical studies of the Thermage procedure have been performed primarily on the face, using a single treatment, to demonstrate safety and effectiveness. We have conducted a split face study that demonstrated the comparability of our 3.0 cm^2 and 1.5 cm^2 treatment tips. Our study results have shown the Thermage procedure to have a low incidence of injury. The most frequent of these injuries consists of temporary burns related to overheating the skin. Generally, study results of effectiveness demonstrate that the majority of patients are satisfied with their treatment results. Our studies typically follow patients over six months, though we have studied patients for up to a year. Generally, results have found improvement in the effect of the treatment increasing up to six months following treatment. Our study results going out one year indicate that results of the procedure are not temporary. If a patient has improvement at six months, the patient will likely have lasting improvement at 12 months. Additionally, when comparing results of a single treatment with results of multiple treatments over time, we have not found a material difference between the two.

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Our studies consistently include patients that experience a range in effect from no improvement to significant improvement. We believe that our study results generally demonstrate that most patients will obtain modest wrinkle reduction from a single treatment. We typically use multiple approaches to assessing improvement in a patient. The most common approaches are subjective before and after evaluations by the treated patient and by the treating physician. We have also used instruments such as the BTC-2000, which is a device that measures the physical properties of the skin by means of vacuum pressure that pulls an area of skin into a chamber, where lasers are used to measure how far the skin is pulled in, at what rate, and how quickly the skin snaps back. We have also used a widely accepted method known as the Fitzpatrick s Wrinkle Assessment Scale to measure improvement.

As of December 31, 2006, our clinical research department had a staff of eight that included clinical research associates and imaging specialists. This department compliments our product development efforts by conducting in-house bench and animal testing for the development and evaluation of products and by providing support to scientific and clinical studies conducted by investigators and institutions studying the use of our technologies. The department also is able to assist outside investigators who seek our help in writing protocols, collecting data, site monitoring and performing research.

As part of our clinical research, we have studied and continue to study the interaction of RF energy and tissue, both to understand the mechanism of action of the Thermage procedure and to guide our efforts to develop new products and treatments. We have used transmission electron microscopy on biopsied tissue samples to corroborate that our products induce the denaturing of collagen that leads to immediate tissue tightening. We have developed histology techniques to investigate the depth of heat in tissue and a wound healing process that we believe is responsible for long-term improvement and tightening of tissue. We have also created three-dimensional computer models to study tissue heating with our products. Determining the effectiveness of an aesthetic treatment is inherently a subjective evaluation. When performing our clinical research and studies, we attempt to utilize the most compelling measures we can in order to provide compelling evidence of efficacy.

As of December 31, 2006, there were 40 published peer-reviewed scientific journal articles and 24 medical conference abstracts that discuss the tissue-tightening effect of our non-invasive monopolar RF technology, authored both by physicians affiliated with our company as clinical and scientific advisors and by unaffiliated, independent, physicians.

Manufacturing

Our manufacturing strategy involves the combined utilization of our internal manufacturing resources and expertise, approved suppliers and contract manufacturers. Our internal manufacturing activities include the assembly, testing and packaging of ThermaTips and handpieces, as well as the final integration, system testing and packaging of our ThermaCool NXT system. We outsource the manufacture of components, subassemblies and certain finished products that are produced to our specifications and shipped to our facility for final assembly or inspection, testing and certification. Finished product is stored at and distributed primarily from our Hayward facility. Quality control, risk management, efficiency and the ability to respond quickly to changing requirements are the primary goals of our manufacturing operations.

We have arrangements with our suppliers that allow us to adjust the delivery quantities of components, subassemblies and finished products, as well as delivery schedules, to match our changing requirements. The forecasts we use are based on historical trends, current utilization patterns and sales forecasts of future demand. Lead times for components, subassemblies and finished products may vary significantly depending on the size of the order, specific supplier requirements and current market demand for the components and subassemblies. Most of our suppliers have no contractual obligations to supply us with, and we are not contractually obligated to purchase from them, the components used in our devices.

We obtain programmable memory chips for our treatment tips and the coolant valve for our handpiece from single suppliers, for which we attempt to mitigate risks through inventory management and utilization of

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12- to 18-month purchase orders, and sterilization services from a single vendor, for which we attempt to mitigate risks by using two sterilization chambers at each of two locations. Other products and components come from single suppliers, but alternate suppliers have been qualified or, we believe, can be readily identified and qualified. In addition, the availability of cryogen for our cooling module, which we can source from multiple suppliers, may fluctuate due to changes in the global supply of this material. To date, we have not experienced material delays in obtaining any of our components, subassemblies or finished products, nor has the ready supply of finished product to our customers been adversely affected.

We are required to manufacture our products in compliance with the FDA s Quality System Regulation, or QSR. The QSR covers the methods and documentation of the design, testing, control, manufacturing, labeling, quality assurance, packaging, storage and shipping of our products. We maintain quality assurance and quality management certifications to enable us to market our products in the member states of the European Union, the European Free Trade Association and countries which have entered into Mutual Recognition Agreements with the European Union. These certifications include EN ISO 9001:2000 and CAN/CSA ISO 13485:2003 and are also required to maintain our product registration in a number of other foreign markets such as Canada.

We use small quantities of common cleaning products in our manufacturing operations, which are lawfully disposed of through a normal waste management program. We do not forecast any material costs due to compliance with environmental laws or regulations.

Services and Support

We strive to provide highly responsive service and support for both our ThermaCool RF generator and our single-use ThermaTip products.

Our ThermaTips are shipped from finished goods inventory typically on the day of the order. All ThermaTips are identified with lot numbers and date codes that indicate the expiration date of the product and are fully warranted until the date of expiration. We maintain a staff of customer service personnel in our Hayward, California facility that is available by phone to our customers to answer questions regarding the use of our ThermaCool system. In addition, in the United States our direct sales force provides on-site support and training to our customers in the use of our ThermaCool system.

In the United States, our ThermaCool RF generator and accessory products are shipped to a customer s site for initial installation and training by one of our direct sales consultants. Our direct sales force, our customer service personnel and our product service staff provide post-installation support and service. In the event of a failure of a ThermaCool RF generator, our customer service department arranges for the immediate shipment of loaner equipment to the customer for its use during the time that the equipment is being repaired. Our goal is to minimize the disruption caused by a service event, and our customers typically receive loaner equipment within one day after notifying us of a problem. In addition, we arrange for the customer s equipment to be returned to our Hayward facility where we confirm and diagnose the problem. Any necessary repairs are performed either at our facility or, in the case of the first generation ThermaCool system, at a contract manufacturer s facility. All ThermaCool systems and components are serialized or lot tracked, and device history records are maintained that track service history and configuration. In markets outside of the United States, our ThermaCool system is serviced and supported through our independent distributors.

Government Regulation

Our ThermaCool system is a medical device subject to extensive and rigorous regulation by the FDA, as well as other regulatory bodies. FDA regulations govern the following activities that we perform, or that are

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performed on our behalf, to ensure that medical products distributed domestically or exported internationally are safe and effective for their intended uses:

- product design and development;
- product testing;
- product manufacturing;
- product safety;
- product labeling;
- product storage;
- recordkeeping;
- premarket clearance or approval;
- advertising and promotion;
- production; and
- product sales and distribution.

FDA s Premarket Clearance and Approval Requirements

Unless an exemption applies, each medical device we wish to commercially distribute in the United States will require either prior 510(k) clearance or premarket approval from the FDA. The FDA classifies medical devices into one of three classes. Devices deemed to pose lower risks are placed in either class I or II, which requires the manufacturer to submit to the FDA a premarket notification requesting clearance to commercially distribute the device. This process is generally known as 510(k) clearance. Some low risk devices are exempted from this requirement. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or devices deemed not substantially equivalent to a previously cleared 510(k) device, are placed in class III, requiring premarket approval. All of our current products are class II devices.

510(k) Clearance Pathway

When a 510(k) clearance is required, we must submit a premarket notification to the FDA demonstrating that our proposed device is substantially equivalent to a previously cleared and legally marketed 510(k) device or a device that was in commercial distribution before May 28, 1976 for which the FDA has not yet called for the submission of premarket approval applications, or PMA. By regulation, the FDA is required to clear or deny a 510(k) premarket notification within 90 days of submission of the application. As a practical matter, clearance often takes significantly longer. The FDA may require further information, including clinical data, to make a determination regarding substantial

equivalence. If the FDA determines that the device, or its intended use, is not substantially equivalent to a previously cleared device or use, the FDA will place the device, or the particular use, into class III.

Radiofrequency devices used for aesthetic procedures, such as wrinkle reduction, have generally qualified for clearance under 510(k) procedures. We received FDA clearance to market our ThermaCool system

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for the treatment of periorbital wrinkles and rhytids in November 2002 and for treatment of facial wrinkles and rhytids in June 2004. In December 2005, we received FDA clearance to market our ThermaCool system for full body treatment of wrinkles. In October 2006, we received FDA clearance to market the TherMassager, an accessory to our ThermaCool system, for the relief of minor muscle aches and pains, relief of muscle spasm, temporary improvement of local circulation (i.e., blood circulation) and temporary improvement in the appearance of cellulite. We have a pending application for FDA clearance to market our ThermaCool system specifically for the treatment of eyelids, though eyelids are not contraindicated in our clearance. We cannot predict when or if such clearance will be obtained.

Premarket Approval Pathway

A PMA must be submitted to the FDA if the device cannot be cleared through the 510(k) process. A PMA must be supported by extensive data, including but not limited to, technical, preclinical, clinical, manufacturing and labeling to demonstrate to the FDA s satisfaction the safety and effectiveness of the device.

No device that we have developed has required premarket approval, nor do we currently expect that any future device or indication will require premarket approval.

Product Modifications

We have modified aspects of our ThermaCool system and accessories since receiving regulatory clearance, and we have made additional 510(k) filings when we deem it necessary. Decisions and rationale not to file a 510(k) for device modifications are documented. After a device receives 510(k) clearance any modification that could affect its safety or effectiveness, or that would constitute a major change in its intended use, will require a new clearance or approval. The FDA requires each manufacturer to make this determination initially, but the FDA can review any decision and disagree with a manufacturer s determination not to file a new 510(k) or PMA. If the FDA disagrees with our determination the FDA may retroactively require us to seek 510(k) clearance or premarket approval. The FDA could also require us to cease marketing and distribution and/or recall the modified device until 510(k) clearance or premarket approval is obtained. Also, in these circumstances, we may be subject to significant regulatory fines or penalties.

Clinical Trials

Clinical trials are almost always required to support an FDA premarket application and are sometimes required for 510(k) clearance. In the United States, these trials generally require submission of an application for an Investigational Device Exemption, or IDE, to the FDA. The IDE application must be supported by appropriate data, such as animal and laboratory testing results, showing that it is safe to test the device in humans and that the testing protocol is scientifically sound. The IDE must be approved in advance by the FDA for a specific number of patients unless the product is deemed a non-significant risk device eligible for more abbreviated IDE requirements. Clinical trials for significant risk devices may not begin until the IDE application is approved by FDA and the appropriate institutional review boards, or IRBs, at the clinical trial sites. Our clinical trials must be conducted under the oversight of an IRB at the relevant clinical trial sites and in accordance with FDA regulations, including but not limited to those relating to good clinical practices. We are also required to obtain patients informed consent that complies with both FDA requirements and state and federal privacy regulations. We, the FDA or the IRB at each site at which a clinical trial is being performed may suspend a clinical trial at any time for various reasons, including a belief that the risks to study subjects outweigh the benefits. Even if a trial is completed, the results of clinical testing may not demonstrate the safety and efficacy of the device, may be equivocal or may otherwise not be sufficient to obtain clearance or approval of the product. Similarly, in Europe the clinical study must be approved by the local ethics committee and in some cases, including studies with high-risk devices, by the Ministry of Health in the applicable country.

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Pervasive and Continuing Regulation

After a device is placed on the market, numerous regulatory requirements continue to apply. These include:

- Quality System regulations, or QSRs, which require manufacturers, including third-party manufacturers, to follow stringent design, testing, control, documentation and other quality assurance procedures during all aspects of the manufacturing process;
- labeling regulations and FDA prohibitions against the promotion of products for uncleared, unapproved or off-label uses;
- medical device reporting, or MDR, regulations, which require that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if the malfunction were to recur; and
- post-market surveillance regulations, which apply when necessary to protect the public health or to provide additional safety and effectiveness data for the device.

The FDA has broad post-market and regulatory enforcement powers. We and our third-party manufacturers are subject to unannounced inspections by the FDA and the Food and Drug Branch of the California Department of Health Services, or CDHS, to determine compliance with the QSR and other regulations. In the past, our facility has been inspected, and observations were noted. The FDA and CDHS have accepted our responses to these observations, and we believe that we are in substantial compliance with the QSR.

Failure to comply with applicable regulatory requirements can result in enforcement action by the FDA, which may include any of the following sanctions:

- warning letters, fines, injunctions, consent decrees and civil penalties;
- repair, replacement, refunds, recall or seizure of our products;
- operating restrictions, partial suspension or total shutdown of production;
- refusing our requests for 510(k) clearance or premarket approval of new products or new intended uses;
- withdrawing 510(k) clearance or premarket approvals that are already granted; and
- criminal prosecution.

If any of these events were to occur, they could have a material adverse effect on our business.

We are also subject to a wide range of federal, state and local laws and regulations, including those related to the environment, health and safety, land use and quality assurance. We believe that compliance with these laws and regulations as currently in effect will not have a material adverse effect on our capital expenditures, earnings and competitive and financial position.

International

International sales of medical devices are subject to foreign governmental regulations, which vary substantially from country to country. The time required to obtain clearance or approval by a foreign country

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may be longer or shorter than that required for FDA clearance or approval, and the requirements may be different. Some countries, such as Japan, have their own governmental approval process through which clinical trial data and other information are submitted to a regulatory authority. In other countries, a medical device may be commercialized if the product has been approved in the United States or in Europe.

The primary regulatory environment in Europe is that of the European Union. The European Union has adopted numerous directives and European Standardization Committees have promulgated voluntary standards regulating the design, manufacture, clinical trials, labeling and adverse event reporting for medical devices. Devices that comply with the requirements of a relevant directive will be entitled to bear CE conformity marking, indicating that the device conforms with the essential requirements of the applicable directives and, accordingly, can be commercially distributed throughout the European Union. The method of assessing conformity varies, depending on the type and class of the product, but normally involves a combination of self-assessment by the manufacturer and a third-party assessment by a Notified Body, an independent and neutral institution appointed by a country to conduct an assessment of compliance with applicable directives. This third-party assessment may consist of an audit of the manufacturer s quality system, standards, and specific testing of the manufacturer s device. An assessment by a Notified Body is required in order for a manufacturer to commercially distribute a product throughout the participating countries. Our products are CE Marked and in conformance with applicable medical device directives and can be commercially sold throughout the European Union, as well as in other countries that recognize products bearing the CE Mark. Our facility has been awarded the ISO 9001:2000 and the CAN/CSA ISO 13485:2003 certifications.

Employees

As of December 31, 2006, we had 154 employees, with 64 employees in sales and marketing, four employees in technical services, 31 employees in manufacturing operations, 30 employees in research and development including clinical, regulatory and certain quality functions, and 25 employees in general and administrative. We believe that our future success will depend in part on our continued ability to attract, hire and retain qualified personnel. None of our employees is represented by a labor union, and we believe our employee relations are good.

Available Information

You may find on our website at http://www.thermage.com electronic copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. Such filings are placed on our website as soon as reasonably possible after they are filed with the SEC. Our most recent charter for our Audit and Compensation Committees and our Code of Ethics are available on our website as well. In the event that we grant a waiver under our Code of Ethics to any of our officers or directors we will publish it on our website.

You can read our SEC filings over the Internet at the SEC s web site at www.sec.gov. You may also read and copy any document we file with the SEC at its public reference facilities at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. Please call the SEC at (202) 551-8090 or (800) 732-0330 for further information on the operation of the public reference facilities.

Item 1A. ***Risk Factors***

We are totally dependent upon the success of our ThermaCool system, which has a limited commercial history. If the ThermaCool system fails to gain or loses market acceptance, our business will suffer.

We introduced our ThermaCool system in 2002, and expect that sales of our ThermaCool system, including our line of single-use ThermaTips, will account for substantially all of our revenue for the foreseeable

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future. We expect to expand our line of ThermaTips in the near future for new applications. This may not occur when expected, or at all, which would negatively affect our anticipated revenue. Our ThermaCool system may not significantly penetrate current or new markets. If demand for the ThermaCool system does not increase as we anticipate, or declines, our business, financial condition and results of operations will be harmed.

Performing clinical studies on, and collecting data from, the Thermage procedure is inherently subjective, and we have limited data regarding the efficacy of our ThermaCool system. If future data is not positive or consistent with our prior experience, rates of physician adoption will likely be harmed.

We believe that in order to significantly grow our business, we will need to conduct future clinical studies of the effectiveness of the ThermaCool system. Clinical studies of aesthetic wrinkle treatments are subject to a number of limitations. First, these studies do not involve well-established objective standards for measuring the effectiveness of treatment. Subjective, before and after, evaluation of the extent of change in the patient s appearance, performed by a medical professional or by the patient, is the most common method of evaluating effectiveness. A clinical study may conclude that a treatment is effective even if the change in appearance is subtle and not long-lasting. Second, as with other non-invasive, energy-based devices, the effect of the Thermage procedure varies from patient to patient and can be influenced by a number of factors, including the area of the body being treated, the age and skin laxity of the patient and operator technique.

Most published studies of our ThermaCool system have investigated the tissue-tightening effect of our monopolar RF technology in procedures on the face, using a single treatment with our first generation 1.0 cm^2 ThermaTip and our prior procedure protocol, which involved the use of fewer energy pulses at a higher power than our current procedure protocol. There are no published, peer-reviewed studies regarding the effectiveness of our latest generation 0.25 cm^2 and 3.0 cm^2 ThermaTips or our current procedure protocol, which have essentially replaced our first generation tip and procedure protocol, or for procedures on other parts of the body. Additionally, we have not conducted any head-to-head clinical studies that compare results from treatment with our ThermaCool system to surgery or treatment with other aesthetic devices. Without head-to-head studies against competing alternative treatments, which we have no current plans to conduct, potential customers may not find clinical studies of our technology sufficiently compelling to purchase our ThermaCool system. If we decide to pursue additional studies in the future, they could be expensive and time consuming, and the data collected may not produce favorable or compelling results. If the results of such studies do not meet physicians expectations, our ThermaCool system may not become widely adopted, physicians may recommend alternative treatments for their patients, and our business may be harmed.

Our ability to market our ThermaCool system in the United States is limited. If we want to expand our marketing claims, we will need to obtain additional FDA clearances or approvals, which may not be granted.

Developing and promoting new applications for our ThermaCool system are elements of our growth strategy. We currently have U.S. Food and Drug Administration, or FDA, clearance in the United States to market our ThermaCool system for the non-invasive treatment of wrinkles and rhytids, and for the temporary improvement in the appearance of cellulite and for therapeutic massage. These clearances restrict our ability to market or advertise our ThermaCool system for many specific indications, which could affect our growth. We intend to expand our line of ThermaTips for new applications and conditions. We are in the process of seeking, and intend to continue to seek, clearances from the FDA to expand our marketing efforts. We cannot predict whether we will receive such clearances. Future indications may be more difficult to obtain. The FDA may require us to conduct clinical trials to support a regulatory clearance or approval, which trials may be time-consuming and expensive, and may produce results that do not result in approval of our FDA application. In the event that we do not obtain additional FDA clearances, our ability to promote our ThermaCool system in the United States and to grow our revenue may be adversely affected.

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Our business is not currently profitable, and we may not be able to achieve profitability even if we are able to generate significant revenue.

We incurred a loss of $6.6 million in 2003, a profit of $5.0 million in 2004, a loss of $8.2 million in 2005 and a loss of $3.9 million in 2006. In the past, with increasing revenue, we have expanded our business and increased our expenses to meet anticipated increased demand for our ThermaCool system. We expect this trend to continue for the foreseeable future. We will have to increase our revenue while effectively managing our expenses in order to achieve profitability. We cannot predict if and when we will achieve profitability. Our failure to achieve and sustain profitability could negatively impact the market price of our common stock and require us to seek additional financing for our business.

It is difficult to forecast future performance, which may cause our financial results to fluctuate unpredictably.

Our limited operating history makes it difficult for us to predict future performance. Historically, the demand for our ThermaCool system has varied from quarter to quarter. A number of factors, over which we have limited or no control, may contribute to fluctuations in our financial results, such as:

- delays in receipt of anticipated purchase orders;
- seasonal variations in patient demand for aesthetic procedures;
- performance of our independent distributors;
- positive or negative media coverage of our ThermaCool system, the Thermage procedure or products of our competitors or our industry;
- our ability to obtain further regulatory clearances or approvals;
- delays in, or failure of, product and component deliveries by our subcontractors and suppliers;
- changes in the length of the sales process;
- customer response to the introduction of new product offerings; and
- fluctuations in foreign currency.

Our operating performance has in the past been negatively impacted as we have attempted to determine the proper sales prices for our ThermaCool radiofrequency, or RF, generator and our single-use ThermaTips. Establishing appropriate pricing for our capital equipment and components has been challenging because there have not existed directly comparable competitive products. We may experience similar pricing challenges in the future as we introduce new products, which could have an unanticipated negative impact on our financial performance.

If there is not sufficient patient demand for Thermage procedures, practitioner demand for our ThermaCool system, including our single-use ThermaTips, could drop, resulting in unfavorable operating results.

Most procedures performed using our ThermaCool system are elective procedures, the cost of which must be borne by the patient, and are not reimbursable through government or private health insurance. The

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decision to undergo a Thermage procedure is thus driven by consumer demand, which may be influenced by a number of factors, such as:

- our sales and marketing efforts directed toward consumers, as to which we have limited experience and resources;
- the extent to which physicians recommend our procedures to their patients;
- the cost, safety and effectiveness of a Thermage procedure versus alternative treatments;
- general consumer sentiment about the benefits and risks of aesthetic procedures; and
- consumer confidence, which may be impacted by economic and political conditions.

Our financial performance could be materially harmed in the event that any of the above factors discourage patients from seeking Thermage procedures.

Negative publicity regarding our Thermage procedure could harm demand, which would adversely affect sales and our financial performance.

We have in the past experienced, and expect that in the future we will experience, negative media exposure. Such publicity may present negative individual physician or patient experience regarding the safety or effectiveness of the Thermage procedure. Competitors could attempt to use such publicity to harm our reputation and disrupt current or potential future customer relationships. While, to date, we have not observed a material impact on our quarterly financial results of operations from negative publicity, future results could be negatively impacted. Additionally, while we believe that obtaining positive publicity is important to our success, and it is an important component of our marketing efforts, we have also not observed a material impact on our quarterly financial results of operations from positive publicity.

Our reputation and competitive position may be harmed not only by negative media exposure, but also by other publicly-available information suggesting that our Thermage procedure is not safe. For example, we file adverse event reports with the FDA that are publicly available on the FDA s website if our product may have caused or contributed to a serious injury or malfunctioned in a way that would likely cause or contribute to a serious injury if it were to recur. There are under 200 such medical device reports, excluding duplicate reports, on the FDA s website related to the Thermage procedure. Based upon an estimated 350,000 Thermage procedures performed to date, the rate of such reports is under 0.1%, with over 99.9% of procedures performed without an adverse event reported. Despite this safety record, competitors may attempt to harm our reputation by pointing to isolated injuries that have been reported or publicized, or by claiming that their product is superior because they have not filed as many adverse event reports with the FDA. Such negative publicity and competitor behavior could harm our reputation and our future sales.

The failure of our ThermaCool system to meet patient expectations or the occurrence of unpleasant side effects from the Thermage procedure could impair our financial performance.

Our future success depends upon patients having a positive experience with the Thermage procedure in order to increase physician demand for our products, as a result of both individual patients repeat business and as a result of word-of-mouth referrals. We believe that patients may be dissatisfied with the Thermage procedure if they find it to be too painful. Furthermore, Thermage patients may experience temporary swelling or reddening of the skin as a procedure side effect. In rare instances patients may receive burns, blisters, skin discoloration or skin depressions. Experiencing excessive pain, any of these side effects or adverse events could discourage a patient from having a Thermage procedure or discourage a patient from having additional procedures or referring

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Thermage procedures to others. In order to generate repeat and referral business, we also believe that patients must be satisfied with the effectiveness of the Thermage procedure. Results obtained from a Thermage procedure are subjective and may be subtle. A Thermage treatment may produce results that may not meet patients expectations. If patients are not satisfied with the procedure or feel that it is too expensive for the results obtained, our reputation and future sales will suffer.

Our success depends on growing physician adoption of our ThermaCool system and continued use of our ThermaTips.

Our target physician customers typically already own one or more aesthetic device products. Our ability to grow our business and convince physicians to purchase our ThermaCool system depends on the success of our sales and marketing efforts. Our business model involves both a capital equipment purchase of our ThermaCool RF generator and continued purchases by our customers of single-use ThermaTips. This may be a novel business model for many potential customers who may be used to competing products that are either exclusively capital equipment, such as many laser-based systems, or that are exclusively single-use products, such as Botox or dermal fillers. We must be able to demonstrate that the cost of our ThermaCool system and the revenue that the physician can derive from performing procedures using our product are compelling when compared to the cost and revenue associated with alternative products. When marketing to plastic surgeons, we must also, in some cases, overcome a bias against non-invasive aesthetic procedures. If we are unable to increase physician adoption of our ThermaCool system and use of our ThermaTips, our financial performance will be adversely affected.

We have limited sales and marketing experience and failure to build and manage our sales force or to market and distribute our ThermaCool system effectively could have a material adverse effect on our business.

We rely on a direct sales force to sell our ThermaCool system in the United States. In order to meet our anticipated sales objectives, we expect to grow our domestic sales organization significantly over the next several years. There are significant risks involved in building and managing our sales organization, including risks related to our ability to:

- hire qualified individuals as needed;
- provide adequate training for the effective sale of our ThermaCool system; and
- retain and motivate our sales employees.

In addition, sales to non-traditional practitioners of aesthetic procedures is a key element of our growth strategy. However, our sales force historically has sold primarily to dermatologists and plastic surgeons. Also, our ThermaCool system competes with products that are well-established in the market. Accordingly, it is difficult for us to predict how well our sales force will perform. Our failure to adequately address these risks could have a material adverse effect on our ability to sell our ThermaCool system, causing our revenue to be lower than expected and harming our results of operations.

To successfully market and sell our ThermaCool system internationally, we must address many issues with which we have limited experience.

International sales accounted 48% of our revenue for the year ended December 31, 2006. We believe that a significant portion of our business will continue to come from international sales through increased penetration in countries where we currently sell our ThermaCool system, combined with expansion into new international markets. However, international sales are subject to a number of risks, including:

- difficulties in staffing and managing our international operations;

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difficulties in penetrating markets in which our competitors products are more established;

reduced or no protection for intellectual property rights in some countries;

export restrictions, trade regulations and foreign tax laws;

regulation of the sale of the hydroflurocarbon used with our ThermaCool system;

fluctuating foreign currency exchange rates;

foreign certification and regulatory clearance or approval requirements;

difficulties in developing effective marketing campaigns for unfamiliar, foreign countries;

customs clearance and shipping delays;

political and economic instability; and

preference for locally produced products.

If one or more of these risks were realized, it could require us to dedicate significant resources to remedy the situation, and if we are unable to find a solution, our revenue may decline.

To market and sell our ThermaCool system internationally, we depend on distributors, and they may not be successful.

We currently depend exclusively on third-party distributors to sell and service our ThermaCool system internationally and to train our international customers, and if these distributors terminate their relationships with us or under-perform we may be unable to maintain or increase our level of international revenue. We will also need to engage additional international distributors to grow our business and expand the territories in which we sell our ThermaCool system. Distributors may not commit the necessary resources to market, sell and service our ThermaCool system to the level of our expectations. If current or future distributors do not perform adequately, or if we are unable to engage distributors in particular geographic areas, our revenue from international operations will be adversely affected.

We compete against companies that have more established products, longer operating histories and greater resources, which may prevent us from achieving significant market penetration or increased operating results.

The aesthetics market is highly competitive and dynamic, and is marked by rapid and substantial technological development and product innovations. Demand for our ThermaCool system could be diminished by equivalent or superior products and technologies offered by competitors. Specifically, our ThermaCool system competes against a variety of offerings in the aesthetics market, including laser and other light-based medical devices, pharmaceutical products such as Botox, filler injections, chemical peels, microdermabrasion, liposuction, cosmetic surgical procedures and less invasive surgical solutions such as implanted sutures. Our closest competitors are makers of laser and other light-based devices, which include public companies such as Candela, Cutera, Cynosure, Lumenis, Palomar Medical Technologies and Syneron Medical, as well as many private companies.

Competing in the aesthetics market could result in price-cutting, reduced profit margins and loss of market share, any of which would harm our business, financial condition and results of operations. Our ability to compete effectively depends upon our ability to distinguish our company

and our ThermaCool system from our competitors and their products, and on such factors as:

safety and effectiveness;

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product pricing;

success of our marketing initiatives;

compelling clinical data;

intellectual property protection;

quality of customer support; and

development of successful distribution channels, both domestically and internationally.

Some of our competitors have more established products and customer relationships than we do, which could inhibit our market penetration efforts. For example, we have encountered, and expect to continue to encounter, situations where, due to pre-existing relationships, potential customers decided to purchase additional products from our competitors. Potential customers also may need to recoup the cost of expensive products that they have already purchased from our competitors and thus may decide not to purchase our ThermaCool system, or to delay such purchase. If we are unable to achieve continued market penetration, we will be unable to compete effectively and our business will be harmed.

In addition, some of our current and potential competitors have significantly greater financial, research and development, manufacturing, and sales and marketing resources than we have. Our competitors could utilize their greater financial resources to acquire other companies to gain enhanced name recognition and market share, as well as new technologies or products that could effectively compete with our existing product line. Given the relatively few competitors currently in the market, any business combination could exacerbate any existing competitive pressures, which could harm our business.

Competition among providers of devices for the aesthetics market is characterized by rapid innovation, and we must continuously develop new products or our revenue may decline.

While we attempt to protect our ThermaCool system through patents and other intellectual property rights, there are few barriers to entry that would prevent new entrants or existing competitors from developing products that compete directly with ours. For example, while we believe our monopolar RF technology maintains a strong intellectual property position, there are other companies employing competing technologies which claim to have a similar clinical effect to ours. Additionally, there are others who may market monopolar RF technology for competing purposes in a direct challenge to our intellectual property position. As we continue to create market demand for a non-surgical, non-invasive way to treat wrinkles, competitors will enter the market with other products making similar or superior claims. We expect that any competitive advantage we may enjoy from our current and future innovations may diminish over time, as companies successfully respond to our, or create their own, innovations. Consequently, we believe that we will have to continuously innovate and improve our ThermaCool system and technology to compete successfully. If we are unable to innovate successfully, our ThermaCool system could become obsolete and our revenue will decline as our customers purchase competing products.

We may not be successful in commercializing a product for cellulite.

We recently received FDA clearance to market the TherMassager, an accessory to our ThermaCool system, for the temporary improvement in the appearance of cellulite and for therapeutic massage, which we currently intend to commercially launch in 2007. We have not previously marketed our ThermaCool system to reduce the appearance of cellulite, and our anticipated marketing and training efforts may not be successful in encouraging physicians and patients to adopt this new procedure in commercially meaningful numbers. We expect to face significant competition in the area of cellulite products, in some cases from companies that are

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more established, market more widely known products and have greater resources than we do. We may not be able to differentiate our cellulite product sufficiently from our competitors products to achieve significant market penetration. In addition, integrating a new accessory into our existing ThermaCool system will require additional physician training as well as manufacturing and technical support. As a result of these factors, we may incur significant marketing and development expenses relating to this new product opportunity without achieving commercial success, which could harm our business and our competitive position.

We outsource the repair of key elements of our ThermaCool RF generator to a single manufacturing subcontractor.

We outsource the repair of our first generation RF generator to a single contract manufacturer, Stellartech. If Stellartech s operations are interrupted, we may be limited in our ability to repair equipment at customer sites. Stellartech is dependent on trained technical labor to effectively repair our ThermaCool RF generator. In addition, Stellartech is a medical device manufacturer and is required to demonstrate and maintain compliance with the FDA s Quality System Regulation, or QSR. If Stellartech fails to comply with the FDA s QSR, its repair operations could be halted and our ability to repair first generation ThermaCool systems would be impaired.

Our manufacturing operations and those of our key manufacturing subcontractors are dependent upon third-party suppliers, making us vulnerable to supply shortages and price fluctuations, which could harm our business.

Several components and materials that comprise our ThermaCool system are currently manufactured by a single supplier or a limited number of suppliers. In many of these cases, we have not yet qualified alternate suppliers and rely upon purchase orders, rather than long-term supply agreements. A supply interruption or an increase in demand beyond our current suppliers capabilities could harm our ability to manufacture our ThermaCool system until new sources of supply are identified and qualified. Our reliance on these suppliers subjects us to a number of risks that could harm our business, including:

- interruption of supply resulting from modifications to or discontinuation of a supplier s operations;
- delays in product shipments resulting from uncorrected defects, reliability issues or a supplier s variation in a component;
- a lack of long-term supply arrangements for key components with our suppliers;
- inability to obtain adequate supply in a timely manner, or to obtain adequate supply on commercially reasonable terms;
- difficulty locating and qualifying alternative suppliers for our components in a timely manner;
- production delays related to the evaluation and testing of products from alternative suppliers, and corresponding regulatory qualifications;
- delay in delivery due to our suppliers prioritizing other customer orders over ours;
- damage to our brand reputation caused by defective components produced by our suppliers;
- increased cost of our warranty program due to product repair or replacement based upon defects in components produced by our suppliers; and

fluctuation in delivery by our suppliers due to changes in demand from us or their other customers.

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Any interruption in the supply of components or materials, or our inability to obtain substitute components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers, which would have an adverse effect on our business.

If, in the future, we decide to perform additional manufacturing functions internally that we currently outsource, our business could be harmed by our limited manufacturing experience and related capabilities.

We currently perform certain manufacturing processes internally at our principal facility, and we outsource the manufacture of components, subassemblies and certain finished products to a limited number of third parties. For financial or operational purposes, we have in the past elected, and may in the future elect, to perform additional component or system manufacturing functions internally. Implementing complex or specialized manufacturing processes could lead to difficulties in producing sufficient quantities of manufactured items that meet our quality standards and that comply with applicable regulatory requirements in a timely and cost-effective manner. In addition, if we experience internal manufacturing difficulties, it may be expensive and time consuming to engage subcontractor or supplier to fulfill our replacement manufacturing needs. The occurrence of any of these events could harm our business.

If the ThermaCool System malfunctions or if we discover a manufacturing defect that could lead to a malfunction, we may have to initiate a product recall, which could adversely impact our business.

Problems in our manufacturing processes, or those of our manufacturing subcontractors, that lead to an actual or possible malfunction in the ThermaCool system, may require us to recall product from customers and could disrupt our operations. For example, in December 2002, we initiated our only recall to date following a change we had made in the seal around the edge of the treatment tip. We discovered that the newly-designed seal could fail to hold, resulting in leakage of cryogen and the possibility of skin damage. Burns, including one classified as third degree, were reported in five patients and we filed Medical Device Reports, or MDRs, with the FDA for each of these injuries. The problem was resolved within two weeks and did not have a significant impact on our ability to supply products to our customers or, more generally, on our results of operations. However, our results of operations, our reputation and market acceptance of our products could be harmed if we encounter difficulties in manufacturing that result in a more significant recall or significant patient injury, and delays in our ability to fill customer orders.

We may not be able to develop an alternative cooling system that will be in compliance with changing environmental regulations in a timely or cost-effective manner.

The cooling capability of our first generation and ThermaCool NXT RF generators relies upon a hydroflurocarbon, or HFC, called R134a, to protect the outer layer of the skin from over-heating while our device delivers RF energy to the subcutaneous tissue. New environmental regulations phasing out certain HFCs over the next decade have been adopted or are under consideration in a number of countries, and recent European Union directives require the phase-out of certain HFCs and place certain restrictions on the import of R134a, and new products that utilize R134a beginning July 4, 2007. If we are unable to develop an alternative cooling system for our device which is not dependent on R134a in a timely or cost-effective manner, our ThermaCool system may not be in compliance with environmental regulations, which could result in fines, civil penalties and the inability to sell our products in certain major international markets.

In addition, the impending restrictions on HFCs may reduce their availability, as suppliers have lower incentive to expand production capacity or maintain existing capacity. This change in supply could expose us to supply shortages or increased prices for R134a, which could impair our ability to support our current or future customers.

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We forecast sales to determine requirements for components and materials used in our ThermaCool system, and if our forecasts are incorrect, we may experience delays in shipments or increased inventory costs.

We keep limited materials, components and finished product on hand. To manage our manufacturing operations with our suppliers, we forecast anticipated product orders and material requirements to predict our inventory needs up to six months in advance and enter into purchase orders on the basis of these requirements. Our limited historical experience may not provide us with enough data to accurately predict future demand. If our business expands, our demand for components and materials would increase and our suppliers may be unable to meet our demand. If we overestimate our component and material requirements, we will have excess inventory, which would increase our expenses. If we underestimate our component and material requirements, we may have inadequate inventory, which could interrupt, delay or prevent delivery of our ThermaCool system to our customers. Any of these occurrences would negatively affect our financial performance and the level of satisfaction our customers have with our business.

Even though we require training for users of our ThermaCool system and do not sell our ThermaCool system to non-physicians, there exists a potential for misuse, which could harm our reputation and our business.

While we only sell our ThermaCool system to licensed physicians who have met our training requirements, Federal regulations allow us to sell our ThermaCool system to licensed practitioners. The definition of licensed practitioners varies from state to state. As a result, our ThermaCool system may be operated by licensed practitioners with varying levels of training, and in many states by non-physicians, including physician assistants, registered nurses and nurse practitioners. Thus, in some states, the definition of licensed practitioner may result in the legal use of our ThermaCool system by non-physicians. Outside the United States, our independent distributors sell in many jurisdictions that do not require specific qualifications or training for purchasers or operators of our ThermaCool system. We do not supervise the procedures performed with our ThermaCool system, nor can we be assured that direct physician supervision of our equipment occurs according to our recommendations. We, and our distributors, require purchasers of our ThermaCool system to undergo an initial training session as a condition of purchase, but do not require ongoing training. In addition, we prohibit the sale of our system to companies that rent our system to third parties, but cannot prevent an otherwise qualified physician from contracting with a rental company in violation of their purchase agreement with us. The use of our ThermaCool system by non-physicians, as well as noncompliance with the operating guidelines set forth in our training programs, may result in product misuse and adverse treatment outcomes, which could harm our reputation and expose us to costly product liability litigation.

Product liability suits could be brought against us due to defective design, labeling, material or workmanship, or misuse of our ThermaCool system, and could result in expensive and time-consuming litigation, payment of substantial damages and an increase in our insurance rates.

If our ThermaCool system is defectively designed, manufactured or labeled, contains defective components or is misused, we may become subject to substantial and costly litigation by our customers or their patients. Misusing our ThermaCool system or failing to adhere to operating guidelines could cause significant skin damage and underlying tissue damage. In addition, if our operating guidelines are found to be inadequate, we may be subject to liability. We have been and may, in the future, be involved in litigation related to the use of our ThermaCool system. Product liability claims could divert management s attention from our core business, be expensive to defend and result in sizable damage awards against us. We may not have sufficient insurance coverage for all future claims. We may not be able to obtain insurance in amounts or scope sufficient to provide us with adequate coverage against all potential liabilities. Any product liability claims brought against us, with or without merit, could increase our product liability insurance rates or prevent us from securing continuing coverage, could harm our reputation in the industry and reduce product sales. Product liability claims in excess of our insurance coverage would be paid out of cash reserves, harming our financial condition and reducing our operating results.

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The dielectric material in our ThermaTips may degrade with prolonged operation of our device, which could, in turn, lead to skin burns. Our research and development staff is working to implement strategies to mitigate the risks associated with breakdown of the dielectric material in our ThermaTips. If we are unable to address this issue effectively, we could be subject to product liability litigation, as well as damage to our reputation in the marketplace, as a result of potential injury to patients.

After-market modifications to our ThermaTips by third parties and the development of counterfeit treatment tips could reduce ThermaTip sales, expose us to product liability litigation and dilute our brand quality.

Third parties have introduced adulterated after-market modifications to our ThermaTips which have enabled re-use of our ThermaTips in multiple procedures. Because our ThermaTips are designed to withstand a finite number of firings, modifications intended to increase the number of firings could result in patient injuries caused by the use of worn-out or damaged ThermaTips. In addition, third parties may seek to develop counterfeit treatment tips that are compatible with our ThermaCool system and available to practitioners at lower prices than our own. If security features incorporated into the design of our ThermaCool system are unable to prevent after-market modifications to our ThermaTips or the introduction of counterfeit treatment tips, we could be subject to reduced ThermaTip sales, product liability lawsuits resulting from the use of damaged or defective goods and damage to our reputation for providing a quality product.

We depend on skilled and experienced personnel to operate our business effectively. If we are unable to recruit, hire and retain these employees, our ability to manage and expand our business will be harmed, which would impair our future revenue and profitability.

Our success largely depends on the skills, experience and efforts of our officers and other key employees. We do not have employment contracts with any of our officers or other key employees. Any of our officers and other key employees may terminate their employment at any time. The loss of any of our senior management team members could weaken our management expertise and harm our business.

Our ability to retain our skilled labor force and our success in attracting and hiring new skilled employees will be a critical factor in determining whether we will be successful in the future. We may not be able to meet our future hiring needs or retain existing personnel. We will face particularly significant challenges and risks in hiring, training, managing and retaining engineering and sales and marketing employees, as well as independent distributors, most of whom are geographically dispersed and must be trained in the use and benefits of our ThermaCool system. Failure to attract and retain personnel, particularly technical and sales and marketing personnel, would materially harm our ability to compete effectively and grow our business.

Risks Related to Our Intellectual Property

Intellectual property rights may not provide adequate protection for our ThermaCool system, which may permit third parties to compete against us more effectively.

We rely on patent, copyright, trade secret and trademark laws and confidentiality agreements to protect our technology and ThermaCool system. As of December 31, 2006, we had 28 issued U.S. patents and 15 issued foreign patents outside of the United States, mostly covering our ThermaCool system. Some of our system components are not, and in the future may not be, protected by patents. Additionally, our patent applications may not issue as patents or, if issued, may not issue in a form that will be advantageous to us. Any patents we obtain may be challenged, invalidated or legally circumvented by third parties. Consequently, competitors could market products and use manufacturing processes that are substantially similar to, or superior to, ours. We may not be able to prevent the unauthorized disclosure or use of our technical knowledge or other trade secrets by

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consultants, vendors, former employees or current employees, despite the existence generally of confidentiality agreements and other contractual restrictions. Monitoring unauthorized uses and disclosures of our intellectual property is difficult, and we do not know whether the steps we have taken to protect our intellectual property will be effective. Moreover, we do not have patent rights in all foreign countries in which a market may exist, and where we have applied for foreign patent rights, the laws of many foreign countries will not protect our intellectual property rights to the same extent as the laws of the United States.

In addition, competitors could purchase our ThermaCool system and attempt to replicate some or all of the competitive advantages we derive from our development efforts, willfully infringe our intellectual property rights, design around our protected technology or develop their own competitive technologies that fall outside of our intellectual property rights. If our intellectual property is not adequately protected so as to protect our market against competitors products and methods, our competitive position could be adversely affected, as could our business.

We may be involved in future costly intellectual property litigation, which could impact our future business and financial performance.

Our industry has been characterized by frequent intellectual property litigation. Our competitors or other patent holders may assert that our ThermaCool system and the methods we employ are covered by their patents. If our ThermaCool system or methods are found to infringe, we could be prevented from marketing our ThermaCool system. In addition, we do not know whether our competitors or potential competitors have applied for, or will apply for or obtain, patents that will prevent, limit or interfere with our ability to make, use, sell, import or export our ThermaCool system. We may also initiate litigation against third parties to protect our own intellectual property. For example, in July 2004 we filed a lawsuit in federal court against Syneron, and during the course of the litigation we asserted infringement of six Thermage patents. This lawsuit was expensive and protracted, and was not resolved until a settlement was reached in June 2005. We believe that there are companies that are marketing or may, in the future, market products for competing purposes in a direct challenge to our intellectual property position, and we may be required to initiate litigation in order to stop them. We have notified certain competitors of our belief that they may be infringing or may need a license under one or more of our issued patents. These notices may result in litigation in the future in the United States or abroad. Our intellectual property has not been tested at trial. If we initiate litigation to protect our rights, we run the risk of having our patents invalidated, which would undermine our competitive position.

Litigation related to infringement and other intellectual property claims, with or without merit, is unpredictable, can be expensive and time-consuming and could divert management s attention from our core business. If we lose this kind of litigation, a court could require us to pay substantial damages, and prohibit us from using technologies essential to our ThermaCool system, any of which would have a material adverse effect on our business, results of operations and financial condition. We do not know whether necessary licenses would be available to us on satisfactory terms, or whether we could redesign our ThermaCool system or processes to avoid infringement.

Competing products may also appear in other countries in which our patent coverage might not exist or be as strong. If we lose a foreign patent lawsuit, we could be prevented from marketing our ThermaCool system in one or more countries.

In addition, we may hereafter become involved in litigation to protect our trademark rights associated with our company name or the names used with our ThermaCool system. Names used with our ThermaCool system and procedures may be claimed to infringe names held by others or to be ineligible for proprietary protection. If we have to change the name of our company or ThermaCool system, we may experience a loss in goodwill associated with our brand name, customer confusion and a loss of sales.

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Risks Related to Regulatory Matters

If we fail to obtain and maintain necessary FDA clearances for our ThermaCool system and indications, if clearances for future products and indications are delayed, not issued or rescinded or if there are federal or state level regulatory changes, our commercial operations would be harmed.

Our ThermaCool system is a medical device that is subject to extensive regulation in the United States by the FDA for manufacturing, labeling, sale, promotion, distribution and shipping. Before a new medical device, or a new use of or claim for an existing product, can be marketed in the United States, it must first receive either 510(k) clearance or premarketing approval from the FDA, unless an exemption applies. Either process can be expensive and lengthy. The FDA s 510(k) clearance process usually takes from three to 12 months, but it can last significantly longer. The process of obtaining premarketing approval is much more costly and uncertain than the 510(k) clearance process, and it generally takes from one to three years, or even longer, from the time the application is filed with the FDA.

Medical devices may be marketed only for the indications for which they are approved or cleared. We have obtained 510(k) clearance for the non-invasive treatment of wrinkles and rhytids. However, our clearances can be revoked if safety or effectiveness problems develop. We also are subject to Medical Device Reporting regulations, which require us to report to the FDA if our product causes or contributes to a death or serious injury, or malfunctions in a way that would likely cause or contribute to a death or serious injury. Our ThermaCool system is also subject to state regulations which are, in many instances, in flux. Changes in state regulations may impede sales. For example, federal regulations allow our ThermaCool system to be sold to, or on the order of, licensed practitioners, as determined on a state-by-state basis. As a result, in some states, non-physicians may legally purchase and operate our ThermaCool system. However, a state could change its regulations at any time, disallowing sales to particular types of end users. We cannot predict the impact or effect of future legislation or regulations at the federal or state levels.

The FDA and state authorities have broad enforcement powers. Our failure to comply with applicable regulatory requirements could result in enforcement action by the FDA or state agencies, which may include any of the following sanctions:

warning letters, fines, injunctions, consent decrees and civil penalties;

repair, replacement, refunds, recall or seizure of our product;

operating restrictions or partial suspension or total shutdown of production;

refusing our requests for 510(k) clearance or premarket approval of new products, new intended uses or modifications to our existing product;

withdrawing 510(k) clearance or premarket approvals that have already been granted; and

criminal prosecution.

If any of these events were to occur, our business could be harmed.

If we modify our FDA-cleared device, we may need to seek and obtain new clearances, which, if not granted, would prevent us from selling our modified product or require us to redesign our product.

Any modifications to an FDA-cleared device that would significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance or possibly a premarket approval. We may not be able to obtain additional 510(k) clearances or premarket approvals for new

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products or for modifications to, or additional indications for, our existing product in a timely fashion, or at all. Delays in obtaining future clearances would adversely affect our ability to introduce new or enhanced products in a timely manner, which in turn would harm our revenue and potential future profitability. We have made modifications to our device in the past and may make additional modifications in the future that we believe do not or will not require additional clearances or approvals. If the FDA disagrees, and requires new clearances or approvals for the modifications, we may be required to recall and to stop marketing the modified device, which could harm our operating results and require us to redesign our product.

If we or our third-party manufacturers fail to comply with the FDA s Quality System Regulation, our business would suffer.

We and our third-party manufacturers are required to demonstrate and maintain compliance with the FDA s Quality System Regulation, or QSR. The QSR is a complex regulatory scheme that covers the methods and documentation of the design, testing, control, manufacturing, labeling, quality assurance, packaging, storage and shipping of our product. The FDA enforces the QSR through periodic unannounced inspections. We have been, and anticipate in the future to be, subject to such inspections. Our failure, or the failure of our third-party manufacturers, to take satisfactory corrective action in response to an adverse QSR inspection could result in enforcement actions, including a public warning letter, a shutdown of our manufacturing operations, a recall of our product, civil or criminal penalties or other sanctions, which would cause our sales and business to suffer.

We may be unable to obtain or maintain international regulatory qualifications or approvals for our current or future products and indications, which could harm our business.

Sales of our ThermaCool system outside the United States are subject to foreign regulatory requirements that vary widely from country to country. In addition, the FDA regulates exports of medical devices from the United States. Complying with international regulatory requirements can be an expensive and time-consuming process and approval is not certain. The time required to obtain clearance or approvals, if required by other countries, may be longer than that required for FDA clearance or approvals, and requirements for such clearances or approvals may significantly differ from FDA requirements. We rely upon third-party distributors to obtain all regulatory clearances and approvals required in other countries, and these distributors may be unable to obtain or maintain such clearances or approvals. Our distributors may also incur significant costs in attempting to obtain and in maintaining foreign regulatory approvals or qualifications, which could increase the difficulty of attracting and retaining qualified distributors. If our distributors experience delays in receiving necessary qualifications, clearances or approvals to market our products outside the United States, or if they fail to receive those qualifications, clearances or approvals, we may be unable to market our products or enhancements in international markets effectively, or at all.

Risks Related to Our Capital Requirements and Finances

Our financial controls and procedures may not be sufficient to ensure timely and reliable reporting of financial information, which, as a public company, could materially harm our stock price and Nasdaq listing.

As a public company, we will require greater financial resources than we have had as a private company. We cannot provide you with assurance that our finance department has or will maintain adequate resources to ensure that we will not have any future material weakness in our system of internal controls. The effectiveness of our controls and procedures may in the future be limited by a variety of factors, including:

- faulty human judgment and simple errors, omissions or mistakes;
- fraudulent action of an individual or collusion of two or more people;

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inappropriate management override of procedures; and

the possibility that any enhancements to controls and procedures may still not be adequate to assure timely and accurate financial information.

If we fail to have effective controls and procedures for financial reporting in place, we could be unable to provide timely and accurate financial information and be subject to Nasdaq delisting, Securities and Exchange Commission investigation and civil or criminal sanctions.

We must implement additional and expensive procedures and controls in order to grow our business and organization and to satisfy new reporting requirements, which will increase our costs and require additional management resources.

As a public reporting company, we will be required to comply with the Sarbanes-Oxley Act of 2002 and the related rules and regulations of the SEC, including the requirements that we maintain disclosure controls and procedures and adequate internal control over financial reporting. Upon approval for listing as a public company on Nasdaq, we will also be required to comply with marketplace rules and the heightened corporate governance standards of Nasdaq. Compliance with the Sarbanes-Oxley Act and other SEC and Nasdaq requirements will increase our costs and require additional management resources. We recently have begun upgrading our procedures and controls and will need to continue to implement additional procedures and controls as we grow our business and organization and to satisfy new reporting requirements. If we are unable to complete the required assessment as to the adequacy of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act or if we fail to maintain internal control over financial reporting, our ability to produce timely, accurate and reliable periodic financial statements could be impaired. We have previously restated our fiscal 2004 financial statements to reflect an adjustment to the calculation of net income allocable to common stockholders and the calculation of basic and diluted net income per share available to common stockholders as further described in Note 1 to the financial statements included in our Amendment No. 5 to Form S-1 filed on November 9, 2006. If we do not maintain adequate internal control over financial reporting, investors could lose confidence in the accuracy of our periodic reports filed under the Exchange Act. Additionally, our ability to obtain additional financing could be impaired. A lack of investor confidence in the reliability and accuracy of our public reporting could cause our stock price to decline.

Any acquisitions that we make could disrupt our business and harm our financial condition.

We expect to evaluate potential strategic acquisitions of complementary businesses, products or technologies. We may also consider joint ventures and other collaborative projects. We may not be able to identify appropriate acquisition candidates or strategic partners, or successfully negotiate, finance or integrate acquisitions of any businesses, products or technologies. Furthermore, the integration of any acquisition and management of any collaborative project may divert management s time and resources from our core business and disrupt our operations. We do not have any experience with acquiring companies or products. If we decide to expand our product offerings beyond radiofrequency technologies, we may spend time and money on projects that do not increase our revenue. Any cash acquisition we pursue would diminish funds available to us for other uses, and any stock acquisition would dilute our stockholders ownership. While we from time to time evaluate potential collaborative projects and acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any acquisitions or collaborative projects.

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Risks Related to Our Common Stock

If our public guidance or our future operating performance does not meet investor expectations, our stock price could decline.

We intend to provide guidance to the investing community regarding our anticipated future operating performance. Our business typically has a short sales cycle, so that we do not have significant backlog of orders at the start of a quarter, and our ability to sell our ThermaCool system successfully is subject to many uncertainties, as discussed in this prospectus. In light of these factors, it is difficult for us to estimate with accuracy our future results. Our expectations regarding these results will be subject to numerous risks and uncertainties that could make actual results differ materially from those anticipated. If our actual results do not meet our public guidance or our guidance or actual results do not meet the expectations of third-party financial analysts, our stock price could decline significantly.

We expect that the price of our common stock will fluctuate substantially.

The market price of our common stock is likely to be highly volatile and may fluctuate substantially due to many factors, including:

volume and timing of sales of our ThermaCool system;

the introduction of new products or product enhancements by us or our competitors;

disputes or other developments with respect to our intellectual property rights or the intellectual property rights of others;

our ability to develop, obtain regulatory clearance or approval for and market new and enhanced products on a timely basis;

product liability claims or other litigation;

quarterly variations in our or our competitors results of operations;

sales of large blocks of our common stock, including sales by our executive officers and directors;

developments in our industry;

media exposure of our ThermaCool system or products of our competitors;

changes in governmental regulations or in the status of our regulatory approvals or applications;

changes in earnings estimates or recommendations by securities analysts; and

general market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

These and other factors may make the price of our stock volatile and subject to unexpected fluctuation.

A sale of a substantial number of shares of our common stock may cause the price of our common stock to decline.

If our stockholders sell substantial amounts of our common stock in the public market, for example, upon the expiration of lock-up agreements approximately 180 days following our initial public offering,

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including shares issued upon the exercise of outstanding options or warrants, the market price of our common stock could decline. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem reasonable or appropriate.

Our directors, officers and principal stockholders have significant voting power and may take actions that may not be in the best interests of our other stockholders.

Our officers, directors and principal stockholders each holding more than 5% of our common stock collectively control approximately 55% of our outstanding common stock. As a result, these stockholders, if they act together, will be able to control the management and affairs of our company and most matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control and might adversely affect the market price of our common stock. This concentration of ownership may not be in the best interests of our other stockholders.

Anti-takeover provisions in our Amended and Restated Certificate of Incorporation and Bylaws, and Delaware law, contain provisions that could discourage a takeover.

Our certificate of incorporation and bylaws, and Delaware law, contain provisions that might enable our management to resist a takeover, and might make it more difficult for an investor to acquire a substantial block of our common stock. These provisions include:

- a classified board of directors;
- advance notice requirements to stockholders for matters to be brought at stockholder meetings;
- a supermajority stockholder vote requirement for amending certain provisions of our Amended and Restated Certificate of Incorporation and Bylaws;
- limitations on stockholder actions by written consent; and
- the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

These provisions might discourage, delay or prevent a change in control of our company or a change in our management. The existence of these provisions could adversely affect the voting power of holders of common stock and limit the price that investors might be willing to pay in the future for shares of our common stock.

We have a large number of authorized but unissued shares of stock, which could negatively impact you if you purchase our common stock.

Our certificate of incorporation provides for 100,000,000 shares of authorized common stock, of which 77.1 million shares will be available for future issuance, and 10,000,000 shares of preferred stock, all of which will be available for future issuance. The issuance of additional shares of common stock may have a dilutive effect on earnings per share and relative voting power. We could use the shares of common stock that are available for future issuance in dilutive equity financing transactions, or to oppose a hostile takeover attempt or delay or prevent changes in control or changes in or removal of management, including transactions that are favored by a majority of the stockholders or in which the stockholders might otherwise receive a premium for their shares over then-current market prices or benefit in some other manner.

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Our board of directors will be authorized, without further stockholder approval, to issue up to 10,000,000 shares of preferred stock with such rights, preferences and privileges as our board may determine. These rights, preferences and privileges may include dividend rights, conversion rights, voting rights and liquidation rights that may be greater than the rights of our common stock. As a result, the rights of holders of our common stock will be subject to, and could be adversely affected by, the rights of holders of any preferred stock that may be issued in the future.

We have not paid dividends in the past and do not expect to pay dividends in the future, and any return on investment may be limited to the value of our stock.

We have never paid cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The payment of dividends on our common stock will depend on our earnings, financial condition and other business and economic factors affecting us at such time as our board of directors may consider relevant. If we do not pay dividends, our stock may be less valuable because a return on your investment will only occur if our stock price appreciates.

Item 1B. ***Unresolved Staff Comments***
Not applicable

Item 2. ***Properties***
We occupy an 88,000 square foot facility in Hayward, California, under a lease that ends in September 2010, with an option to extend for an additional three-year term.

Item 3. ***Legal Proceedings***
We are not a party to any material pending or threatened litigation.

Item 4. ***Submission of Matters to a Vote of Security Holders***
Not applicable

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PART II

Item 5. ***Market for the Registrant s Common Stock and Related Shareholder Matters***

Stock Exchange Listing

Our common stock has traded on the Nasdaq Global Market under the symbol THRM since our initial public offering on November 9, 2006. Prior to that time, there was no public market for our stock. On February 28, 2007, the closing sale price of our common stock was $8.70 per share.

Common Stockholders

As of February 28, 2007, there were approximately 139 stockholders of record of our common stock.

Stock Prices

The following table sets forth quarterly high and low closing sales prices of our common stock for the indicated periods.

Year Ended December 31, 2006	High	Low
Fourth Quarter	$ 8.15	$ 6.40

Dividend Policy

We have never paid a cash dividend and have no present intention to pay cash dividends in the foreseeable future. The Board of Directors currently intends to retain any future earnings for use in our business.

Use of Proceeds

In November 9, 2006, a registration statement (Registration No. 333-136501) relating to our initial public offering of our common stock was declared effective by the Securities and Exchange Commission. Under this registration statement, we registered 6,000,000 shares of our common stock, and another 900,000 shares subject to the underwriters over-allotment option. The 6,000,000 shares of common stock registered under the registration statement, as well as 150,000 shares covered by the over-allotment option, were sold at a price to the public of $7.00 per share. The offering closed on November 15, 2006. The managing underwriters were Merrill Lynch, Pierce, Fenner & Smith Incorporated, Thomas Weisel Partners LLC, Wachovia Capital Markets, LLC, C.E. Unterberg, Towbin, LLC and Maxim Group LLC.

Proceeds from the offering after deducting underwriting discounts and commissions of $3.0 million, but before expenses were $40.0 million. Of the $40.0 million in net proceeds, through December 31, 2006, we have spent approximately, $3.1 million for sales and marketing initiatives, $1.3 million for research and development activities and $1.3 million for operating and general corporate purposes. We also used $5.0 million to pay off our working capital line with GE Capital. In addition, we invested the remaining proceeds from the offering in money market funds.

We did not sell any unregistered securities during the period covered by this Annual Report on Form 10-K.

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Securities Authorized for Issuance Under Equity Compensation Plans

The information required by this Item regarding equity compensation plans is incorporated by reference to the information set forth in PART III Item 12 of this Annual Report on Form 10-K.

Stock Performance Graph

The following graph compares the cumulative total stockholder return on our common stock with the cumulative total return of the Nasdaq Composite Index and the Nasdaq Medical Equipment Index for the period beginning on November 10, 2006, our first day of trading after our initial public offering, and ending on December 31, 2006.

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* The graph assumes that $100 was invested on November 10, 2006 in our common stock, or on October 31, 2006 in the Nasdaq Composite Index and the Nasdaq Medical Equipment Index, and that all dividends were reinvested. No dividends have been declared or paid on our common stock. Stock performance shown in the above chart for the common stock is historical and should not be considered indicative of future price performance. This graph was prepared by Research Data Group, Inc.

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Item 6. ***Selected Financial Data***

The following table presents certain financial data for each of the last five fiscal years. You should read the following financial information together with the information under Management s Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and related notes included in this Form 10-K.

Statement of Operations Data

(in thousands of dollars, except share and per share data)	Years Ended December 31,				
	2006	2005	2004	2003	2002
Net revenue	$ 54,320	$ 40,655	$ 50,384	$ 24,910	$ 1,704
Cost of revenue	15,259	12,309	12,452	12,566	1,807
Gross margin	39,061	28,346	37,932	12,344	(103)
Operating expenses					
Sales and marketing	24,071	19,997	15,596	8,945	2,694
Research and development	9,639	8,908	8,490	6,569	7,316
General and administrative	9,973	7,414	8,873	3,612	1,541
Litigation settlement gain		(1,646)			
Total operating expenses	43,683	34,673	32,959	19,126	11,551
Income (loss) from operations	(4,622)	(6,327)	4,973	(6,782)	(11,654)
Interest and other income	768	340	177	205	253
Interest and other expense	(55)	(1,549)	(14)	(7)	(8)
Income (loss) before income taxes and cumulative effect of change in accounting principle	(3,909)	(7,536)	5,136	(6,584)	(11,409)
Provision for income taxes			(103)		
Net income (loss) before cumulative effect of change in accounting principle	(3,909)	(7,536)	5,033	(6,584)	(11,409)
Cumulative effect of change in accounting principle		(697)			
Net income (loss)	$ (3,909)	$ (8,233)	$ 5,033	$ (6,584)	$ (11,409)
Net income (loss) allocable to common stockholders	$ (3,909)	$ (8,233)	$ 313	$ (6,584)	$ (11,409)
Net income (loss) per share basic and diluted:					
Before cumulative effect of change in accounting principle		$ (2.06)			
Cumulative effect of change in accounting principle		(0.19)			
Net income (loss) per share basic	$ (0.60)	$ (2.25)	$ 0.10	$ (2.85)	$ (6.10)
Net income (loss) per share diluted	$ (0.60)	$ (2.25)	$ 0.06	$ (2.85)	$ (6.10)
Weighted average shares outstanding used in calculating net income (loss) per common share:					
Basic	6,561,648	3,664,990	3,023,225	2,307,238	1,868,232
Diluted	1,824,386	3,664,990	5,319,754	2,307,238	1,868,232

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	As of December 31,				
	2006	2005	2004	2003	2002
			(in thousands)		
Balance Sheet Data					
Cash and cash equivalents	$ 45,915	$ 10,121	$ 11,706	$ 12,383	$ 15,588
Working capital	46,153	10,947	12,110	9,435	15,317
Total assets	59,875	24,032	26,202	17,667	19,399
Borrowings, less current portion		4,040	13	18	5
Preferred stock warrant liability		3,937			
Redeemable convertible preferred stock		45,169	45,169	45,167	45,013
Total stockholders equity (deficit)	$ 49,121	$ (38,733)	$ (29,440)	$ (35,189)	$ (28,826)

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion should be read in conjunction with the attached financial statements and notes thereto. This Annual report on Form 10-K, including the following sections, contains forward-looking statements within the meaning of the federal securities laws. These statements include, but are not limited to, those concerning our expectations that ThermaTip sales will continue to increase as a percentage of revenue versus generator sales, while generator sales increase in absolute terms; development and commercialization of new procedures and treatment tips; continued expansion of our customer base; identifying growth opportunities via complementary products, technologies or businesses; sales organization growth; growth in international sales and expansion into new international markets; and our belief that our cash and cash equivalents will be sufficient to satisfy our anticipated cash requirements. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those expressed or implied by such forward-looking statements. For a detailed discussion of these risks and uncertainties, see Risk Factors section in Item 1A of this Annual Report on Form 10-K. We caution the reader not to place undue reliance of these forward-looking statements, which reflect management s analysis only as of the date of this Form 10-K. We undertake no obligation to update forward-looking statements, which reflect events or circumstances occurring after the date of this Form 10-K.

Overview

We design, develop, manufacture and market medical devices for the non-invasive treatment of wrinkles. We were incorporated in 1996, and through the third quarter of 2002, we were principally engaged in development and regulatory clearance activities. We received FDA clearance to market our ThermaCool system for treatment of periorbital wrinkles and rhytids in the fourth quarter of 2002 and for the treatment of facial wrinkles and rhytids in June 2004. In December 2005, we received FDA clearance to market our ThermaCool system for the treatment of wrinkles and rhytids, without limitation to particular areas of the body. Our patented and FDA-cleared ThermaCool system uses radiofrequency, or RF, energy to heat and shrink collagen and tighten tissue while simultaneously cooling and protecting the surface of the skin. The ThermaCool system consists primarily of an RF generator and cooling module with a reusable handpiece, a variety of consumable, single-use ThermaTips that attach to the handpiece, and several other consumable accessories. Since 2002, we have developed several ThermaTips that a physician can select based on the area of the body being treated. We currently offer four ThermaTip sizes in several configurations of pulse counts, pulse durations and heating profiles for efficient implementation of treatment guidelines. Our customers primarily consist of dermatologists and plastic surgeons. As of December 31, 2006, we had an installed base of over 2,000 ThermaCool RF generators and had sold over 350,000 ThermaTips.

Significant Business Trends

We commercially launched our ThermaCool system in the fourth quarter of 2002. From that time until the end of 2003, demand for our product increased as a result of rapid uptake by early adopters. During 2004, we slightly increased the average selling price of our RF generator and significantly increased the average selling price of our ThermaTips. In addition, we began implementation of a new procedure algorithm and focused our sales force on the time-consuming and difficult process of re-training and certifying our customers on the revised algorithm to the detriment of system sales. These factors contributed to a trend of declining unit sales beginning in the second half of 2004. During 2005 and 2006, we responded to the declining sales trends by implementing several changes, including lowering ThermaTip prices, providing a wider array of ThermaTip product options, including introduction of a larger treatment tip that reduced procedure time, and reorganizing our sales and marketing organization. Beginning with the last quarter of 2005, we experienced a reversal in the negative unit sales trends that were experienced in the previous twelve months. This improved performance and market penetration continued during through the end of 2006.

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We derive revenue primarily from the sale of ThermaTips and other consumables and sales of our ThermaCool RF generator. For 2004, 2005 and 2006 we derived 60%, 66% and 73% respectively, of our revenue from ThermaTip and other consumable sales, and 39%, 31% and 24% respectively, of our revenue from ThermaCool RF generator sales. As the installed base of ThermaCool RF generators has grown, so too have grown the number of physicians performing our Thermage procedure, and, consequently, sales of disposable ThermaTips have increased as a percentage of revenue versus generator sales. We expect this trend to continue, and we expect to derive a greater percentage of our revenue from sales of ThermaTips and other consumables in the future. During 2004 and 2005, sales of RF generators have declined, not only on a percentage basis, but also on an absolute basis. This reflects our decision to prioritize our limited resources towards servicing existing customers demands, rather than seeking new customers, because we believe we maximize operating results by emphasizing repeat ThermaTip sales over one time RF generator sales. With growth in our sales organization, we believe that the sale of RF generators will grow in absolute terms, but continue to decline as a percentage of revenue. The balance of our revenue is derived from product service and shipping. Variations in unit sales of ThermaTips and our ThermaCool RF generator may significantly impact revenue in a given quarter.

We market the ThermaCool system, including our single-use ThermaTips, in the United States to physicians through a direct sales force and internationally through a network of 31 distributors in 78 countries. In 2004, 2005 and 2006, we derived 72%, 56% and 52%, respectively, of our revenue from sales of our products and services within the United States. For 2004, 2005 and 2006, we derived 28%, 44% and 48%, respectively, of our revenue from sales of our products and services outside the United States. We believe that a significant portion of our business will continue to come from international sales through increased penetration in countries where we currently sell our ThermaCool system, combined with expansion into new international markets. The percentages of our revenue by region are presented in the below table:

	Years Ended December 31,		
	2006	2005	2004
United States	52%	56%	72%
Asia Pacific	24%	23%	16%
Europe/Middle East	13%	11%	3%
Rest of the world	11%	10%	9%
Total net revenue	100%	100%	100%

We expect our operating expenses to increase in the future as a result of increased sales and marketing activity to promote revenue growth and geographic expansion, continued research and development of new products and technologies, and increased general and administrative expenses to support our overall anticipated growth and public company requirements. We also expect additional stock-based compensation expense in future periods due to our adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, beginning January 1, 2006.

Future operating results are difficult to predict accurately. We anticipate that our quarterly results of operations may fluctuate for the foreseeable future due to several factors, including the timing of introduction and the degree of acceptance of future product offerings, unanticipated interruptions and expenses related to our manufacturing operations, and the performance of our direct sales force and international distributors.

Significant Industry Factors

The growth of our business relies on our ability to continue to develop new products, applications and innovative technologies, obtain and maintain regulatory clearances for our products, protect our proprietary technology and products and our manufacturing processes, manufacture our products cost-effectively, and successfully market and distribute our products. Our industry is characterized by seasonally lower demand during the third calendar quarter of the year, when both physicians and prospective patients take summer vacations.

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Additionally, our industry is highly competitive and our success depends on our ability to compete successfully. We have in the past noticed brief increases both in demand for our products and in demand for our Thermage procedure, as well as in traffic to our website, following positive national media coverage, such as when Thermage was featured on *Oprah* in 2003 and on subsequent rebroadcasts. However, we believe that, conversely, negative media exposure has adversely impacted potential sales. We experience frequent positive, negative and neutral media coverage throughout a fiscal quarter. Our sales are also impacted by other factors outside of our control, such as prior patient and practicing physician recommendations. Consequently, while we believe that media exposure and other factors outside of our direct control play a role in our long-term success, to date we have not been able to quantify the impact of particular media exposure or media exposure, in general, and have not observed any material effect, positive or negative, on our quarterly financial results of operations. A detailed discussion of these and other factors that impact our business is provided in the Risk Factors section in this Annual Report on Form 10-K.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses, and disclosures at the date of the financial statements. On a periodic basis, we evaluate our estimates, including those related to accounts receivable, inventories and warranty reserve. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from those estimates.

We believe that the following critical accounting policies are affected by our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104. Product revenue is recognized when title and risk of ownership have been transferred, provided that persuasive evidence of an arrangement exists, the price is fixed and determinable, remaining obligations are insignificant and collectibility is reasonably assured. Transfer of title and risk of ownership occur when the product is shipped to the customer. Revenue is recorded net of customer and distributor discounts. Revenue from the sale of extended service contracts for products beyond their warranty term is recognized on a straight-line basis over the period of the applicable extended contract. We also earn service revenue from customers outside of their warranty term or extended service contracts. Such service revenue is recognized as the services are provided.

Our ThermaCool RF generator sales in the United States typically have post-sale obligations of installation and training. These obligations are fulfilled after product shipment, and in these cases, we recognize revenue in accordance with the multiple element accounting guidance set forth in Emerging Issues Task Force No. 00-21, *Revenue Arrangements with Multiple Deliverables*. When we have objective and reliable evidence of fair value of the undelivered elements, we defer revenue attributable to the post-shipment obligations and recognize such revenue when the obligation is fulfilled. Otherwise, we will defer all revenue until all elements are delivered.

We sell to end-users in the United States and to distributors outside of the United States. Sales to distributors do not include return rights. We typically recognize revenues upon shipment for sales to our independent third party distributors as we have no continuing obligations subsequent to shipment, other than replacement parts warranty coverage. The distributors are responsible for all marketing, sales, installation, training and warranty services for our products. We do not provide price protection or stock rotation rights to any of our distributors. In addition, our distributor agreements do not allow the distributor to return or exchange

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products and the distributor is obligated to pay us for the sale regardless of whether the distributor is able to resell the product. In the quarter ended December 31, 2005, we changed our standard distributor payment terms from upfront payments to payments due within 30 days of shipment. For sales transactions with non-standard extended payment terms or when collectibility is not reasonably assured, we recognize revenue upon receipt of cash payment. At December 31, 2005 and 2006, we had deferred revenue balances of $0.3 million and $0.2 million, respectively, related to sales transactions with extended payment terms.

Certain of our physician customers in the United States who purchased systems prior to August 2003 had the general right to return unused consumable products. Prior to 2004, we lacked sufficient historical experience to reliably estimate sales returns and therefore deferred recognition of revenue and cost of revenues related to such transactions until there was sufficient evidence that the products had been consumed. Since 2004, we have had a sufficient historical basis to estimate return rates and have recorded revenue on such transactions upon shipment, provided that all other revenue recognition criteria are met. Deferred revenues and deferred cost of revenues related to return rights at December 31, 2003 of $0.6 million and $0.1 million, respectively, were recognized in 2004.

Accounts Receivable

Accounts receivable are typically unsecured and derived from revenues earned from customers. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We estimate appropriate allowances based upon any specific customer collection issues that we have identified. Our assessment of the ability of our customers to pay generally includes direct contact with the customer, a review of their financial status, as well as consideration of their payment history with us. Allowance for doubtful accounts was $29,000 and $31,000 at December 31, 2005 and 2006, respectively. Doubtful account write-offs have been insignificant during the years ended December 31, 2004, 2005 and 2006.

Warranty Reserve

We provide for the estimated cost of product warranties at the time revenue is recognized. As we sell new products to our customers, we must exercise considerable judgment in estimating the expected failure rates. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required. Our estimated warranty liability was $0.3 million and $0.3 million at December 31, 2005 and 2006, respectively. We offer a three year warranty for systems sold in the United States and a one year replacement parts warranty for systems sold to distributors. We also provide a warranty for our consumable products.

Inventory

We state our inventories at the lower of cost or market value, cost being determined on a standard cost basis (which approximates actual cost on a first-in, first-out basis) and market value being determined as the lower of replacement cost or net realizable value. Standard costs are monitored on a monthly basis and updated at least annually and as necessary to reflect changes in raw material costs and labor and overhead rates. Inventory reserves are established when conditions indicate that the selling price could be less than cost due to physical deterioration, usage, obsolescence, reductions in estimated future demand and reductions in selling prices. Inventory reserves are charged to cost of revenue and establish a lower cost basis for the inventory. We balance the need to maintain strategic inventory levels with the risk of obsolescence due to changing technology and customer demand levels. Unfavorable changes in market conditions may result in a need for additional inventory reserves that could adversely impact our gross margins. Conversely, favorable changes in demand could result in higher gross margins. Our inventory reserves as of December 31, 2005 and 2006 were $1.0 million and $0.4 million, respectively.

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Litigation and Claims

We routinely assess the likelihood of any adverse judgments or outcomes related to legal matters and claims, as well as ranges of probable losses. A determination of the amount of the reserves required, if any, for these contingencies is made after thoughtful analysis of each known issue and an analysis of historical experience in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, or SFAS No. 5, and related pronouncements. Also in accordance with SFAS No. 5, we do not record gain contingencies.

Income Taxes

We account for income taxes under the liability method. Under this method, we determine deferred tax assets and liabilities at the balance sheet date based upon the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. The tax consequences of most events recognized in the current year s financial statements are included in determining income taxes currently payable. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses and gains and losses, differences arise between the amount of taxable income and pretax financial income for a year and between the tax bases of assets or liabilities and their reported amounts in our financial statements. Because it is assumed that the reported amounts of assets and liabilities will be recovered and settled, respectively, a difference between the tax basis of an asset or a liability and its reported amount on the balance sheet will result in a taxable or a deductible amount in some future years when the related liabilities are settled or the reported amounts of the assets are recovered. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and unless we believe that recovery is more likely than not, we must establish a valuation allowance to reduce the deferred tax assets to the amounts expected to be realized. As part of the process of preparing our financial statements, we are required to estimate our income taxes. This process involves estimating our current tax liability, together with assessing temporary differences that may result in deferred tax assets.

Based on the available objective evidence, we believe it is more likely than not that the net deferred tax assets will not be fully realized. Accordingly, we have provided a full valuation allowance on those assets and no benefit has been recognized for our net operating loss and other deferred tax assets. Accordingly, deferred tax valuation allowances have been established as of December 31, 2004 and 2005 and 2006 to reflect these uncertainties. If we are able to demonstrate consistent profitability in the future, and we are able to establish that recovery is more likely than not, we would reduce the valuation allowance at a future date. As of December 31, 2006, we had federal and state net operating loss carryforwards of approximately $34.0 million and $22.0 million, respectively, available to reduce future taxable income, if any, for federal and state income taxes, respectively. The net operating loss carryforwards begin to expire in 2011 and 2010 for federal and state income tax purposes, respectively. Utilization of the net operating loss carryforwards may be subject to an annual limitations due to the ownership percentage change limitations provided by the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of the net operating loss carryforwards before utilization.

Stock-Based Compensation Expense

Prior to January 1, 2006, we accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB No. 25, and its interpretations and complied with the disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of our stock and the exercise price. Employee stock-based compensation is amortized on a straight-line basis over the vesting period of the underlying options.

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SFAS No. 123 defines a fair value based method of accounting for an employee stock option or similar equity investment.

During the years ended December 31, 2005 and 2006, we issued stock options to certain employees with exercise prices below the fair market value of our common stock at the date of grant, determined with hindsight. In accordance with the requirements of APB No. 25, we have recorded deferred stock-based compensation for the difference between the exercise price of the stock options granted and the fair market value of our stock at the date of grant, determined with hindsight. During the year ended December 31, 2005, we recorded deferred stock-based compensation related to these options of $3.9 million. This deferred stock based compensation is amortized to expense on a straight-line basis over the period during which the options vest, generally four years. Amortization of deferred stock-based compensation was $0.3 millions and $0.2 million during the year ended December 31, 2005 and 2006, respectively.

Effective January 1, 2006, we adopted the fair value provisions of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, or SFAS No. 123R, which supersedes previous accounting under APB No. 25. SFAS No. 123R requires the recognition of compensation expense, using a fair-value based method, for costs related to all share-based payments including stock options. SFAS No. 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. We adopted SFAS No. 123R using the prospective transition method, which requires that for nonpublic entities that used the minimum value method for either pro forma or financial statement recognition purposes, SFAS No. 123R shall be applied to option awards granted, modified, repurchased or cancelled after the required effective date. For options granted prior to the SFAS No. 123R effective date, which the requisite service period has not been performed as of January 1, 2006, we will continue to recognize compensation expense on the remaining unvested awards under the intrinsic-value method of APB No. 25. For options accounted for under APB No. 25 that were granted prior to January 1, 2006 and then modified after January 1, 2006, we will apply SFAS No. 123R to these option grants upon the date of modification. All option grants valued after January 1, 2006 will be expensed on a straight-line basis.

Under SFAS No. 123R, we calculated the fair value of the stock option grants using the Black-Scholes option-pricing model. For the year ended December 31, 2006, the fair value was based on the following weighted average assumptions: the expected term of 4.25 years; the expected volatility of 55%, the risk free interest rate of 4.77% and 0.0% for the dividend yield. Estimated volatility for the year ended December 31, 2006 reflects the application of SAB 107 interpretive guidance and, accordingly, due to a lack of historical information regarding the volatility of our stock price, incorporates historical and volatility of similar public entities in the aesthetics market. The expected term has been computed based upon the vesting term, cancellation history, historical exercises and contractual term of the options. Future expense amounts for any particular quarterly or annual period could be affected by changes in our assumptions or changes in market conditions. The aggregate intrinsic value of the outstanding options vested and expected to vest at December 31, 2006 was $16.1 million, based upon the fair market value of common stock at December 31, 2006 of $6.99 per share.

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Equity instruments issued to non-employees are recorded at their fair value on the measurement date and are subject to periodic adjustment as the underlying equity instruments vest. Non-employee stock-based compensation charges are amortized over the vesting period, on a straight-line basis.

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Results of Operations

Year Ended December 31, 2005 and December 31, 2006

Net Revenue. Revenue is derived from the sale of single-use ThermaTips and other consumables, ThermaCool RF generator sales, and service and other revenue. Net revenue increased $13.6 million, or 34%, from $40.7 million to $54.3 million for the year ended December 31, 2005 and 2006, respectively. Sales of ThermaTips and other consumables increased $12.4 million, or 46%, from $27.0 million to $39.4 million for the year ended December 31, 2005 and 2006, respectively. Sales of ThermaCool RF generator increased $0.7 million, or 6%, from $12.6 million to $13.3 million for the year ended December 31, 2005 and 2006, respectively. Product unit volume of ThermaTips was 83,660 units and 130,690 units for the year ended December 31, 2005 and 2006, respectively. Product unit volume of our ThermaCool RF generator was 408 units and 437 units for the year ended December 31, 2005 and 2006, respectively. International sales to distributors accounted for 44% and 48% of revenue for the year ended December 31, 2005 and 2006, respectively. The increase in revenue was driven by increased adoption of our 3.0 cm^2 ThermaTip, the introduction of our new 0.25 cm^2 ThermaTip and expansion into new international markets, partially offset by lower average selling prices beginning in April 2005.

Cost of Revenue. Our cost of revenue consists primarily of material, labor and manufacturing overhead expenses. Cost of revenue increased $3.0 million, or 24%, from $12.3 million to $15.3 million for the year ended December 31, 2005 and 2006, respectively. The increase was primarily due to the increased volume of ThermaTips and other consumables sold. Gross margin was 70% and 72% for the year ended December 31, 2005 and 2006, respectively.

Sales and Marketing. Sales and marketing expenses consist primarily of personnel costs and costs related to customer-attended workshops and trade shows, marketing, customer service and business development. Sales and marketing expenses increased $4.1 million, or 20%, from $20.0 million to $24.1 million for the year ended December 31, 2005 and 2006, respectively. The increase was primarily attributable to an increase of $2.8 million in personnel and commission costs and related travel expenses associated with the expansion of our international sales force and marketing staff, as well as an increase of $0.2 million in promotional costs primarily due to an increased number of customer workshops, trade shows and promotional efforts and an increase in stock-based compensation charges of $1.1 million.

Research and Development. Research and development expenses consist primarily of personnel costs, clinical and regulatory costs, material costs and regulatory and quality assurance costs not directly related to the manufacturing of our products. Research and development expenses increased $0.7 million, or 8%, from $8.9 million to $9.6 million for the year ended December 31, 2005 and 2006, respectively. The increase was primarily related to increased stock-based compensation charges of $0.5 million, higher personnel costs of $0.4 million, partially offset by lower clinical studies costs and other research and development discretionary spending of $0.2 million.

General and Administrative. General and administrative expenses consist primarily of personnel costs, legal and accounting fees, information technology costs, human resources costs and other general operating expenses. General and administrative expenses increased $2.6 million, or 35%, from $7.4 million to $10.0 million for the year ended December 31, 2005 and 2006, respectively. The increase was primarily attributable to expenses incurred in connection with the November 2006 initial public offering of $0.9 million, an increase in stock-based compensation charges of $1.4 million and higher employee related and other expenses of $0.3million.

Litigation Settlement. In June 2005, we reached an agreement with Syneron that settled patent-related claims of the parties against each other. Under this agreement, the parties granted each other non-exclusive paid-up licenses under the patents in the suit and related patents. We received a one-time payment of $1.8

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million, recorded net of certain legal expenses as $1.6 million. The license granted to Syneron excludes the right to utilize our monopolar RF and capacitive electrical coupling and the license granted to us excludes the right to utilize Syneron s Electro-Optical Synergy technology.

Interest and Other Income. Interest and other income consists primarily of interest income generated from our cash and cash equivalent balances. Interest and other income increased $0.5 million, or 126%, from $0.3 million to $0.8 million for the year ended December 31, 2005 and 2006, respectively due to higher average cash balances resulting from the proceeds of our initial public offering and GE Capital borrowings.

Interest and Other Expense. Interest and other expense consists primarily of interest expense on our borrowings and changes in the fair value of our convertible preferred stock warrants under FSP 150-5. Interest and other expense decreased $1.4 million from $1.5 million to $55,000 for the year ended December 31, 2005 and 2006, respectively. The decrease was primarily attributable to $2.3 million decrease in the fair value of the convertible preferred stock warrants, partially offset by increase in interest expense of $0.8 million.

Years Ended December 31, 2004 and December 31, 2005

Net Revenue. Net revenue decreased $9.7 million, or 19%, from $50.4 million in 2004 to $40.7 million in 2005. Sales of ThermaTips and other consumables decreased $3.1 million, or 10%, from $30.1 million in 2004 to $27.0 million in 2005. Sales of ThermaCool RF generator decreased $7.1 million, or 36%, from $19.7 million in 2004 to $12.6 million in 2005. Product unit volume of ThermaTips was 94,099 units and 83,662 units for 2004 and 2005, respectively. Product unit volume of ThermaCool RF generator was 612 units and 408 units for 2004 and 2005, respectively. International sales to distributors accounted for 28% and 44% of revenue for 2004 and 2005, respectively. The decrease in revenue was primarily attributable to a decline in unit volume sales resulting from the reorganization of our U.S. sales force in 2005, which led to the replacement of over 50% of our sales personnel, as well as a reduction in pricing of ThermaCool RF generator and most ThermaTips of 10% to 15%, partially offset by expansion into new international markets.

Cost of Revenue. Cost of revenue decreased $0.2 million, or 1%, from $12.5 million in 2004 to $12.3 million in 2005. The decrease was primarily due to the decrease in sales. Gross margin decreased from 75% in 2004 to 70% in 2005, primarily as a result of a reduction in product pricing.

Sales and Marketing. Sales and marketing expenses increased $4.4 million, or 28%, from $15.6 million in 2004 to $20.0 million in 2005. The increase was primarily attributable to an increase of $1.8 million in personnel costs and $0.5 million in related travel expenses associated with the expansion of our international sales force and marketing staff, as well as an increase of $1.4 million in promotional costs primarily due to an increased number of customer workshops, trade shows and promotional efforts. Stock-based compensation charges accounted for $0.1 million of the year-over-year increase in expenses.

Research and Development. Research and development expenses increased $0.4 million, or 5%, from $8.5 million in 2004 to $8.9 million in 2005. The increase was primarily related to the development of our 3.0 cm^2 ThermaTip, which was commercially launched in the fourth quarter of 2005, our 0.25 cm^2 ThermaTip, which was commercially launched in the first quarter of 2006, development of a new proprietary generator platform, additional expenditures on research into new applications.

General and Administrative. General and administrative expenses decreased $1.5 million, or 16%, from $8.9 million in 2004 to $7.4 million in 2005. The decrease was primarily attributable to a $1.0 million decrease in patent litigation costs regarding an infringement suit we initiated against Syneron that was settled in June 2005. Stock-based compensation charges accounted for $0.1 million of expense in 2005, compared to $0.2 million of expense in 2004.

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Litigation Settlement. In June 2005, we reached an agreement with Syneron that settled patent-related claims of the parties against each other. Under this agreement, the parties granted each other non-exclusive paid-up licenses under the patents in the suit and related patents under the parties control. We received a one-time payment of $1.8 million, recorded net of certain legal expenses as $1.6 million. The license granted to Syneron excludes the right to utilize our monopolar RF and capacitive electrical coupling and the license granted to us excludes the right to utilize Syneron s Electro-Optical Synergy technology.

Interest and Other Income. Interest and other income increased $163,000, or 92%, from $177,000 in 2004 to $340,000 in 2005 primarily due to higher market rates of interest on our cash balances.

Interest and Other Expense. Interest and other expense of $1.5 million for 2005 consists primarily of approximately $1.4 million of expense related to changes in the fair value of our convertible preferred stock warrants under FSP 150-5 and approximately $90,000 of interest expense associated with our borrowings. Interest and other expense for the comparable time period in 2004 was $14,000 and consisted primarily of interest expense. We drew $5.0 million from GE Capital in the fourth quarter of 2005. Total outstanding debt balances were $18,000 and $5.0 million as of the December 31, 2004 and December 31, 2005, respectively.

Change in Accounting Principles. Freestanding warrants related to our redeemable convertible preferred stock are accounted for in accordance with FSP 150-5 which requires that the warrants be classified as liabilities and recorded at fair value at the end of each reporting period. FSP 150-5 was adopted during the year ended December 31, 2005. A charge of $0.7 million was recorded in 2005 in connection with the change in accounting principle upon the adoption of FSP 150-5. We will continue to recognize any changes to the fair value of the warrants until the earlier of the exercise or expiration of the preferred stock warrants or the completion of a liquidation event.

Income Taxes. The provision for income taxes for 2004 of $103,000 consisted of $80,000 for federal taxes and $23,000 for state taxes. The provision for income taxes primarily reflects U.S. alternative minimum taxes as well as U.S. state taxes.

Stock-Based Compensation

For the years ended December 31, 2004 and 2005 and 2006, employee and non-employee stock-based compensation expense has been allocated as follows:

	December 31,		
	2006	**2005**	**2004**
Cost of revenue	$ 73	$ 4	$ 41
Sales and marketing	1,306	216	126
Research and development	666	124	77
General and administrative	1,472	112	219
Total stock-based compensation expense	$ 3,517	$ 456	$ 463

We recorded stock-based compensation expense of $3.5 million in the year ended December 31, 2006. At December 31, 2006, the total compensation cost related to stock-based awards granted or modified under SFAS 123R to employees and directors but not yet recognized was approximately $6.2 million, net of estimated forfeitures. We will amortize this cost on a straight-line basis over a weighted average period of approximately 3.0 years.

During March 2006, we repriced stock option awards held by 116 of our employees. Under the terms of this repricing, we repriced certain employee stock options having an exercise price of $2.00 or above to an exercise price of $1.90. Other than the exercise price, all other terms of the repriced options, such as vesting and

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contractual life, remained the same. In consideration for the repricing of eligible stock option awards, employees who were previously granted stock option awards on February 2, 2005 were also required to return these awards for cancellation. As a result of this repricing, we repriced 447,565 vested options and 1,523,035 unvested options having a weighted average original exercise price of $4.18 and $4.10, respectively. Such options were repriced at a new exercise price of $1.90 per share. As a result of this repricing, we also cancelled 35,216 outstanding employee options with an original exercise price of $4.00 that were granted on February 2, 2005. We have accounted for the repricing and cancellation transactions as a modification under SFAS No. 123R and recorded any net incremental fair value related to vested awards as compensation expense on the date of modification. In accordance with SFAS No. 123R, we will record the incremental fair value related to the unvested awards, together with unamortized stock-based compensation expense associated with the unvested awards, over the remaining requisite service period of the option holders. In connection with the repricing, we recorded stock-based compensation expense of $2.0 million in the year ended December 31, 2006.

In connection with the repricing of stock options during the year ended December 31, 2006, we followed the provisions of SFAS No. 123R and eliminated deferred stock-based compensation amounts of approximately $3.3 million related to the repriced stock options. Stock compensation charges for the repriced options will be recorded in accordance with SFAS No. 123R.

Stock-based compensation expense related to stock options granted to non-employees is recognized on a straight-line basis. The options generally vest ratably over four years. The values attributable to these options are amortized over the service period and the unvested portion of these options are remeasured as the services are provided and the options are earned. The stock-based compensation expense will fluctuate as the deemed fair value of the common stock fluctuates. In connection with the grant of stock options to non-employees, we recorded stock-based compensation expense of $110,000, $132,000 and $200,000 for the years ended December 31, 2004 and 2005 and 2006.

Liquidity and Capital Resources

To date, we have not achieved sustained profitability. Prior to our initial public offering in November 2006, we have funded our operations principally from the issuance of our preferred stock that resulted in aggregate net proceeds of $45.2 million. In addition, in 2005, we obtained a working capital line with GE Capital on which we drew $2.5 million in November 2005, bearing interest at the rate of 10.2% per annum, and $2.5 million in December 2005, bearing interest at the rate of 10.6% per annum. On November 9, 2006, we completed an initial public offering of 6,000,000 shares of our common stock at $7.00 per share. Additionally, on December 4, 2006, the underwriters partially exercised their over-allotment option and purchased 150,000 shares at $7.00 per share. We raised approximately $38.3 million, net of underwriting discounts, commissions and other offering costs. Upon the closing of the offering, all of our outstanding shares of preferred stock converted on a one-to-one basis into 12,406,134 shares of common stock. Upon the completion of our initial public offering, we repaid the outstanding balance and interests on the working capital line.

On December 31, 2006, we had working capital of $46.2 million, which consists primarily of $45.9 million in cash and cash equivalents.

The following table discloses aggregate information about our contractual obligations and the periods in which payments are due as of December 31, 2006:

		Payments Due by Period	
	Total	Less than 1 year	1-3 years
		(in thousands)	
Operating leases	$ 3,710	$ 820	$ 2,890
Deferred rent	55	55	
Total contractual obligations	$ 3,765	$ 875	$ 2,890

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Year Ended December 31, 2005 and December 31, 2006

Net Cash Provided by (Used in) Operating Activities. Net cash used in operating activities was $4.3 million for the years ended December 31, 2005 and net cash provided by operating activities was $1.2 million for the year ended December 31, 2006. During 2006, net cash provided by operating activities primarily resulted from $3.9 million of net loss, changes in preferred stock warrant liability of $0.8 million, non-cash decrease in reserve for excess and obsolete inventory of $0.6 million, increase in accounts receivable of $0.4 million and decrease in accounts payable of $0.6 million, offset by non-cash amortization of stock-based compensation of $3.5 million, non-cash depreciation and amortization of $2.1 million, and an increase in accrued and other liabilities of $2.1 million. The decrease in preferred stock liability was the result of the decrease in fair market value and the exercise of the preferred stock warrants upon the completion of our initial public offering. The increase in accrued and other liabilities was primarily due to increased levels of bonus and payroll related expenses and inventory purchases to support higher revenue.

Net Cash Used in Investing Activities. Net cash used in investing activities was $2.3 million and $0.8 million for the years ended December 31, 2005 and 2006, respectively. Our investing activities in the 2005 and 2006 periods consisted principally of property and equipment purchases of $2.2 million in 2005 and $0.9 million in 2006. Expenditures were higher in 2005 as a result of outfitting our new corporate and manufacturing facility that we moved into at the end of 2004.

Net Cash Provided by Financing Activities. Net cash provided by financing activities was $5.0 million and $35.3 million for the years ended December 31, 2005 and 2006, respectively. In 2005, the increase in cash provided by financing was primarily attributable to $5.0 million drawn on a working capital line with GE Capital. In 2006, the increase in cash provided by financing was primarily from proceeds from our initial public offering, proceeds from exercise of stock options and preferred stock warrants, collection of a note receivable from stockholder, partially offset by repayment of $5.0 million of the working capital line with GE Capital.

Years Ended December 31, 2004 and December 31, 2005

Net Cash Provided by (Used in) Operating Activities. Net cash provided by operating activities was $2.2 million in 2004 and net cash used in operating activities was $4.3 million in 2005. During 2005, net cash used by operating activities primarily resulted from $8.2 million of net loss, an increase in accounts receivables of $1.7 million, a decrease in payables and accrued liabilities of $0.2 million, and an increase in prepaid expenses of $0.4 million, offset by charges related to a preferred stock warrant liability of $2.1 million, non-cash depreciation and amortization of $2.0 million, a decline in inventories of $1.6 million, and $0.5 million of non-cash amortization of stock-based compensation. The increase in accounts receivable was the result of changing our distributor standard payment terms from upfront payment to payment within 30 days of shipment. The decrease in payables and accrued liabilities was due to decreased levels of accrued state sales tax and inventory as a result of lower revenue. The decline in inventories was a result of aligning inventory levels with changes in forecasted customer demand.

Net Cash Provided by (Used in) Investing Activities. Net cash provided by investing activities was $0.6 million in 2004 and net cash used in investing activities was $2.3 million in 2005. Our investing activities in 2004 consisted principally of the purchase and maturity of marketable securities for $3.8 million offset by $3.2 million in purchases of property and equipment. Our investing activities in 2005 consisted primarily of $2.2 million for acquisition of property and equipment in connection with our move to a larger corporate and manufacturing facility in the fourth quarter of 2004 that involved leasehold improvements plus additional infrastructure and equipment expenditures.

Net Cash Provided by Financing Activities. Net cash provided by financing activities was $0.3 million and $5.0 million for 2004 and 2005, respectively. In 2004, the increase in cash provided by financing activities was attributable to proceeds from the exercise of stock options. In 2005, the increase in cash provided by financing was primarily attributable to $5.0 million drawn on a working capital line with GE Capital.

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Our future capital requirements depend on a number of factors, including the rate of market acceptance of our current and future products, the resources we devote to developing and supporting our products, and continued progress of our research and development of new products.

We expect to increase capital expenditures consistent with our anticipated growth in manufacturing, infrastructure and personnel. We also may increase our capital expenditures as we expand our product lines or invest to address new markets.

We believe that our current cash and investment balances and cash generated from operations, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. If existing cash and cash generated from operations are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or obtain an additional credit facility. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights senior to those associated with our common stock, and could contain covenants that would restrict our operations. Any additional financing may not be available in amounts or on terms acceptable to us, or at all. If we are unable to obtain this additional financing, we may be required to reduce the scope of our planned product development and marketing efforts.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we engaged in such relationships.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting uncertainty in tax positions. This Interpretation requires that we recognize in our financial statements, the impact of a tax provision, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. We do not expect the adoption of FIN 48 to have a material impact on our financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB 108 became effective for the year ending December 31, 2006. The adoption of SAB 108 did not have any impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FAS115* (SFAS No.159). SFAS No. 159 allows companies

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to chose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. We are currently evaluating the impact of adopting SFAS No. 159 on our financial statements.

Item 7A. ***Quantitative and Qualitative Disclosures about Market Risk***

We invest our excess cash primarily in U.S. government securities and investment-grade marketable debt securities of financial institutions and corporations. These instruments have maturities of three months or less when acquired. We do not utilize derivative financial instruments, derivative commodity instruments or other market risk sensitive instruments, positions or transactions in any material fashion. Accordingly, we believe that, while the instruments we hold are subject to changes in the financial standing of the issuer of such securities, we are not subject to any material risks arising from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices or other market changes that affect market risk sensitive instruments.

Although, currently, all of our sales and purchases are denominated in U.S. dollars, future fluctuations in the value of the U.S. dollar may affect the price competitiveness of our products. We do not believe, however, that we currently have significant direct foreign currency exchange rate risk and have not hedged exposures denominated in foreign currencies.

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Item 8. ***Financial Statements and Supplementary Data***

THERMAGE, INC.

ANNUAL REPORT ON FORM 10-K

INDEX TO FINANCIAL STATEMENTS

The following Financial Statement Schedule of the Registrant for the years ended December 31, 2006, 2005 and 2004 is filed as part of this Report as required to be included in Item 8 and should be read in conjunction with the Financial Statements of the Registrant:

All other required schedules are omitted because of the absence of conditions under which they are required or because the required information is given in the Financials Statements or the Notes thereto.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Thermage, Inc.

In our opinion, the accompanying balance sheets and the related statements of operations, of stockholders equity (deficit) and of cash flows present fairly, in all material respects, the financial position of Thermage, Inc. at December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule appearing under Item 8 on page 83 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule 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 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.

As discussed in Note 2 to the financial statements, the Company changed the manner in which it accounts for share-based compensation for the year ended December 31, 2006.

As discussed in Note 3 to the financial statements, the Company adopted FASB Staff Position 150-5 (FSP 150-5), *Issuers Accounting under FASB Statement No. 150 for Free-standing Warrants and Other Instruments on Shares that are Redeemable,* during the year ended December 31, 2005.

/s/ PricewaterhouseCoopers LLP

San Jose, California

March 30, 2007

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Thermage, Inc.

BALANCE SHEETS

(in thousands of dollars, except share and per share data)	December 31, 2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 45,915	$ 10,121
Accounts receivable, net of allowance for doubtful accounts in 2006 and 2005 of $31 and $29, respectively	3,285	2,857
Inventories, net	5,219	5,411
Prepaid expenses and other current assets	1,717	1,350
Total current assets	56,136	19,739
Restricted cash		107
Property and equipment, net	3,638	4,073
Other assets	101	113
Total assets	$ 59,875	$ 24,032
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)		
Liabilities:		
Accounts payable	$ 1,398	$ 1,977
Accrued liabilities	7,372	4,774
Current portion of deferred revenue	1,151	1,188
Customer deposits	62	45
Current portion of borrowings		808
Total current liabilities	9,983	8,792
Deferred rent, net of current portion	55	110
Other long-term liabilities		107
Deferred revenue, net of current portion	716	610
Borrowings, net of current portion		4,040
Preferred stock warrants liability		3,937
Total liabilities	10,754	17,596
Commitments and contingencies (Note 6)		
Redeemable convertible preferred stock, $0.001 par value:		
Authorized: 10,000,000 and 26,360,000 shares at December 31, 2006 and 2005, respectively		
Issued and outstanding: none and 12,042,274 shares at December 31. 2006 and 2005, respectively		45,169
Stockholders equity (deficit):		
Common stock, $0.001 par value:		
Authorized: 100,000,000 and 29,100,000 shares at December 31, 2006 and 2005, respectively		
Issued and outstanding: 22,906,851 and 4,037,774 shares at December 31, 2006 and 2005, respectively	23	4
Additional paid-in capital	93,418	5,682
Deferred stock-based compensation	(6)	(3,541)
Notes receivable from stockholders	(125)	(598)
Accumulated deficit	(44,189)	(40,280)
Total stockholders equity (deficit)	49,121	(38,733)
Total liabilities and stockholders equity (deficit)	$ 59,875	$ 24,032

The accompanying notes are an integral part of these condensed financial statements.

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Thermage, Inc.

STATEMENTS OF OPERATIONS

(in thousands of dollars, except share and per share data)	Years Ended December 31, 2006	2005	2004
Net revenue	$ 54,320	$ 40,655	$ 50,384
Cost of revenue	15,259	12,309	12,452
Gross margin	39,061	28,346	37,932
Operating expenses			
Sales and marketing	24,071	19,997	15,596
Research and development	9,639	8,908	8,490
General and administrative	9,973	7,414	8,873
Litigation settlement gain		(1,646)	
Total operating expenses	43,683	34,673	32,959
Income (loss) from operations	(4,622)	(6,327)	4,973
Interest and other income	768	340	177
Interest and other expense	(55)	(1,549)	(14)
Income (loss) before income taxes and cumulative effect of change in accounting principle	(3,909)	(7,536)	5,136
Provision for income taxes			(103)
Net income (loss) before cumulative effect of change in accounting	(3,909)	(7,536)	5,033

principle			
Cumulative effect of change in accounting principle (Note 3)	(697)		
Net income (loss)	$ (3,909)	$ (8,233)	$ 5,033
Net income (loss) allocable to common stockholders	$ (3,909)	$ (8,233)	$ 313
Net income (loss) per share basic and diluted:			

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

For the year ended December 31,	***2006***	***2005****	***2004****
Interest and Fee Income			
Loans	$164,756	$155,476	$133,226
Money market assets and funds sold	5	3	1
Investment securities:			
Available for sale			
Taxable	16,844	19,699	33,230
Tax-exempt	12,519	13,186	14,514
Held to maturity			
Taxable	28,809	30,557	17,209
Tax-exempt	23,582	23,876	18,157
Total Interest and fee Income	246,515	242,797	216,337
Interest Expense			
Transaction deposits	1,771	1,460	612
Savings deposits	4,198	3,744	3,931
Time deposits	27,578	17,160	8,504
Short-term borrowed funds	29,389	18,941	5,878
Debt financing and notes payable	2,332	2,344	2,181
Total Interest Expense	65,268	43,649	21,106
Net Interest Income	181,247	199,148	195,231
Provision for Credit Losses	445	900	2,700
Net Interest Income After Provision for Credit Losses	180,802	198,248	192,531
Noninterest Income			
Service charges on deposit accounts	28,414	29,106	28,621
Merchant credit card	9,860	9,097	3,509
Financial services commissions	1,368	1,387	1,250
Trust fees	1,178	1,181	1,027
Securities (losses) gains, net	0	(4,903)	2,169
Loss on extinguishment of debt	0	0	(2,204)
Securities impairment	0	0	(7,180)
Sale of real estate	239	3,700	0
Other	14,288	14,972	11,391
Total Noninterest Income	55,347	54,540	38,583

Noninterest Expense			
Salaries and related benefits	52,302	55,854	55,855
Occupancy	13,047	12,579	11,935
Data processing	6,097	6,156	6,057
Furniture and equipment	4,949	5,212	4,794
Courier service	3,627	3,831	3,605
Amortization of intangibles	4,087	3,625	543
Professional fees	2,437	2,420	1,869
Other	15,178	17,573	17,441
Total Noninterest Expense	101,724	107,250	102,099
Income Before Income Taxes	134,425	145,538	129,015
Provision for income taxes	35,619	39,497	35,756
Net Income	$ 98,806	$106,041	$ 93,259
Average Shares Outstanding	31,202	32,291	31,821
Diluted Average Shares Outstanding	31,739	32,897	32,461
Per Share Data			
Basic earnings	$ 3.17	$ 3.28	$ 2.93
Diluted earnings	3.11	3.22	2.87
Dividends paid	1.30	1.22	1.10

See accompanying notes to consolidated financial statements.

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME
(In thousands)

	Shares	*Common Stock*	*Deferred Compensation*	*Accumulated Other Comprehensive Income (Loss)*	*Retained Earnings*	*Total*
December 31, 2003*	32,287	243,761	1,824	13,191	89,528	348,304
Comprehensive income						
Net income for the year 2004					93,259	93,259
Other comprehensive income, net of tax:						
Net unrealized losses on securities available for sale				(3,553)		(3,553)
Total comprehensive income						89,706
Stock issued for stock options	403	12,810				12,810
Stock option tax benefits*		2,236				2,236
Restricted stock activity	16	467	322			789
Stock based compensation*		3,348				3,348
Purchase and retirement of stock	(1,066)	(7,417)			(48,027)	(55,444)
Dividends					(35,090)	(35,090)
December 31, 2004*	31,640	255,205	2,146	9,638	99,670	366,659
Comprehensive income						
Net income for the year 2005					106,041	106,041

Other comprehensive income, net of tax:						
Net unrealized losses on securities available for sale				(7,756)		(7,756)
Total comprehensive income						98,285
Stock issued in connection with purchase of Redwood Empire Bancorp	1,639	89,538				89,538
Stock issued for stock options	381	10,026				10,026
Stock option tax benefits*		1,761				1,761
Restricted stock activity	21	797	277			1,074
Stock based compensation*		2,394				2,394
Purchase and retirement of stock	(1,799)	(16,686)			(78,665)	(95,351)
Dividends					(39,322)	(39,322)
December 31, 2005*	31,882	343,035	2,423	1,882	87,724	435,064
Adjustment to initially apply SAB Statement No. 108, net of tax					1,756	1,756
Balance at January 1, 2006	31,882	343,035	2,423	1,882	89,480	436,820
Comprehensive income						
Net income for the year 2006					98,806	98,806
Other comprehensive income, net of tax:						
Net unrealized losses on				362		362

securities available for sale						
Total comprehensive income						99,168
Unamortized post-retirement benefit transition obligation, net of tax				(394)		(394)
Stock issued for stock options	412	12,909				12,909
Stock option tax benefits		1,867				1,867
Restricted stock activity	20	727	311			1,038
Stock based compensation		2,504				2,504
Purchase and retirement of stock	(1,767)	(19,513)			(69,468)	(88,981)
Dividends					(40,696)	(40,696)
December 31, 2006	30,547	$341,529	$2,734	$ 1,850	$ 78,122	$ 424,235

See accompanying notes to consolidated financial statements.

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

For the year ended December 31,	***2006***	***2005****	***2004****
Operating Activities:			
Net income	$ 98,806	$ 106,041	$ 93,259
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	10,221	9,810	6,163
Loan loss provision	445	900	2,700
Net amortization of loan fees, net of cost	(414)	(51)	(105)
Decrease (increase) in interest income receivable	1,327	(1,007)	1,217
Increase in other assets	(5,712)	(3,961)	(2,936)
Stock option compensation expense	2,504	2,394	3,348
Excess tax benefits from stock-based compensation	(1,867)	(1,761)	(2,236)
Decrease in income taxes payable	(423)	(1,331)	(3,779)
Increase in interest expense payable	1,875	2,067	43
Increase in other liabilities	1,452	3,472	7,020
Impairment of investment securities	0	0	7,180
Loss (gain) on sale of securities	0	4,903	(2,169)
Loss on extinguishment of debt	0	0	2,204
Gain on sale of real estate and other assets	(239)	(3,700)	(402)
Net loss on sales/write-down of fixed assets	6	39	47
Originations of loans for resale	(860)	(484)	(3,988)
Net proceeds from sale of loans originated for resale	869	483	3,955
Net gain on sale of property acquired in satisfaction of debt	0	(24)	(231)
Net Cash Provided by Operating Activities	107,990	117,790	111,290
Investing Activities			
Net cash issued in mergers and acquisitions	0	(35,210)	0
Net repayments of loans	139,280	66,942	20,778
Purchases of investment securities available for sale	(30,832)	(19,208)	(96,027)
Proceeds from maturity/calls of securities available for sale	78,068	104,832	348,027
Proceeds from sale of securities available for sale	0	196,216	209,173
Purchases of investment securities held to maturity	0	(232,203)	(890,836)
Proceeds from maturity/calls of securities held to maturity	172,125	165,447	158,929

Purchases of property, plant and equipment	(1,008)	(1,655)	(3,390)
Proceeds from sale of property and equipment	420	4,533	0
Proceeds from maturity/sale of money market assets	0	6	0
Purchases of FRB/FHLB securities	(141)	(4,414)	0
Proceeds from sale of FRB/FHLB securities	247	1,547	0
Proceeds from sale of other real estate owned	0	64	321
Net Cash Provided (Used) In Investing Activities	358,159	246,897	(253,025)
Financing Activities			
Net (decrease) increase in deposits	(329,367)	(107,498)	119,628
Net (decrease) increase in short-term borrowings	(43,196)	(47,649)	144,776
Repayments to the Federal Home Loan Bank	0	0	(107,204)
Repayments of notes payable	(3,362)	(3,338)	(3,214)
Exercise of stock options/issuance of shares	12,755	9,830	12,572
Excess tax benefit from stock-based compensation	1,867	1,761	2,236
Retirement of common stock including repurchases	(88,981)	(95,351)	(55,444)
Dividends paid	(40,696)	(39,322)	(35,090)
Net Cash (Used) Provided By Financing Activities	(490,980)	(281,567)	78,260
Net (Decrease) Increase In Cash and Cash Equivalents	(24,831)	83,120	(63,475)
Cash and Cash Equivalents at Beginning of Year	209,273	126,153	189,628
Cash and Cash Equivalents at End of Year	$ 184,442	$ 209,273	$ 126,153
Supplemental Disclosures:			
Supplemental disclosure of noncash activities:			
Loans transferred to other real estate owned	$ 647	$ 40	$ 0
Unrealized gain (loss) on securities available for sale, net	362	(7,756)	(3,553)

The acquisition of Redwood Empire Bancorp involved the following:			
Cash issued		57,128	
Common stock issued		89,538	
Fair value of liabilities assumed		500,659	
Fair value of assets acquired, other than cash and cash equivalents		(495,596)	
Core deposit intangible		(16,600)	
Customer based intangible merchant draft processing		(10,300)	
Goodwill		(102,911)	
Net Cash and Cash Equivalents Received		21,918	
Supplemental disclosure of cash flow activity:			
Interest paid for the period	**67,143**	46,325	21,149
Income tax payments for the period	37,353	39,414	37,432

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

See accompanying notes to consolidated financial statements.

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WESTAMERICA BANCORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Business and Accounting Policies

Westamerica Bancorporation, a registered bank holding company (the Company), provides a full range of banking services to corporate and individual customers in Northern and Central California through its subsidiary bank, Westamerica Bank (the Bank). The Bank is subject to competition from both financial and nonfinancial institutions and to the regulations of certain agencies and undergoes periodic examinations by those regulatory authorities.

Summary of Significant Accounting Policies

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The following is a summary of significant policies used in the preparation of the accompanying financial statements.

Accounting Estimates. Certain accounting policies underlying the preparation of these financial statements require management to make estimates and judgments. These estimates and judgments may affect reported amounts of assets and liabilities, revenues and expenses, and disclosures of contingent assets and liabilities. The most significant of these involve the Allowance for Credit Losses, as discussed below under Allowance for Credit Losses.

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and all the Company s subsidiaries. Significant intercompany transactions have been eliminated in consolidation. The Company does not maintain or conduct transactions with any unconsolidated special purpose entities other than low income housing partnerships sponsored by third parties.

Cash Equivalents. Cash equivalents include Due From Banks balances and Federal Funds Sold which are both readily convertible to known amounts of cash and are generally 90 days or less from maturity at the time of purchase, presenting insignificant risk of changes in value due to interest rate changes.

Securities. Investment securities consist of debt securities of the U.S. Treasury, government sponsored entities, states, counties and municipalities, corporations, mortgage-backed securities, and equity securities. The Company classifies its debt and marketable equity securities in one of three categories: trading, available for sale or held to maturity. Securities transactions are recorded on a trade date basis. Trading securities are bought and held principally for the purpose of selling them in the near term. Held to maturity securities are those debt securities which the Company has the ability and intent to hold until maturity. Securities not included in trading or held to maturity are classified as available for sale. Trading and available for sale securities are recorded at fair value. Held to maturity securities are recorded at amortized cost, adjusted for the amortization of premiums or accretion of discounts. Unrealized gains and losses on trading securities are included in earnings. Unrealized gains and losses, net of the related tax effect, on available for sale securities are reported as a separate component of shareholders equity until realized.

A decline in the market value of any available for sale or held to maturity security below cost that is deemed other than temporary results in a charge to earnings and the establishment of a new cost basis for the security. Unrealized investment securities losses are evaluated at least quarterly to determine whether such declines in value should be considered other than temporary and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the

security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other than temporary include ratings by recognized rating agencies, actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security, the financial condition, capital strength and near-term prospects of the issuer, and recommendations of investment advisors or market analysts.

Purchase premiums are amortized and purchase discounts are accreted over the estimated life of the related investment security as an adjustment to yield using the effective interest method. Unamortized premiums, unaccreted discounts, and early payment premiums are recognized in interest income upon disposition of the related security. Interest and dividend income are recognized when earned. Realized gains and losses from the sale of available for sale securities are included in earnings using the specific identification method.

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Loans. Loans are stated at the principal amount outstanding, net of unearned discount and unamortized deferred fees and costs. Interest is accrued daily on the outstanding principal balances. Loans which are more than 90 days delinquent with respect to interest or principal, unless they are well secured and in the process of collection, and other loans on which full recovery of principal or interest is in doubt, are placed on nonaccrual status. Interest previously accrued on loans placed on nonaccrual status is charged against interest income. In addition, some loans secured by real estate with temporarily impaired values and commercial loans to borrowers experiencing financial difficulties are placed on nonaccrual status (performing nonaccrual loans) even though the borrowers continue to repay the loans as scheduled. When the ability to fully collect nonaccrual loan principal is in doubt, payments received are applied against the principal balance of the loans until such time as full collection of the remaining recorded balance is expected. Any additional interest payments received after that time are recorded as interest income on a cash basis. Performing nonaccrual loans are reinstated to accrual status when improvements in credit quality eliminate the doubt as to the full collectibility of both interest and principal. Certain consumer loans or auto receivables are charged to the allowance for credit losses when they become 120 days past due. The Company recognizes a loan as impaired when, based on current information and events, it is probable that it will be unable to collect both the contractual interest and principal payments as scheduled in the loan agreement. Income recognition on impaired loans conforms to that used on nonaccrual loans.
Nonrefundable fees and certain costs associated with originating or acquiring loans are deferred and amortized as an adjustment to interest income over the contractual loan lives. Upon prepayment, unamortized loan fees are immediately recognized in interest income. Other fees, including those collected upon principal prepayments, are included in interest income when received. Loans held for sale are identified upon origination and are reported at the lower of cost or market value on an aggregate loan basis.
Allowance for Credit Losses. The allowance for credit losses is established through provisions for credit losses charged to income. Losses on loans, including impaired loans, are charged to the allowance for credit losses when all or a portion of a loan is deemed to be uncollectible. Recoveries of loans previously charged off are credited to the allowance when realized. The Company s allowance for credit losses is maintained at a level considered adequate to provide for losses that can be estimated based upon specific and general conditions. These include conditions unique to individual borrowers, as well as overall credit loss experience, the amount of past due, nonperforming and classified loans, recommendations of regulatory authorities, prevailing economic conditions and other factors. A portion of the allowance is specifically allocated to impaired and other identified loans whose full collectibility is uncertain. Such allocations are determined by Management based on loan-by-loan analyses. A second allocation is based in part on quantitative analyses of historical credit loss experience, in which criticized and classified loan balances identified through an internal loan review process are analyzed using a linear regression model to determine standard loss rates. The results of this analysis are applied to current criticized and classified loan balances to allocate the reserve to the respective segments of the loan portfolio. In addition, loans with similar characteristics not usually criticized using regulatory guidelines are analyzed based on the historical loss rates and delinquency trends, grouped by the number of days the payments on these loans are delinquent. Last, allocations are made to non-criticized and classified commercial loans and residential real estate loans based on commercial office vacancy rates, mortgage loan foreclosure trends, agriculture commodity prices, and levels of government funding. The remainder of the reserve is considered to be unallocated and is established at a level

considered necessary based on relevant economic conditions and available data, including unemployment statistics, economic and business conditions, the quality of lending management and staff, credit quality trends, concentrations of credit, and changing underwriting standards due to competitive factors.

Other Real Estate Owned. Other real estate owned is comprised of property acquired through foreclosure proceedings, acceptances of deeds-in-lieu of foreclosure and some vacated bank properties. Losses recognized at the time of acquiring property in full or partial satisfaction of debt are charged against the allowance for credit losses. Other real estate owned is recorded at the lower of the related loan balance or fair value of the collateral, generally based upon an independent property appraisal, less estimated disposition costs. Subsequently, other real estate owned is valued at the lower of the amount recorded at the date acquired or the then current fair value less estimated disposition costs. Subsequent losses incurred due to any decline in annual independent property appraisals are recognized as noninterest expense. Routine holding costs, such as property taxes, insurance and maintenance, and losses from sales and dispositions, are recognized as noninterest expense.

Premises and Equipment. Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed substantially on the straight-line method over the estimated useful life of each type of asset. Estimated useful lives of premises and equipment range from 20 to 50 years and from 3 to 20 years, respectively. Leasehold improvements are amortized over the terms of the lease or their estimated useful life, whichever is shorter.

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Intangible assets. Intangible assets are comprised of goodwill, core deposit intangibles and other identifiable intangibles acquired in business combinations. Intangible assets with definite useful lives are amortized over their respective estimated useful lives to their estimated residual values. If an event occurs that indicates the carrying amount of an intangible asset may not be recoverable, Management reviews the asset for impairment. Any goodwill and any intangible asset acquired in a purchase business combination determined to have an indefinite useful life is not amortized, but is annually evaluated for impairment.

Impairment of Long-Lived Assets. The Company reviews its long-lived and certain intangible assets for impairment whenever events or changes indicate that the carrying amount of an asset may not be recoverable. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Income taxes. The Company and its subsidiaries file consolidated tax returns. For financial reporting purposes, the income tax effects of transactions are recognized in the year in which they enter into the determination of recorded income, regardless of when they are recognized for income tax purposes. Accordingly, the provisions for income taxes in the consolidated statements of income include charges or credits for deferred income taxes relating to temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are reflected at currently enacted income tax rates in the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Derivative Instruments and Hedging Activities. The Company s accounting for derivative instruments, including certain derivative instruments embedded in other contracts, requires the Company to recognize those items as assets or liabilities in the statement of financial position and measure them at fair value.

Stock Options. Effective January 1, 2006, the Company adopted FASB Statement No.123(revised 2004), Share-Based Payment (SFAS No. 123(R)) on a modified retrospective basis. SFAS No. 123(R) requires the Company to begin using the fair value method to account for stock based awards granted to employees in exchange for their services. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock option plans using the intrinsic value method, as permitted by SFAS No. 123, Accounting for Stock-Based Compensation. Under the prior intrinsic value method, compensation expense was recorded for stock options only if the price of the underlying stock on the date of grant exceeded the exercise price of the option. The Company s historical stock option grants were awarded with exercise prices equal to the prevailing price of the underlying stock on the dates of grant; therefore, no compensation expense was recorded using the intrinsic value method. The Company s recognition of compensation expense for restricted performance share grants has not changed with the adoption of SFAS No. 123(R). The Company has recognized compensation expense for historical restricted performance share grants over the relevant attribution period. Restricted performance share grants have no exercise price, therefore, the intrinsic value is measured using an estimated per share price at the vesting date for each restricted performance share. The estimated per share price is adjusted during the attribution period to reflect actual stock price performance. The Company s obligation for unvested outstanding restricted performance share grants is classified as a liability until the vesting date, at which time the issued shares become

classified as shareholders equity.

Earnings Per Share. Basic earnings per share are computed by dividing net income by the average number of shares outstanding during the year. Diluted earnings per share are computed by dividing net income by the average number of shares outstanding during the year plus the impact of dilutive common stock equivalents.

Calculation of basic and diluted net income per share follow:

(In thousands, except per share data)	2006	2005	2004
Weighted average number of common shares outstanding basic	31,202	32,291	31,821
Dilutive stock options	537	606	640
Weighted average number of common shares outstanding diluted	31,739	32,897	32,461
Net income	$ 98,806	$ 106,041	$ 93,259
Basic earnings per share	$ 3.17	$ 3.28	$ 2.93
Diluted earnings per share	3.11	3.22	2.87

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For the years ended December 31, 2006, 2005, and 2004, options to purchase 719 thousand, 294 thousand and 135 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted net income per share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

Extinguishment of Debt. Gains and losses, including fees, incurred in connection with the early extinguishment of debt are charged to current earnings as reductions in noninterest income.

Postretirement Benefits. The Company uses an actuarial-based accrual method of accounting for post-retirement benefits. The Company offers a continuation of group insurance coverage to eligible employees electing early retirement until age 65. The Company pays a portion of these early retirees insurance premium which are determined at their date of retirement. The Company reimburses a portion of Medicare Part B premiums for all retirees and spouses over 65. The Company does not fund its post-retirement benefit plan.

Other. Securities and other property held by the Bank in a fiduciary or agency capacity are not included in the financial statements since such items are not assets of the Company or its subsidiaries.

Recently Issued Accounting Pronouncements

In February 2006, the FASB issued FAS 155, Accounting for Certain Hybrid Financial Instruments, which amends FAS 133, Accounting for Derivatives and Hedging Activities, and FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Hybrid financial instruments are single financial instruments that contain an embedded derivative. Under FAS 155, entities can elect to record certain hybrid financial instruments at fair value as individual financial instruments. Prior to this amendment, certain hybrid financial instruments were required to be separated into two instruments a derivative and host and generally only the derivative was recorded at fair value. FAS 155 also requires that beneficial interests in securitized assets be evaluated for either freestanding or embedded derivatives. FAS 155 is effective for all financial instruments acquired or issued after January 1, 2007. FAS 155 will have no effect on our consolidated financial statements on the date of adoption.

In July 2006, the Financial Accounting Standards Board issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 supplements FAS 109, Accounting for Income Taxes, by defining the threshold for recognizing tax benefits in the financial statements as more likely than not to be sustained by the applicable taxing authority. The benefit recognized for a tax position that meets the more likely than not criterion is measured based on the largest benefit that is more than 50% likely to be realized, taking into consideration the amounts and probabilities of the outcomes upon settlement. The Company will adopt FIN 48 effective January 1, 2007, as required. The cumulative effect of applying the new requirements must be reflected as adjustments to the Company s retained earnings as of January 1, 2007. At December 31, 2006, the Company s reserve for uncertain tax positions was less than $1 million; any adjustment to retained earnings will be immaterial.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. The Company has historically focused on the impact of misstatements on the income statement, including the reversing effect of prior year misstatements. With a focus on the

income statement, the Company s analysis can lead to the accumulation of misstatements in the balance sheet. In applying SAB 108, the Company must also consider accumulated misstatements in the balance sheet. SAB 108 permits companies to initially apply its provisions by recording the cumulative effect of misstatements as adjustments to the balance sheet as of the first day of the fiscal year, with an offsetting adjustment recorded to retained earnings, net of tax. The Company has adopted SAB 108 with an adjustment to reduce other liabilities by $3 million, with a corresponding increase to retained earnings of $1.8 million, net of tax. The $3 million overstatement of other liabilities accumulated over seventeen years, as the liability accrued for stock-based compensation exceeded the amount paid to employees. These misstatements had not previously been material to the income statements for any of those prior periods.

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In September 2006, the Financial Accounting Standards Board issued FASB Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (FAS 158). FAS 158 requires recognition of the funded status of the Company s benefit plans as a net liability or asset, which requires an offsetting adjustment to accumulated other comprehensive income in shareholders equity. The Company adopted these recognition and disclosure provisions of FAS 158 effective December 31, 2006, which required recognition of the previously unrecognized transition obligation for the Company s postretirement medical benefit program. The following table illustrates the adjustments recorded to adopt FAS 158:

Incremental Effect of Applying FAS 158
on Individual Line Items in the Statement of Financial Position
December 31, 2006
(in thousands)

	Before Application of FAS 158	Adjustments	After Application of FAS 158
Liability for postretirement	$ 3,757	$ 673	$ 4,430
Net deferred tax asset	39,561	279	39,840
Total liabilities	4,344,427	673	4,345,100
Accumulated other comprehensive income	2,244	(394)	1,850
Total stockholders equity	424,629	(394)	424,235

FAS 158 requires the Company to measure its benefit obligations as of the balance sheet date effective December 31, 2008. The Company currently uses a September 30 measurement date.

In September 2006, the FASB issued FAS 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. FAS 157 is effective for the year beginning January 1, 2008, with early adoption permitted on January 1, 2007. The Company does not expect that the adoption of FAS 157 will have a material effect on its consolidated financial statements.

In February 2007, the FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (FAS 159). This standard permits entities to choose to measure many financial assets and liabilities and certain other items at fair value. An enterprise will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied on an instrument-by-instrument basis, with several exceptions, such as those investments accounted for by the equity method, and once elected, the option is irrevocable unless a new election date occurs. The fair value option can be applied only to entire instruments and not to portions thereof. FAS 159 is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the

beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. Management is currently evaluating the effects of adopting FAS No. 159 on its consolidated financial statements.

Note 2: Business Combinations

In a business combination, the results of operations of the acquired entity are included in the consolidated financial statements from the date of acquisition. Assets and liabilities of the entity acquired are recorded at fair value on the date of acquisition and goodwill is recorded as the excess of the purchase price over the fair value of the net assets acquired (including identifiable intangible assets such as core deposits). See Intangible Assets below.

Acquisition of Redwood Empire Bancorp

The Company acquired Redwood Empire Bancorp, parent company of National Bank of the Redwoods, on March 1, 2005, in order to increase the Company s market share in Northern California. The cash and stock acquisition was accounted for under the purchase method of accounting. The transaction was valued at approximately $150 million.

The following supplemental pro forma information discloses selected financial information for the periods indicated as though the acquisition had been completed at the beginning of each year presented (unaudited):

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	Year ended December 31,	
	2005*	2004*
	(In thousands, except per share data)	
Earnings as reported:		
Revenue	$ 253,688	$ 233,814
Net income	106,041	93,259
Basic EPS	$ 3.28	$ 2.93
Diluted EPS	3.22	2.87
Pro forma merger adjustments:		
Revenue	$ 5,509	$ 30,592
Net income	1,007	5,219
Pro forma earnings after merger adjustments:		
Revenue	$ 259,197	$ 264,406
Net income	107,048	98,478
Basic EPS	$ 3.28	$ 2.94
Diluted EPS	3.22	2.89

The estimated fair value of assets acquired and liabilities assumed are as follows (unaudited):

Balances as of March 1,	2005 (In thousands)
Assets acquired:	
Cash and cash equivalents	$ 21,918
Investment securities held to maturity	14,063
Investment securities available for sale	31,392
Loans	438,910
Allowance for loan losses	(5,213)
Identifiable intangibles	26,900
Goodwill	102,911
Other assets	18,500
Total assets acquired	$ 649,381
Liabilities assumed	
Deposits	$ 368,689
Subordinated debt	22,189
Other liabilities	109,781
Total liabilities assumed	$ 500,659
Purchase price:	
Cash issued	$ 57,128
Common stock issued	89,538

Capitalized acquisition costs	2,056
Total purchase price	$ 148,722

*Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

Note 3: Investment Securities

The amortized cost, unrealized gains and losses, and estimated market value of the available for sale investment securities portfolio as of December 31, 2006, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
		(In thousands)		
Securities of U.S. Government sponsored entities	$ 332,587	$ 13	($8,337)	$ 324,263
Obligations of States and political subdivisions	201,777	5,834	(31)	207,580
Asset-backed securities	10,266	7	0	10,273
Other securities	67,022	7,086	(699)	73,409
Total	$ 611,652	$ 12,940	($9,067)	$ 615,525

The amortized cost, unrealized gains and losses, and estimated market value of the held to maturity investment securities portfolio as of December 31, 2006, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
		(In thousands)		
Securities of U.S. Government sponsored entities	$ 585,345	$ 93	($13,406)	$ 572,032
Obligations of States and political subdivisions	579,747	6,645	(2,688)	583,704
Total	$ 1,165,092	$ 6,738	($16,094)	$ 1,155,736

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The amortized cost, unrealized gains and losses, and estimated market value of the available for sale investment securities portfolio as of December 31, 2005, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
		(In thousands)		
Securities of U.S. Government sponsored entities	$ 341,259	$ 6	($10,091)	331,174
Obligations of States and political subdivisions	214,297	8,251	(44)	222,504
Asset-backed securities	11,306	0	(50)	11,256
Corporate bonds	25,151	126	(147)	25,130
Other securities	67,128	5,764	(568)	72,324
Total	$ 659,141	$ 14,147	($10,900)	$ 662,388

The amortized cost, unrealized gains and losses, and estimated market value of the held to maturity investment securities portfolio as of December 31, 2005, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
		(In thousands)		
Securities of U.S. Government sponsored entities	$ 740,891	$ 210	($15,430)	$ 725,671
Obligations of States and political subdivisions	596,325	6,857	(5,071)	598,111
Total	$ 1,337,216	$ 7,067	($20,501)	$ 1,323,782

The amortized cost and estimated market value of securities at December 31, 2006, by contractual maturity, are shown in the following table:

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Estimated Market Value	Amortized Cost	Estimated Market Value
		(In thousands)		
Maturity in years:				
1 year or less	$ 6,073	$ 6,126	$ 39,387	$ 39,144
1 to 5 years	196,654	193,985	160,889	158,409
5 to 10 years	143,147	147,744	189,846	192,528
Over 10 years	21,059	21,146	349,625	350,625
Subtotal	366,933	369,001	739,747	740,706
Mortgage-backed	177,697	173,115	425,345	415,030

Other securities	67,022	73,409	0	0
Total	$ 611,652	$ 615,525	$ 1,165,092	$ 1,155,736

Expected maturities of mortgage-backed securities can differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. In addition, such factors as prepayments and interest rates may affect the yield on the carrying value of mortgage-backed securities. At December 31, 2006 and 2005, the Company had no high-risk collateralized mortgage obligations as defined by regulatory guidelines.

An analysis of gross unrealized losses of the available for sale investment securities portfolio as of December 31, 2006, follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Securities of U.S. Government sponsored entities	$ 24,580	($324)	$ 282,147	($8,013)	$ 306,727	($8,337)
Obligations of States and political subdivisions	964	(2)	2,983	(29)	3,947	(31)
Other securities	19,156	(699)	0	0	19,156	(699)
Total	44,700	(1,025)	285,130	(8,042)	329,830	(9,067)

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An analysis of gross unrealized losses of the held to maturity investment securities portfolio as of December 31, 2006, follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Securities of U.S. Government sponsored entities	$ 28,731	($168)	$535,774	($13,238)	$564,505	($13,406)
Obligations of States and political subdivisions	100,252	(530)	120,441	(2,158)	220,693	(2,688)
Total	128,983	(698)	656,215	(15,396)	785,198	(16,094)

An analysis of gross unrealized losses of the available for sale investment securities portfolio as of December 31, 2005, follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Securities of U.S. Government sponsored entities	$ 80,651	($1,479)	$249,547	($8,613)	$330,198	($10,092)
Obligations of States and political subdivisions	3,205	(20)	2,708	(23)	5,913	(43)
Asset-backed securities	9,948	(50)	0	0	9,948	(50)
Corporate bonds	4,857	(147)	0	0	4,857	(147)
Other securities	24,287	(568)	0	0	24,287	(568)
Total	122,948	(2,264)	252,255	(8,636)	375,203	(10,900)

An analysis of gross unrealized losses of the held to maturity investment securities portfolio as of December 31, 2005, follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Securities of U.S. Government sponsored entities	$322,727	($4,679)	$383,572	($10,751)	$ 706,299	($15,430)
Obligations of States and political subdivisions	236,116	(2,969)	66,273	(2,102)	302,389	(5,071)
Total	558,843	(7,648)	449,845	(12,853)	1,008,688	(20,501)

Substantially all of the securities set forth in the two preceding tables are investment-grade debt securities which have experienced a decline in fair value due to changes in market interest rates, not in estimated cash flows. Since the Company has the intent and ability to retain its investment in these securities for a period of time to allow for any anticipated recovery in market value, no other than temporary impairment was recorded on these securities during 2005 and 2006.

In the fourth quarter of 2004, the Company recognized a $7.2 million securities impairment writedown to market value of certain issues of Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) preferred stock held in the available for sale investment portfolio. The writedown was recorded as a reduction to noninterest income. The after-tax effect was $4.2 million, net of tax benefits of $3.0 million. At December 31, 2005, the Company held FNMA and FHLMC preferred stock with a cost basis of $63.9 million and a tax-equivalent dividend yield of 7.65%. At December 31, 2006, the Company held FNMA and FHLMC preferred stock with a cost basis of $63.9 million and a tax-equivalent dividend yield of 8.82%.

As of December 31, 2006, $937.9 million of investment securities were pledged to secure public deposits and short-term funding needs, compared to $842.3 million in 2005. The Bank is a member of the Federal Reserve Bank (FRB) and held Federal Reserve Bank stock stated at cost of $11.3 million at December 31, 2006 and $11.3 million at December 31, 2005.

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Note 4: Loans and Allowance for Credit Losses

Loans at December 31 consisted of the following:

	2006	2005
	(In thousands)	
Commercial	$ 556,564	$ 678,168
Real estate-commercial	907,259	916,757
Real estate-construction	70,650	72,095
Real estate-residential	507,553	508,174
Total real estate loans	1,485,462	1,497,026
Installment and personal	489,708	497,027
Gross loans	2,531,734	2,672,221
Allowance for loan losses	(55,330)	(55,849)
Net loans	$ 2,476,404	$ 2,616,372

There were no loans held for sale at December 31, 2006 and 2005.

The following summarizes the allowance for credit losses of the Company for the periods indicated:

	2006	2005	2004
		(In thousands)	
Balance at January 1,	$ 59,537	$ 54,152	$ 53,910
Provision for loan losses	445	900	2,700
Provision for unfunded credit commitment losses	5	0	0
Loans charged off	(3,622)	(2,738)	(5,593)
Recoveries of loans previously charged off	2,658	2,010	3,135
Acquisition		5,213	
Balance at December 31,	$ 59,023	$ 59,537	$ 54,152
Components:			
Allowance for loan losses	$ 55,330	$ 55,849	$ 54,152
Reserve for unfunded credit commitments (1)	3,693	3,688	
Allowance for credit losses	$ 59,023	$ 59,537	$ 54,152

(1) Effective December 31, 2005, the Company transferred the

portion of the allowance for loan losses related to lending commitments and letters of credit to other liabilities.

At December 31, specific impaired loans were $493 thousand for 2006 compared with $117 thousand for 2005. Total reserves allocated to these loans were $493 thousand for 2006 and $117 thousand for 2005. For the year ended December 31, 2006, the average recorded net investment in impaired loans was approximately $234 thousand compared with $29 thousand and $731 thousand, for the years ended December 31, 2005 and 2004, respectively. In general, the Company does not recognize any interest income on troubled debt restructuring or on loans that are classified as nonaccrual. The Company had no troubled debt restructurings at December 31, 2006. For other impaired loans, interest income may be recorded as cash is received, provided that the Company s recorded investment in such loans is deemed collectible.

Nonaccrual loans at December 31, 2006 and 2005 were $4.5 million and $6.3 million, respectively. The following is a summary of the effect of nonaccrual loans on interest income for the years ended December 31:

	2006	2005	2004
		(In thousands)	
Interest income that would have been recognized had the loans performed in accordance with their original terms	$ $502	$ 556	$ 462
Less: Interest income recognized on nonaccrual loans	(488)	(353)	(439)
Total reduction of interest income	$ 14	$ 203	$ 23

There were no commitments to lend additional funds to borrowers whose loans are included above.

Note 5: Concentration of Credit Risk

The Company s business activity is with customers in Northern and Central California. The loan portfolio is well diversified, although the Company has significant credit arrangements that are secured by real estate collateral. In addition to real estate loans outstanding as disclosed in Note 4, the Company had loan commitments and standby letters of credit related to real estate loans of $80.5 million and $62.4 million at December 31, 2006 and 2005, respectively. The Company requires collateral on all real estate loans and generally attempts to maintain loan-to-value ratios no greater than 75% on commercial real estate loans and no greater than 80% percent on residential real estate loans unless covered by mortgage insurance.

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Note 6: Premises and Equipment

Premises and equipment as of December 31 consisted of the following:

	Cost	Accumulated Depreciation and Amortization	Net Book Value
		(In thousands)	
2006			
Land	$ 8,858	$	$ 8,858
Buildings and improvements	33,549	(17,788)	15,761
Leasehold improvements	5,823	(4,405)	1,418
Furniture and equipment	14,258	(10,107)	4,151
Total	$ 62,488	($ 32,300)	$ 30,188
2005			
Land	$ 8,858	$	$ 8,858
Buildings and improvements	33,640	(16,533)	17,107
Leasehold improvements	5,599	(3,926)	1,673
Furniture and equipment	14,166	(8,583)	5,583
Total	$ 62,263	($ 29,042)	$ 33,221

Depreciation and amortization included in noninterest expense amounted to $3.9 million in 2006, $4.1 million in 2005, and $3.9 million in 2004.

Note 7: Goodwill and Identifiable Intangible Assets

The following table summarizes the Company s goodwill and identifiable intangible assets as of January 1 and December 31 for 2006 and 2005. In 2006, goodwill relating to the REBC acquisition was reduced by $193 thousand related to stock options issued in connection with the acquisition and increased $5 thousand related to accrued expenses. In connection with the acquisition of REBC in the first quarter of 2005, the Company recorded goodwill of $109 million and identifiable intangibles of $27 million in accordance with the purchase method of accounting. In 2005, goodwill relating to the REBC acquisition was subsequently reduced by $6 million, of which related to the premium received on the required divestiture of a former REBC branch office and purchase accounting adjustments for stock options and taxes.

	At January 1, 2006	Additions	Reductions	At December 31, 2006
(In thousands)				
Goodwill	$ 125,879	$ 5	($ 193)	$ 125,691
Accumulated Amortization	(3,972)	0	0	(3,972)

Net	$121,907	$ 5	($ 193)	$121,719
Core Deposit Intangibles	$ 24,383	$ 0	$ 0	$ 24,383
Accumulated Amortization	(6,972)	0	(2,280)	(9,252)
Merchant Draft Processing Intangible	10,300	0	0	10,300
Accumulated Amortization	(1,541)	0	(1,808)	(3,349)
Net	$ 26,170	$ 0	($ 4,088)	$ 22,082

(In thousands)	At January 1, 2005	Additions	Reductions	At December 31, 2005
Goodwill	$ 22,968	$108,507	($ 5,596)	$125,879
Accumulated Amortization	(3,972)	0	0	(3,972)
Net	$ 18,996	$108,507	($ 5,596)	$121,907
Core Deposit Intangibles	$ 7,783	$ 16,600	$ 0	$ 24,383
Accumulated Amortization	(4,889)	0	(2,083)	(6,972)
Merchant Draft Processing Intangible	0	10,300	0	10,300
Accumulated Amortization	0	0	(1,541)	(1,541)
Net	$ 2,894	$ 26,900	($ 3,624)	$ 26,170

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At December 31, 2006, the estimated amortization of core deposit intangibles, in thousands of dollars, annually through 2011 is $2,153, $2,021, $1,859, $1,636 and $1,386 respectively. The weighted average remaining amortization period for core deposit intangibles is 12 years. At December 31, 2006, the estimated amortization of merchant draft processing intangible, in thousands of dollars, annually through 2011 is $1,500, $1,200, $962, $774 and $624, respectively. The merchant draft processing intangibles estimated amortization period is 11 years.

Note 8: Deposits and Borrowed Funds

Debt financing and notes payable, including the unsecured obligations of the Company, as of December 31, were as follows:

		2006	2005
		(In thousands)	
Senior Fixed-rate note(1)		$15,000	$15,000
Fixed-rate note(2)		0	3,214
Total senior debt	Parent	15,000	18,214
Subordinated			
Fixed-rate note(3)		11,899	12,034
Adjustable-rate note(4)		10,021	10,033
Total subordinated debt	Parent	21,920	22,067
Total debt financing and notes payable	Parent	$36,920	$40,281

(1) Senior note, issued by Westamerica Bancorporation, originated in October 2003 and maturing October 31, 2013. Interest of 5.31% per annum is payable semiannually on April 30 and October 31, with original principal payment due at maturity.

(2)

Senior notes, issued by Westamerica Bancorporation, originated in February 1996 and matured February 1, 2006. Interest of 7.11% per annum is payable semiannually on February 1 and August 1, with annual principal payments commencing February 1, 2000 and the remaining principal amount due at maturity.

(3) Subordinated debt, assumed by Westamerica Bancorporation March 1, 2005, originated February 22, 2001. Par amount $10,000, interest of 10.2% per annum, payable semiannually. Matures February 22, 2031, redeemable February 22, 2021 at par and February 22, 2011 at a premium.

(4) Subordinated debt, assumed by Westamerica Bancorporation

March 1, 2005, originated July 22, 2003. Par amount $10,000, interest of 6.35% per annum, payable quarterly. Interest coupon resets to three-month LIBOR plus 3.1% per annum effective July 22, 2008. Matures July 22, 2038, redeemable July 22, 2008 at par.

The senior notes are subject to financial covenants requiring the Company to maintain, at all times, certain minimum levels of consolidated tangible net worth and maximum levels of capital debt. The Company is in compliance with all of the covenants in the senior notes indenture as of December 31, 2006.

Short-term borrowed funds include federal funds purchased, business customers sweep accounts, outstanding amounts under a $35 million unsecured line of credit, and securities sold with repurchase agreements which are held in the custody of independent securities brokers. Interest paid on time deposits with balances in excess of $100 thousand was $21.0 million in 2006 and $11.6 million in 2005. The following table summarizes deposits and borrowed funds of the Company for the periods indicated:

	2006			2005		
	Balance At December 31,	Average Balance	Weighted Average Rate	Balance At December 31,	Average Balance	Weighted Average Rate
		(In thousands)			(In thousands)	
Federal funds purchased	$551,000	$525,068	5.02%	$575,925	$550,523	3.24%
Sweep accounts	134,634	140,363	0.25	158,153	140,362	0.25
Securities sold under repurchase agreements	25,830	53,439	3.39	26,825	13,429	2.30
Line of credit	20,513	16,100	5.33	14,270	12,670	3.50
Time deposits Over $100 thousand	499,962	504,980	4.17	486,069	444,862	2.58

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Note 9: Shareholders Equity

The Company grants stock options and restricted performance shares (RPSs) to employees in exchange for employee services, pursuant to the shareholder-approved 1995 Stock Option Plan, which was amended and restated in 2003. Stock options are granted with an exercise price equal to the fair market value of the related common stock on the grant date and generally became exercisable in equal annual installments over a three-year period with each installment vesting on the anniversary date of the grant. Each stock option has a maximum ten-year term. A restricted performance share grant becomes vested after three years of being awarded, provided the Company has attained its performance goals for such three-year period.

Effective January 1, 2006, the Company adopted FASB Statement No.123(revised 2004), Share-Based Payment (SFAS No. 123(R)) on a modified retrospective basis. SFAS No. 123(R) requires the Company to begin using the fair value method to account for stock based awards granted to employees in exchange for their services. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock option plans using the intrinsic value method, as permitted by SFAS No. 123, Accounting for Stock-Based Compensation. Under the prior intrinsic value method, compensation expense was recorded for stock options only if the price of the underlying stock on the date of grant exceeded the exercise price of the option. The Company s historical stock option grants were awarded with exercise prices equal to the prevailing price of the underlying stock on the dates of grant; therefore, no compensation expense was recorded using the intrinsic value method. The Company s recognition of compensation expense for restricted performance share grants has not changed with the adoption of SFAS No. 123(R). The Company has recognized compensation expense for historical restricted performance share grants over the relevant attribution period. Restricted performance share grants have no exercise price, therefore, the intrinsic value is measured using an estimated per share price at the vesting date for each restricted performance share. The estimated per share price is adjusted during the attribution period to reflect actual stock price performance. The Company s obligation for unvested outstanding restricted performance share grants is classified as a liability until the vesting date, at which time the issued shares become classified as shareholders equity.

The scope of SFAS 123(R) includes a wide range of stock-based compensation arrangements including stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee stock purchase plans. SFAS 123(R) requires that the Company measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the grant date. That cost must be recognized in the income statement over the vesting period of the award. In applying the modified retrospective method to implement SFAS No. 123 (R), the Company adjusted the financial statements for prior periods to give effect to the fair-value-based method of accounting for awards that were granted, modified or settled in the fiscal years beginning after December 15, 1994 on a basis consistent with the pro forma disclosures required by Statement 123. Accordingly, compensation costs and the related tax effects are recognized in those financial statements as though awards for those periods before the effective date of Statement 123(R) had been accounted for under Statement 123. In addition, the opening balances of common stock, deferred taxes and retained earnings for the earliest year presented are adjusted to reflect the cumulative effect of the modified retrospective application on earlier periods.

The following table summarizes information about stock options granted under the Plans as of December 31, 2006. The intrinsic value is calculated as the difference between the market value as of December 31, 2006 and the exercise price of the shares. The market

value as of December 31, 2006 was $50.63 per share as reported by the NASDAQ Global Select Market:

	Options Outstanding				Options Exercisable			
Range of Exercise Price	Number Outstanding at 12/31/2006 (in thousands)	Aggregate Intrinsic Value (in thousands)	Weighted Average Remaining Contractual Life (yrs)	Weighted Average Exercise Price	Number Exercisable at 12/31/2006	Aggregate Intrinsic Value (in thousands)	Weighted Average Remaining Contractual Life (yrs)	Weighted Average Exercise Price
$ 10 - 15	11	$ 412	1.4	$ 13	11	$ 412	1.4	$ 13
15 - 20	1	25	1.4	17	1	25	1.4	17
20 - 25	383	10,204	3.1	24	383	10,204	3.1	24
32 - 33	218	3,892	1.1	33	218	3,892	1.1	33
33 - 35	248	3,978	2.1	35	248	3,978	2.1	35
35 - 40	644	7,484	4.5	39	644	7,484	4.5	39
40 - 45	417	4,123	5.9	41	417	4,123	5.9	41
45 - 50	447	456	6.9	50	298	304	6.8	50
50 - 55	695	0	8.3	53	157	0	7.8	53
$ 10 - 55	3,064	$30,574	5.3	$ 41	2,377	$$30,422	4.5	$ 38

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The Company applies the Roll-Geske option pricing model (Modified Roll) to determine grant date fair value of stock option grants. This model modifies the Black Scholes Model to take into account dividends and American options. During the twelve months ended December 31, 2006, 2005 and 2004, the Company granted 258 thousand, 560 thousand, and 540 thousand stock options, respectively. The following weighted average assumptions were used in the option pricing to value stock options granted in the periods indicated:

	For the Twelve months ended December 31,		
	2006	2005	2004
Expected volatility*1	16%	15%	15%
Expected life in years*2	4.0	7.0	7.0
Risk-free interest rate*3	4.41%	3.91%	3.41%
Expected dividend yield	2.63%	2.47%	2.25%
Fair value per award	$6.54	$6.61	$6.93

*1 Measured using daily price changes of Company s stock over respective expected term of the option and the implied volatility derived from the market prices of the Company s stock and traded options.

*2 the expected life is the number of years that the Company estimates that the options will be outstanding prior to exercise

*3 the risk-free rate for periods within the contractual term of the option is based on the US

Treasury yield curve in effect at the time of the grant

Employee stock option grants are being expensed by the Company over the grants three year vesting period. The Company issues new shares upon the exercise of options. The number of shares authorized to be issued for options is 2.2 million.

The impact of adopting SFAS 123(R) is summarized in the following table (in thousands, except per share data):

	For the twelve months ended December 31,					
	2006		2005		2004	
	Intrinsic Value Method	Fair Value Method	Intrinsic Value Method	Fair Value Method	Intrinsic Value Method	Fair Value Method
Income before income taxes	$ 136,929	$ 134,425	$ 147,932	$ 145,538	$132,363	$129,015
Net income	100,271	98,806	107,441	106,041	95,218	93,259
Net earnings per share basic	$ 3.21	$ 3.17	$ 3.33	$ 3.28	$ 2.99	$ 2.93
Net earnings per share diluted share	3.16	3.11	3.27	3.22	2.93	2.87
Cash flow provided by operations	$ 109,857	$ 107,990	$ 119,551	$ 117,790	$113,526	$111,290
Cash flow (used in) provided by financing activities	(492,847)	(490,980)	(283,328)	(281,567)	76,024	78,260

A summary of option activity during the twelve months ended December 31, 2006 is presented below:

	Shares (In Thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term
Outstanding at January 1, 2006	3,269	$39.13	
Granted	258	52.56	
Exercised	(408)	31.22	
Forfeited or expired	(55)	52.18	
Outstanding at December 31, 2006	3,064	41.08	5.3

Exercisable at December 31, 2006	2,377	37.96	4.5 years

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A summary of the Company s nonvested option activity during the twelve months ended December 31, 2006 is presented below.

	Shares (In Thousands)	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2006	968	
Granted	258	
Vested	(487)	
Forfeited	(52)	
Nonvested at December 31, 2006	687	$ 6.66

The weighted average estimated grant date fair value, as defined by SFAS 123(R), for options granted under the Company s stock option plan during the twelve months ended December 31, 2006, 2005 and 2004 was $6.54, $6.61 and $6.93 per share, respectively. The total remaining unrecognized compensation cost related to nonvested awards as of December 31, 2006 is $3.3 million and the weighted average period over which the cost is expected to be recognized is 1.7 years.

The total intrinsic value of options exercised during the twelve months ended December 31, 2006, 2005 and 2004 was $7.8 million, $9.8 million and $8.6 million, respectively. The total fair value of RPSs that vested during the twelve months ended December 31, 2006, 2005 and 2004 was $1.0 million, $1.1 million and $789 thousand, respectively. The total fair value of options vested during the twelve months ended December 31, 2006, 2005 and 2004 was $3.6 million, $4.1 million, and $4.5 million, respectively. The actual tax benefit recognized for the tax deductions from the exercise of options totaled $1.9 million, $1.8 million and $2.2 million, respectively, for the twelve months ended December 31, 2006, 2005 and 2004.

A summary of the status of the Company s restricted performance shares as of December 31, 2006 and 2005 and changes during the twelve months ended on those dates, follows (in thousands):

	2006	2005	2004
Outstanding at January 1,	44	58	54
Granted	15	21	20
Issued upon vesting	(20)	(21)	(16)
Forfeited	(2)	(14)	0
Outstanding at December 31,	37	44	58

As of December 31, 2006 and 2005, the restricted performance shares had a weighted-average contractual life of 1.2 years. The compensation cost that was charged against income for the Company s restricted performance shares granted was $606 thousand and $525 thousand for the twelve month ended December 31, 2006 and 2005,

respectively. There were no stock appreciation rights or incentive stock options granted in the twelve months ended December 31, 2006 and 2005. The Company repurchases and retires its common stock in accordance with Board of Directors approved share repurchase programs. At December 31, 2006, 1.4 million shares remained available to repurchase under such plans.

Shareholders have authorized two additional classes of stock of one million shares each, to be denominated Class B Common Stock and Preferred Stock, respectively, in addition to the 150 million shares of common stock presently authorized. At December 31, 2006, no shares of Class B Common Stock or Preferred Stock had been issued.

In December 1986, the Company declared a dividend distribution of one common share purchase right (the Right) for each outstanding share of common stock. The Rights, which have been amended and restated in 1989, 1992, 1995, 1999 and 2004, are exercisable only in the event of an acquisition of, or announcement of a tender offer to acquire, 10 percent or more of the Company s stock without the prior consent of the Board of Directors. If the Rights become exercisable, the holder may purchase one share of the Company s common stock for $110.00, subject to adjustment. In the event a person or a group has acquired, or obtained the right to acquire, beneficial ownership of securities having 10 percent or more of the voting power of all outstanding voting power of the Company, proper provision shall be made so that each holder of a Right will, for a 60-day period thereafter, have the right to receive upon exercise that number of shares of common stock having a market value of two times the exercise price of the Right, to the extent available, and then a common stock equivalent having a market value of two times the exercise price of the Right. Under certain circumstances, the Rights may be redeemed by the Company at $.001 per Right prior to becoming exercisable and in certain circumstances thereafter. The Rights will expire on the earliest of (i) December 31, 2009, (ii) consummation of a merger transaction meeting certain characteristics or (iii) redemption of the Rights by the Company.

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Note 10: Risk-Based Capital

The Company and the Bank are subject to various regulatory capital adequacy requirements administered by federal and state agencies. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required that regulatory agencies adopt regulations defining five capital tiers for banks: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Failure to meet minimum capital requirements can initiate discretionary actions by regulators that, if undertaken, could have a direct, material effect on the Company s financial statements. Quantitative measures, established by the regulators to ensure capital adequacy, require that the Company and the Bank maintain minimum ratios of capital to risk-weighted assets. There are two categories of capital under the guidelines. Tier 1 capital includes common shareholders equity and qualifying preferred stock less goodwill and other deductions including the unrealized net gains and losses, after taxes, of available for sale securities. Tier 2 capital includes preferred stock not qualifying for Tier 1 capital, mandatory convertible debt, subordinated debt, certain unsecured senior debt issued by the Company and the allowance for loan losses, subject to limitations within the guidelines. Under the guidelines, capital is compared to the relative risk of the balance sheet, derived from applying one of four risk weights (0%, 20%, 50% and 100%) to various categories of balance sheet assets and unfunded commitments to extend credit, primarily based on the credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

As of December 31, 2006, the Company and the Bank met all capital adequacy requirements to which they are subject.

The most recent notification from the Federal Reserve Board categorized the Company and the Bank as well capitalized under the FDICIA regulatory framework for prompt corrective action. To be well capitalized, the institution must maintain a total risk-based capital ratio as set forth in the following table and not be subject to a capital directive order. Since that notification, there are no conditions or events that Management believes have changed the risk-based capital category of the Company or the Bank.

The following table shows capital ratios for the Company and the Bank:

December 31, 2006			For Capital Adequacy Purposes		To Be Well Capitalized Under the FDICIA Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
Total Capital (to risk-weighted assets)						
Consolidated Company	$339,114	11.09%	$244,564	8.00%	$305,705	10.00%
Westamerica Bank	341,687	11.34%	241,040	8.00%	301,301	10.00%
Tier 1 Capital (to risk-weighted assets)						
	298,576	9.77%	122,282	4.00%	183,423	6.00%

Consolidated Company						
Westamerica Bank	297,700	9.88%	120,520	4.00%	180,780	6.00%
Leverage Ratio *						
Consolidated Company	298,576	6.42%	185,996	4.00%	232,495	5.00%
Westamerica Bank	297,700	6.46%	184,309	4.00%	230,386	5.00%

December 31, 2005	Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To Be Well Capitalized Under the FDICIA Prompt Corrective Action Provisions Amount	Ratio
	(Dollars in thousands)					
Total Capital (to risk-weighted assets)						
Consolidated Company	$339,881	10.40%	$261,378	8.00%	$326,723	10.00%
Westamerica Bank	351,842	10.88%	258,708	8.00%	323,385	10.00%
Tier 1 Capital (to risk-weighted assets)						
Consolidated Company	296,746	9.08%	130,689	4.00%	196,034	6.00%
Westamerica Bank	305,138	9.44%	129,354	4.00%	194,031	6.00%
Leverage Ratio *						
Consolidated Company	296,746	6.01%	197,640	4.00%	247,050	5.00%
Westamerica Bank	305,138	6.22%	196,368	4.00%	245,460	5.00%

* The leverage ratio consists of Tier 1 capital divided by quarterly average assets excluding certain intangible assets. The minimum leverage ratio guideline is 3.00% for banking organizations that do not

anticipate significant growth and that have well-diversified risk, excellent asset quality, high liquidity, good earnings and, in general, are considered top-rated, strong banking organizations.

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Note 11: Income Taxes

Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the amounts reported in the financial statements of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Amounts for the current year are based upon estimates and assumptions as of the date of these financial statements and could vary significantly from amounts shown on the tax returns as filed.

The components of the net deferred tax asset as of December 31 are as follows:

	2006	2005*
	(In thousands)	
Deferred tax asset		
Allowance for credit losses	$ 24,817	$ 25,033
State franchise taxes	4,591	5,204
Deferred compensation	15,771	16,553
Interest on nonaccrual loans	189	147
Post retirement benefits	1,803	1,443
Other reserves	787	820
Impaired asset writedown	3,019	3,019
Other	1,325	1,401
Subtotal deferred tax asset	52,302	53,620
Valuation allowance	0	0
Total deferred tax asset	52,302	53,620
Deferred tax liability		
Net deferred loan costs	262	195
Fixed assets	217	484
Intangible assets	9,551	11,047
Securities available for sale	1,628	1,365
Leases	403	531
Other	401	417
Total deferred tax liability	12,462	14,039
Net deferred tax asset	$ 39,840	$ 39,581

* Adjusted to adopt Financial Accounting Standard 123

(revised 2004), Share-Based Payment. See Note 9.

Based on Management s judgment, a valuation allowance is not needed to reduce the gross deferred tax asset because it is more likely than not that the gross deferred tax asset will be realized through recoverable taxes or future taxable income. Net deferred tax assets are included with Interest Receivable and Other Assets in the Consolidated Balance Sheets.

The provision for federal and state income taxes consists of amounts currently payable and amounts deferred which, for the years ended December 31, are as follows:

	2006	2005*	2004*
		(In thousands)	
Current income tax expense:			
Federal	$ 24,085	$ 30,888	$ 30,577
State	12,957	13,895	14,645
Total current	37,042	44,783	45,222
Deferred income tax benefit:			
Federal	(1,069)	(4,097)	(7,537)
State	(354)	(1,189)	(1,929)
Total deferred	(1,423)	(5,286)	(9,466)
Provision for income taxes	$ 35,619	$ 39,497	$ 35,756

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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The provision for income taxes differs from the provision computed by applying the statutory federal income tax rate of 35% to income before taxes for the years ended December 31, as follows:

	2006	2005*	2004*
		(In thousands)	
Federal income taxes due at statutory rate	$ 47,049	$ 50,938	$ 45,156
Reductions in income taxes resulting from:			
Interest on state and municipal securities not taxable for federal income tax purposes	(14,422)	(15,282)	(13,981)
State franchise taxes, net of federal income tax benefit	8,192	8,259	8,266
Costs related to acquisitions	0	70	49
Low income housing tax credits	(2,108)	(2,299)	(1,925)
Dividend receivable deduction	(951)	(947)	(923)
Other	(2,141)	(1,242)	(886)
Provision for income taxes	$ 35,619	$ 39,497	$ 35,756

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

At December 31, 2006, the company had no net operating loss and general tax credit carryforwards for tax return purposes.

Note 12: Fair Value of Financial Instruments

The fair values presented represent the Company s best estimate of fair value using the methodologies discussed below. The fair values of financial instruments which have a relatively short period of time between their origination and their expected realization were valued using historical cost. The values assigned do not necessarily represent amounts which ultimately may be realized. In addition, these values do not give effect to discounts to fair value which may occur when financial instruments are sold in larger quantities. Such financial instruments and their estimated fair values at December 31 were:

	2006	2005
	(In thousands)	
Cash and cash equivalents	$ 184,442	$ 209,273
Money market assets	567	534
Interest and taxes receivable	69,036	60,733
Noninterest bearing and interest-bearing transaction and savings deposits	2,794,955	3,100,625

Short-term borrowed funds	731,977	775,173
Interest payable	6,668	4,793

The fair values at December 31 of the following financial instruments were estimated using quoted market prices:

	2006		2005	
	Book Value	Fair Value	Book Value	Fair Value
	(In thousands)			
Investment securities available for sale	$ 615,525	$ 615,525	$ 662,388	$ 662,388
Investment securities held to maturity	1,165,092	1,155,736	1,337,216	1,323,782

Loans were separated into two groups for valuation. Variable rate loans, except for those described below, which reprice frequently with changes in market rates were valued using historical cost. Fixed rate loans and variable rate loans that have reached their maximum contractual interest rates were valued by discounting the future cash flows expected to be received from the loans using current interest rates charged on loans with similar characteristics. Additionally, the allowance for loan losses of $55.3 million in 2006 and $55.8 million in 2005 were applied against the estimated fair values to recognize estimated future defaults of contractual cash flows. The book values and the estimated fair values of loans at December 31 were:

	2006		2005	
	Book Value	Fair Value	Book Value	Fair Value
	(In thousands)			
Loans	$2,476,404	$2,455,393	$2,616,372	$2,597,931

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The fair values of time deposits and notes payable were estimated by discounting future cash flows related to these financial instruments using current market rates for financial instruments with similar characteristics. The book values and the estimated fair values at December 31 were:

	2006		2005	
	Book Value	Fair Value	Book Value	Fair Value
	(In thousands)			
Time deposits	$ 721,779	$ 716,217	$ 745,476	$ 741,127
Senior notes payable	15,000	14,027	18,214	17,089
Subordinated notes	21,920	20,870	22,067	21,485

The majority of the Company s standby letters of credit and other commitments to extend credit carry current market interest rates if converted to loans. No premium or discount was ascribed to these commitments because virtually all funding would be at current market rates.

Note 13: Lease Commitments

Twenty-seven banking offices and a centralized administrative service center are owned and sixty-nine facilities are leased. Substantially all the leases contain multiple renewal options and provisions for rental increases, principally for cost of living index, property taxes and maintenance. The Company also leases certain pieces of equipment.

Minimum future rental payments, net of sublease income, at December 31, 2006, are as follows:

	(In thousands)
2007	$ 6,103
2008	5,659
2009	4,674
2010	4,233
2011	3,704
Thereafter	8,251
Total minimum lease payments	$ 32,624

Total rentals for premises and equipment, net of sublease income, included in noninterest expense were $5.8 million in 2006, $5.1 million in 2005 and $4.8 million in 2004.

Note 14: Commitments and Contingent Liabilities

Loan commitments are agreements to lend to a customer provided there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future funding requirements. Loan commitments are subject to the Company s normal credit policies and collateral requirements. Unfunded loan commitments were $490.8 million and $491.1 million at December 31, 2006 and 2005, respectively. Standby

letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. Standby letters of credit are primarily issued to support customers short-term financing requirements and must meet the Company s normal credit policies and collateral requirements. Standby letters of credit outstanding totaled $20.1 million and $30.1 million at December 31, 2006 and 2005, respectively.

Due to the nature of its business, the Company is subject to various threatened or filed legal cases. Based on the advice of legal counsel, the Company does not expect such cases will have a material, adverse effect on its financial position or results of operations.

Note 15: Retirement Benefit Plans

The Company sponsors a defined contribution Deferred Profit-Sharing Plan covering substantially all of its salaried employees with one or more years of service. Eligible employees become vested in account balances subject to a five-year cliff vesting schedule. Company contributions charged to noninterest expense were $1.1 million in 2006 and $1.6 million in 2005 and 2004.

In addition to the Deferred Profit-Sharing Plan, all salaried employees are eligible to participate in the Tax Deferred Savings/Retirement Plan (ESOP) upon completion of a 90-day introductory period. The Tax Deferred Savings/ Retirement Plan (ESOP) allows employees to defer, on a pretax basis, a portion of their salaries as contributions to this Plan. Participants may invest in several funds, including one fund that invests exclusively in Westamerica Bancorporation common stock. The Company makes matching contributions to employee accounts which vest immediately; such contributions charged to compensation expense were $1.3 million in 2006 and $1.5 million in 2005 and 2004.

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The Company offers a continuation of group insurance coverage to qualifying employees electing early retirement, for the period from the date of retirement until age 65. For eligible employees the Company pays a portion of these early retirees insurance premiums which are determined at their date of retirement. The Company reimburses a portion of Medicare Part B premiums for all qualifying retirees over age 65 and their spouses. Eligibility for post-retirement medical benefits is based on age and years of service, and restricted to employees hired prior to February 1, 2006. The Company uses an actuarial-based accrual method of accounting for post-retirement benefits. The Company uses a September 30 measurement date for determining post-retirement benefit calculations.

The following tables set forth the net periodic post-retirement benefit cost for the years ended December 31 and the funded status of the post-retirement benefit plan and the change in the benefit obligation as of December 31:

Net Periodic Benefit Cost

(In thousands)	2006	2005	2004
Service cost	$ 18	$ 189	$ 190
Interest cost	258	211	196
Amortization of unrecognized transition obligation	61	61	61
Net periodic cost	$ 337	$ 461	$ 447

Other Changes in Benefit Obligations Recognized in Accumulated Other Comprehensive Income	
Unamortized transition obligation, net of tax	394
Total recognized in accumulated other comprehensive income	394
Total recognized in net periodic benefit cost and accumulated other comprehensive income	$ 731

The remaining transition obligation cost for this post-retirement benefit plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $61 thousand.

Obligation and Funded Status

(In thousands)	2006	2005	2004
Change in benefit obligation Benefit obligation at beginning of year	$ 4,297	$ 4,016	$ 3,736
Service cost	18	189	190
Interest cost	258	211	196

Benefits paid	(143)	(119)	(106)
Benefit obligation at end of year	$ 4,430	$ 4,297	$ 4,016
Accumulated post retirement benefit obligation attributable to:			
Retirees	$ 3,233	$ 2,933	$ 2,686
Fully eligible participants	956	1,116	1,067
Other	241	248	263
Total	$ 4,430	$ 4,297	$ 4,016
Fair value of plan assets	$	$	$
Accumulated post retirement benefit obligation in excess of plan assets	$ 4,430	$ 4,297	$ 4,016
Comprised of:			
Unrecognized transition obligation	$ 0	$ 734	$ 795
Recognized post-retirement obligation	4,430	3,563	3,221
Total	$ 4,430	$ 4,297	$ 4,016

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Additional Information
Assumptions

	2006	2005	2004
Weighted-average assumptions used to determine benefit obligations at December 31			
Discount rate	6.00%	5.50%	5.25%
Weighted-average assumptions used to determine net periodic benefit cost at December 31			
December 31	5.50%	5.25%	5.25%

The above discount rate is based on the Corporate Aa 25-year bond rate, the term of which approximates the term of the benefit obligations. The Company reserves the right to terminate or alter post-employment health benefits, which is considered in estimating the increase in the cost of providing such benefits. The assumed annual average rate of inflation used to measure the expected cost of benefits covered by the plan was 6.50 percent for 2007 and beyond.

Assumed benefit inflation rates have a significant effect on the amounts reported for health care plans. A one percentage point change in the assumed benefit inflation rate would have the following effect on 2006 results:

(in thousands)	One Percentage Point Increase	One Percentage Point Decrease
Effect on total service and and interest cost components	$ 178	($149)
Effect on post-retirement benefit obligation	714	(576)

Estimated future benefit payments (in thousands)	
2007	$ 158
2008	171
2009	181
2010	188
2011	192
Years 2012-2016	888

Note 16: Related Party Transactions

Certain directors and executive officers of the Company and/or its subsidiaries were loan customers of the Bank during 2006 and 2005. All such loans were made in the ordinary course of business on normal credit terms, including interest rate and collateral requirements. In the opinion of Management, these credit transactions did not involve, at the time they were contracted, more than the normal risk of collectibility or present other

unfavorable features. The table below reflects information concerning loans to certain directors and executive officers and/or family members during 2006 and 2005:

	2006	2005
	(In thousands)	
At January 1,	$ 1,334	$ 2,332
Originations	36	0
Payoffs/principal payments	(36)	(51)
Other changes*	0	(947)
At December 31,	$ 1,334	$ 1,334
Percent of total loans outstanding	0.05%	0.05%

* Other changes include loans to former directors and executive officers who are no longer related parties.

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Note 17: Regulatory Matters

Payment of dividends to the Company by the Bank is limited under regulations for Federal Reserve member banks. The amount that can be paid in any calendar year, without prior approval from regulatory agencies, cannot exceed the net profits (as defined) for that year plus the net profits of the preceding two calendar years less dividends paid. Under this regulation, Westamerica Bank sought and obtained approval during 2006 to pay to the Company dividends of $108.1 million in excess of net profits as defined. The Company consistently has paid quarterly dividends to its shareholders since its formation in 1972. As of December 31, 2006, $186.4 million was available for payment of dividends by the Company to its shareholders.

The Bank is required to maintain reserves with the Federal Reserve Bank equal to a percentage of its reservable deposits. The Bank s daily average on deposit at the Federal Reserve Bank was $19.2 million in 2006 and $17.5 million in 2005.

Note 18: Other Comprehensive Income

The components of other comprehensive income and other related tax effects were:

		2004	
(in thousands)	Before tax	Tax effect	Net of tax
Securities available for sale:			
Net unrealized losses arising during the year	($11,146)	$ 4,687	($6,459)
Reclassification of gains included in net income	5,011	(2,105)	2,906
Net unrealized losses arising during the year	(6,135)	2,582	(3,553)
Post-retirement benefit obligation	0	0	0
Other comprehensive income	($6,135)	$ 2,582	($3,553)

		2005	
	Before tax	Tax effect	Net of tax
Securities available for sale:			
Net unrealized losses arising during the year	(18,292)	7,692	(10,600)
Reclassification of gains included in net income	4,903	(2,059)	2,844
Net unrealized losses arising during the year	(13,389)	5,633	(7,756)
Post-retirement benefit obligation	0	0	0
Other comprehensive income	($13,389)	$ 5,633	($7,756)

	Before tax	2006 Tax effect	Net of tax
Securities available for sale:			
Net unrealized gains arising during the year	625	(263)	362
Reclassification of gains (losses) included in net income	0	0	0
Net unrealized gains arising during the year	625	(263)	362
Post-retirement benefit obligation	(673)	279	(394)
Other comprehensive income	($48)	$ 16	($32)

Cumulative other comprehensive income balances were:

(in thousands)	Post-retirement Benefit Obligation	Net Unrealized gains(losses) on securities	Cumulative Other Comprehensive Income
Balance, December 31, 2003	$ 0	$ 13,191	$ 13,191
Net change	0	(3,553)	(3,553)
Balance, December 31, 2004	0	9,638	9,638
Net change	0	(7,756)	(7,756)
Balance, December 31, 2005	0	1,882	1,882
Net change	(394)	362	(32)
Balance, December 31, 2006	($394)	$ 2,244	$ 1,850

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Note 19: Westamerica Bancorporation (Parent Company Only)
Statements of Income and Comprehensive Income

For the year ended December 31,	2006	2005*	2004*
		(In thousands)	
Dividends from subsidiaries	$ 112,595	$ 126,464	$ 98,436
Interest income	224	350	394
Other income	5,676	8,379	5,758
Total income	118,495	135,193	104,588
Interest on borrowings	3,191	2,787	1,298
Salaries and benefits	7,917	8,346	9,198
Other expense	2,076	2,815	2,365
Total expenses	13,184	13,948	12,861
Income before taxes and equity in undistributed income of subsidiaries	105,311	121,245	91,727
Income tax benefit	3,795	3,417	3,710
Earnings of subsidiaries less than subsidiary dividends	(10,300)	(18,621)	(2,178)
Net income	$ 98,806	$ 106,041	$ 93,259
Other comprehensive income, net of tax	362	(7,756)	(3,553)
Comprehensive income	$ 99,168	$ 98,285	$ 89,706

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

Balance Sheets

Balances as of December 31,	2006	2005*

		(In thousands)
Assets		
Cash and cash equivalents	$ 2,157	$ 1,196
Money market assets and investment securities available for sale	6,112	7,213
Investment in subsidiaries	451,208	462,608
Premises and equipment, net	11,901	12,185
Accounts receivable from subsidiaries	748	482
Other assets	25,781	24,006
Total assets	$ 497,907	$ 507,690
Liabilities		
Debt financing and notes payable	$ 58,052	$ 40,901
Other liabilities	15,620	31,725
Total liabilities	73,672	72,626
Shareholders equity	424,235	435,064
Total liabilities and shareholders equity	$ 497,907	$ 507,690

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

Statements of Cash Flows

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For the year ended December 31,	2006	2005*	2004*
		(In thousands)	
Operating Activities			
Net income	$ 98,806	$ 106,041	$ 93,259
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	386	351	321
(Increase) decrease in accounts receivable from affiliates	(266)	99	(39)
Increase in other assets	(588)	(1,165)	(1,664)
Stock option expense	2,504	2,394	3,348
Excess tax benefits from stock based compensation	(1,867)	(1,761)	(2,236)
Provision for deferred income tax	3,050	4,902	8,251
Increase (decrease) in other liabilities	947	(109)	2,973
Earnings of subsidiaries less than subsidiary dividends	10,300	18,621	2,178
Gain on sales of real estate	0	(1,331)	0
Net cash provided by operating activities	113,272	128,042	106,391
Investing Activities			
Net cash used in merger and acquisition	0	(54,032)	0
(Purchases) sales of premises and equipment	(103)	(339)	(146)
Net (increase) decrease in short term investments	(34)	15	(4)
Proceeds from sale of real estate	0	1,752	0
Net cash provided (used) by investing activities	(137)	(52,604)	(150)
Financing Activities			
Increase in short-term debt	6,243	14,269	0
Net reductions in notes payable and long-term borrowings	(3,362)	(3,338)	(3,214)
Exercise of stock options/issuance of shares	12,755	9,830	12,572
Excess tax benefits from stock based compensation	1,867	1,761	2,236
Retirement of common stock including repurchases	(88,981)	(95,351)	(55,444)
Dividends	(40,696)	(39,322)	(35,090)
Net cash used in financing activities	(112,174)	(112,151)	(78,940)

Net increase (decrease) in cash and cash equivalents	961	(36,713)	27,301
Cash and cash equivalents at beginning of year	1,196	37,909	10,608
Cash and cash equivalents at end of year	$ 2,157	$ 1,196	$ 37,909
Supplemental disclosure:			
Unrealized gain (loss) on securities available for sale, net	363	($7,756)	($3,553)
Issuance of common stock in connection with acquisitions	0	89,538	0

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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Note 20: Quarterly Financial Information (Unaudited)

For the Quarter Ended	March 31,	June 30,	September 30,	December 31,
	(In thousands, except per share data and price range of common stock)			
2006				
Interest and fee income (FTE)	$ 68,486	$ 67,788	$ 67,186	$ 66,512
Net interest income (FTE)	53,974	51,503	50,198	49,029
Provision for credit losses	150	150	75	70
Noninterest income	13,639	14,061	13,899	13,747
Noninterest expense	25,483	26,345	25,403	24,492
Income before taxes (FTE)	41,980	39,069	38,619	38,214
Net income	26,117	24,494	24,237	23,958
Basic earnings per share	0.82	0.78	0.78	0.78
Diluted earnings per share	0.81	0.77	0.77	0.77
Dividends paid per share	0.32	0.32	0.32	0.34
Price range, common stock	51.38-55.42	47.20-52.89	45.44-51.38	47.96-51.79
2005*				
Interest and fee income (FTE)	$ 63,376	$ 67,769	$ 68,021	$ 68,349
Net interest income (FTE)	55,019	57,023	55,993	55,830
Provision for credit losses	300	300	150	150
Noninterest income	7,195	15,479	17,440	14,427
Noninterest expense	25,863	27,089	27,319	26,980
Income before taxes (FTE)	36,051	45,113	45,964	43,127
Net income	22,310	27,720	28,885	27,124
Basic earnings per share	0.70	0.85	0.89	0.85
Diluted earnings per share	0.68	0.83	0.88	0.83
Dividends paid per share	0.30	0.30	0.30	0.32
Price range, common stock	50.82-58.44	48.48-54.11	49.90-56.25	47.33-55.48
2004*				
Interest and fee income (FTE)	$ 60,120	$ 58,868	$ 59,570	$ 60,542
Net interest income (FTE)	54,605	54,271	54,528	54,589
Provision for credit losses	750	750	600	600
Noninterest income	10,866	11,661	11,788	4,268
Noninterest expense	25,892	25,848	25,182	25,177
	38,829	39,334	40,534	33,080

Income before taxes (FTE)				
Net income	23,788	24,142	24,691	20,638
Basic earnings per share	0.74	0.76	0.78	0.65
Diluted earnings per share	0.73	0.75	0.76	0.64
Dividends paid per share	0.26	0.28	0.28	0.28
Price range, common stock	47.85-51.63	47.58-52.99	49.04-55.80	54.43-61.05

* Adjusted to adopt Financial Accounting Standard 123 (revised 2004), Share-Based Payment. See Note 9.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Westamerica Bancorporation:

We have audited the accompanying consolidated balance sheets of Westamerica Bancorporation and Subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Westamerica Bancorporation and Subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 9 to the consolidated financial statements, the Company adopted FASB Statement No.123(revised 2004), Share Based Payment, in 2006. Also, as discussed in Note 1 to the consolidated financial statements, the Company changed its method of quantifying errors in 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 26, 2007 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

KPMG LLP
San Francisco, California
February 26, 2007

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

The Company s principal executive officer and the person performing the functions of the Company s principal financial officer have evaluated the effectiveness of the Company s disclosure controls and procedures, as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, as of December 31, 2006. Based upon their evaluation, the principal executive officer and principal financial officer concluded that the Company s disclosure controls and procedures are effective. The evaluation did not identify any change in the Company s internal control over financial reporting that occurred during the quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting. Management s Report on Internal Control Over Financial Reporting and the attestation Report of Independent Registered Public Accounting Firm are found on pages 38-39, immediately preceding the financial statements.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information regarding Directors of the Registrant and compliance with Section 16(a) of the Securities Exchange Act of 1934 required by this Item 10 of this Annual Report on Form 10-K is incorporated by reference from the information contained under the captions Board of Directors and Committees , Proposal 1 Election of Directors and Section 16(a) Beneficial Ownership Reporting Compliance in the Company s Proxy Statement for its 2007 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

Executive Officers

The executive officers of the Corporation and Westamerica Bank serve at the pleasure of the Board of Directors and are subject to annual appointment by the Board at its first meeting following the Annual Meeting of Shareholders. It is anticipated that each of the executive officers listed below will be reappointed to serve in such capacities at that meeting.

Name of Executive	Position	Held Since
David L. Payne	Mr. Payne, born in 1955, is the Chairman of the Board, President and Chief Executive Officer of the Corporation. Mr. Payne is President and Chief Executive Officer of Gibson Printing and Publishing Company and Gibson Radio and Publishing Company which are newspaper, commercial printing and real estate investment companies headquartered in Vallejo, California.	1984
John Robert Thorson	Mr. Thorson, born in 1960, is Senior Vice President and Chief Financial Officer for the Corporation. Mr. Thorson joined Westamerica	2005

	Bancorporation in 1989, was Vice President and Manager of Human Resources from 1995 until 2001 and was Senior Vice President and and Treasurer from 2002 until 2005.	
Jennifer J. Finger	Ms. Finger, born in 1954, is Senior Vice President and Treasurer for the Corporation. Ms. Finger joined Westamerica Corporation in 1997, was Senior Vice President and Chief Financial Officer until 2005.	2005
Dennis R. Hansen	Mr. Hansen, born in 1950, is Senior Vice President and manager of the Operations and Systems Administration of Westamerica Bank. Mr. Hansen joined Westamerica Bancorporation in 1978 and was Senior Vice President and Controller for the Corporation until 2005.	2006
Frank R. Zbacnik	Mr. Zbacnik, born in 1947, is Senior Vice President and Chief Credit Administrator of Westamerica Bank. Mr. Zbacnik joined Westamerica Bank in 1984 and was Vice President and Manager of Consumer Credit from 1995 until 2000.	2001

The Company has adopted a Code of Ethics (as defined in Item 406 of Regulation S-K of the Securities Act of 1933) that is applicable to its senior financial officers including its chief executive officer, chief financial officer, and principal accounting officer & controller. This Code of Ethics has been filed as Exhibit 14 to this Annual Report on Form 10-K.

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ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item 11 of this Annual Report on Form 10-K is incorporated by reference from the information contained under the captions Executive Compensation in the Company s Proxy Statement for its 2007 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

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

The information required by this Item 12 of this Annual Report on Form 10-K is incorporated by reference from the information contained under the caption Stock Ownership in the Company s Proxy Statement for its 2007 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

The following table summarizes the status of the Company s equity compensation plans as of December 31, 2006 (in thousands, except exercise price):

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	3,064	$ 41	2,207*
Equity compensation plans not approved by security holders	0	N/A	0
Total	3,064	$ 41	2,207

* The Amended and Restated Stock Option Plan, Article III, provides that the number of shares reserved for Awards under the plan

may increase on the first day of each fiscal year by an amount equal to the least of 1) 2% of the shares outstanding as of the last day of the prior fiscal year, 2) 675,000 shares, or 3) such lesser amount as determined by the Board.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item 13 of this Annual Report on Form 10-K is incorporated by reference from the information contained under the captions Certain Relationships and Related Party Transactions and Board of Directors and Committees in the Company s Proxy Statement for its 2007 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item 14 of this Annual Report on Form 10-K is incorporated by reference from the information contained under the caption Independent Auditors in the Company s Proxy Statement for its 2007 Annual Meeting of Shareholders which will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1. Financial Statements:

See Index to Financial Statements on page 37. The financial statements included in Item 8 are filed as part of this report.

(a) 2. Financial statement schedules required. No financial statement schedules are filed as part of this report since the required information is included in the consolidated financial statements, including the notes thereto, or the circumstances requiring inclusion of such schedules are not present.

(a) 3. Exhibits:

The exhibit list required by this item is incorporated by reference to the Exhibit Index filed with this report.

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SIGNATURES

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

WESTAMERICA BANCORPORATION

/s/ John Robert Thorson

John Robert Thorson
Senior Vice President
and Chief Financial Officer
(Chief Financial and Accounting Officer)
Date: February 26, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

Signature	Title	Date
/s/ David L. Payne	Chairman of the Board and Director	February 26, 2007
David L. Payne	President and Chief Executive Officer (Principal Executive Officer)	
/s/ John Robert Thorson	Senior Vice President and Chief Financial Officer	February 26, 2007
John Robert Thorson	(Principal Financial and Accounting Officer)	
/s/ Etta Allen	Director	February 26, 2007
Etta Allen		
/s/ Louis E. Bartolini	Director	February 26, 2007
Louis E. Bartolini		
/s/ E. Joseph Bowler	Director	February 26, 2007
E. Joseph Bowler		
/s/ Arthur C. Latno, Jr.	Director	February 26, 2007
Arthur C. Latno, Jr.		
/s/ Patrick D. Lynch	Director	

		February 26, 2007
Patrick D. Lynch		
/s/ Catherine C. MacMillan	Director	February 26, 2007
Catherine C. MacMillan		
/s/ Ronald A. Nelson	Director	February 26, 2007
Ronald A. Nelson		
/s/ Edward B. Sylvester	Director	February 26, 2007
Edward B. Sylvester		

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Exhibit Index

Exhibit Number	
3(a)	Restated Articles of Incorporation (composite copy), incorporated by reference to Exhibit 3(a) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 1997, filed with the Securities and Exchange Commission on March 30, 1998.
3(b)	By-laws, as amended (composite copy)
4(a)	Amended and Restated Rights Agreement dated December 31, 2004, incorporated by reference to Exhibit 99 to the Registrant s Form 8-A/A, Amendment No. 4, filed with the Securities and Exchange Commission on December 22, 2004.
10(a)*	Amended and Restated Stock Option Plan of 1995, incorporated by reference to Exhibit A to the Registrant s definitive Proxy Statement pursuant to Regulation 14(a) filed with the Securities and Exchange Commission on March 17, 2003.
10(c)	Note Purchase Agreement by and between Westamerica Bancorporation and The Northwestern Mutual Life Insurance Company dated as of October 30, 2003, pursuant to which registrant issued its 5.31% Senior Notes due October 31, 2013 in the principal amount of $15 million and form of 5.31% Senior Note due October 31, 2013 incorporated by reference to Exhibit 4 of Registrant s Quarterly Report on Form 10-Q for the third quarter ended September 30, 2003, filed with the Securities and Exchange Commission on November 13, 2003.
10(d)*	Westamerica Bancorporation Chief Executive Officer Deferred Compensation Agreement by and between Westamerica Bancorporation and David L. Payne, dated December 18, 1998 incorporated by reference to Exhibit 10(e) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 1999, filed with the Securities and Exchange Commission on March 29, 2000.
10(e)*	Description of Executive Cash Bonus Program incorporated by reference to Exhibit 10(e) to Exhibit 2.1 of Registrant s Form 8-K filed with the Securities and Exchange Commission on March 11, 2005.
10(f)*	Non-Qualified Annuity Performance Agreement with David L. Payne dated November 19, 1997 incorporated by reference to Exhibit 10(f) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the Securities and Exchange Commission on March 15, 2005.
10(g)*	Amended and Restated Westamerica Bancorporation Stock Option Plan of 1995 Nonstatutory Stock Option Agreement Form incorporated by reference

	to Exhibit 10(g) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the Securities and Exchange Commission on March 15, 2005.
10(h)*	Amended and Restated Westamerica Bancorporation Stock Option Plan of 1995 Restricted Performance Share Grant Agreement Form incorporated by reference to Exhibit 10(h) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the Securities and Exchange Commission on March 15, 2005.

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Exhibit Number	
10(i)*	Westamerica Bancorporation and Subsidiaries Deferred Compensation Plan incorporated by reference to Exhibit 10(i) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 10, 2006.
10(j)*	Westamerica Bancorporation Deferral Plan (Adopted October 26, 1995) incorporated by reference to Exhibit 10(i) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 10, 2006.
10(k)*	Form of Restricted Performance Share Deferral Election pursuant to the Westamerica Bancorporation Deferral Plan incorporated by reference to Exhibit 10(i) to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 10, 2006.
11.1	Statement re computation of per share earnings incorporated by reference to Note 1 of the Notes to the Consolidated Financial Statements of this report.
14	Code of Ethics incorporated by reference to Exhibit 14 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003, filed with the Securities and Exchange Commission on March 10, 2004.
21	Subsidiaries of the registrant.
23(a)	Consent of KPMG LLP
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Indicates management contract or compensatory plan or arrangement.

The Company will furnish to shareholders a copy of any exhibit listed above, but not contained herein, upon written request to the Office of the Corporate Secretary A-2M, Westamerica Bancorporation, P.O. Box 1200, Suisun City, California 94585-1200, and payment to the Company of $.25 per page.