

**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 THE FISCAL YEAR ENDED DECEMBER 31, 2013**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM            TO            .**

COMMISSION FILE NUMBER: 0-14549

**UNITED SECURITY BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or Other Jurisdiction  
of Incorporation or Organization)

63-0843362  
(I.R.S. Employer  
Identification No.)

131 West Front Street, Post Office Box 249  
Thomasville, Alabama  
(Address of Principal Executive Offices)

36784  
(Zip Code)

334-636-5424

(Registrant's telephone number, including area code)

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

Title of Each Class

Name of Exchange on Which Registered

Common Stock, par value \$0.01 per share

The NASDAQ Stock Market LLC

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting common equity held by non-affiliates of the registrant as of June 30, 2013, was \$54,790,679.

As of March 14, 2014, the registrant had outstanding 6,043,292 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be held on May 2, 2014, are incorporated by reference into Part III of this Form 10-K.

**United Security Bancshares, Inc.**  
**Annual Report on Form 10-K**  
**for the fiscal year ended**  
**December 31, 2013**

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\* Portions of the definitive proxy statement for the registrant’s 2014 Annual Meeting of Shareholders to be held on May 2, 2014 are incorporated by reference into Part III of this Annual Report on Form 10-K.

## **FORWARD-LOOKING STATEMENTS**

Statements contained in this Annual Report on Form 10-K that are not historical facts are forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995). In addition, United Security Bancshares, Inc. (“USBI”) and its subsidiaries (collectively, the “Company”), through its senior management, from time to time makes forward-looking statements concerning its expected future operations and performance and other developments. The words “estimate,” “project,” “intend,” “anticipate,” “expect,” “believe” and similar expressions are indicative of forward-looking statements. Such forward-looking statements are necessarily estimates reflecting the Company’s best judgment based upon current information and involve a number of risks and uncertainties, and various factors could cause results to differ materially from those contemplated by such forward-looking statements. Such factors could include those identified from time to time in USBI’s Securities and Exchange Commission filings and other public announcements, including the factors described in this Annual Report on Form 10-K for the year ended December 31, 2013. Specifically, with respect to statements relating to loan demand, growth and earnings potential and the adequacy of the allowance for loan losses, these factors include, but are not limited to, the rate of growth (or lack thereof) in the economy, the relative strength and weakness in the consumer and commercial credit sectors and in the real estate markets and collateral values. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to revise forward-looking statements to reflect circumstances or events that occur after the dates the forward-looking statements are made, except as required by law.

In addition, the Company’s business is subject to a number of general and market risks that would affect any forward-looking statements, including the risks discussed under Item 1A herein entitled “Risk Factors.”

## PART I

### Item 1. Business.

United Security Bancshares, Inc. (“USBI”) is a Delaware corporation organized in 1999 as a successor by merger with United Security Bancshares, Inc., an Alabama corporation. USBI is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the “BHCA”), and it operates one banking subsidiary, First United Security Bank (“FUSB” or “the Bank”).

The Bank conducts a general commercial banking business and offers banking services such as the receipt of demand, savings, individual retirement account and time deposits, personal and commercial loans, safe deposit box services and remote deposit capture. The Bank operates and serves its customers through nineteen banking offices located in Brent, Bucksville, Butler, Calera, Centreville, Coffeetown, Columbiana, Fulton, Gilbertown, Grove Hill, Harpersville, Jackson, Thomasville, Tuscaloosa and Woodstock, Alabama. The Bank has two wholly-owned subsidiaries: Acceptance Loan Company, Inc. (“ALC”) and FUSB Reinsurance, Inc. (“FUSB Reinsurance”). USBI, the Bank, ALC, and FUSB Reinsurance may be referred to collectively or in any combination herein as “the Company.”

ALC is an Alabama corporation with approximately 21,000 consumer and real estate loans outstanding. ALC operates and serves its customers through twenty-four offices in Alabama and southeast Mississippi, including the ALC headquarters located in Jackson, Alabama. ALC’s business is generated through referrals from retail businesses, banks and customer mailings. ALC serves customers with a broad range of consumer loan needs. ALC’s lending guidelines are based on an established company policy that is reviewed regularly by its Loan Committee. The lending guidelines include the consideration of collateral (age, type and loan-to-value), loan term, the borrower’s budget (debt-to-income ratio), employment and residence history, credit score and credit history and prior experience with ALC. ALC’s average loan size is approximately \$2,700, with an average term of 24 to 36 months. ALC currently has loans of approximately \$70 million, which carry an average yield of 24.5%. Interest rates charged vary depending on the consideration of certain factors, such as credit score and collateral. Approximately 37% of ALC’s current loan portfolio is secured by real estate and single family residence loans, with the remaining portion of the portfolio secured by various other types of collateral, depending on the type of loan being secured. As a result of the continued weakness in the real estate market, ALC suspended making new real estate loans in May 2012.

FUSB Reinsurance is an Arizona corporation that underwrites credit life and credit accident and health insurance policies sold to the Bank’s and ALC’s consumer loan customers. FUSB Reinsurance is responsible for the first level of risk on these policies up to a specified maximum amount, and a primary third-party insurer retains the remaining risk. A third-party insurer and/or a third-party administrator are responsible for performing most of the administrative functions of FUSB Reinsurance on a contract basis.

### Employees

USBI has no employees, other than the executive officers discussed in the information incorporated by reference in Part III, Item 10 of this report. As of December 31, 2013, the Bank had 181 full-time equivalent employees, and ALC had 105 full-time equivalent employees. FUSB Reinsurance has no employees.

### Competition

The Company faces strong competition in making loans, acquiring deposits and attracting customers for investment services. Competition among financial institutions is based upon interest rates offered on deposit accounts, interest rates charged on loans, other credit and service charges relating to loans, the quality and scope of the services rendered, the convenience of banking facilities and, in the case of loans to commercial borrowers, relative lending limits. The Bank competes with numerous other financial services providers (in excess of thirty

in its service area), including commercial banks, online banks, credit unions, finance companies, mutual funds, insurance companies, investment banking companies, brokerage firms and other financial intermediaries operating in Alabama and elsewhere. Many of these competitors, some of which are affiliated with large bank holding companies, have substantially greater resources and lending limits. In addition, many of the Bank's non-bank competitors are not subject to the same extensive federal regulations that govern bank holding companies and federally-insured banks.

The financial services industry is likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries.

## **Supervision and Regulation**

### **General**

The Company and the Bank are each extensively regulated under both federal and state law. These laws restrict permissible activities and investments and require compliance with various consumer protection provisions applicable to lending, deposit, brokerage and fiduciary activities. They also impose capital adequacy requirements and condition the Company's ability to repurchase stock or to receive dividends from the Bank. The Company is also subject to comprehensive examination and supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), and the Bank is also subject to comprehensive examination and supervision by the Alabama State Banking Department and the Federal Deposit Insurance Corporation (the "FDIC"). These regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of the Company and the Bank. This supervisory framework could materially impact the conduct and profitability of the Company's and Bank's activities.

To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the text of the particular statutory and regulatory provisions. Proposals to change the laws and regulations governing the banking industry are frequently raised at both the state and federal level. The likelihood and timing of any changes in these laws and regulations, and the impact such changes may have on the Company and the Bank, are difficult to ascertain. A change in applicable laws and regulations, or in the manner such laws or regulations are interpreted by regulatory agencies or courts, may have a material effect on our business, operations and earnings.

### **Bank Holding Company Act (the "BHCA")**

The Company is registered as a bank holding company and is subject to regulation and supervision by the Federal Reserve. The BHCA requires the Company to secure the prior approval of the Federal Reserve before it owns or controls, directly or indirectly, more than five percent (5%) of the voting shares or substantially all of the assets of any bank or thrift, or merges or consolidates with another bank or thrift holding company. Further, under the BHCA, the activities of the Company and any nonbank subsidiary are limited to: (i) those activities that the Federal Reserve determines to be so closely related to banking as to be a proper incident thereto, and (ii) investments in companies not engaged in activities closely related to banking, subject to quantitative limitations on the value of such investments. Prior approval of the Federal Reserve may be required before engaging in certain activities. In making such determinations, the Federal Reserve is required to weigh the expected benefits to the public, such as greater convenience, increased competition and gains in efficiency, against the possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices.

The BHCA was substantially amended by the Gramm-Leach-Bliley Act (the "GLBA") in 1999, which, among other things, permits a "financial holding company" to engage in a broader range of non-banking activities, and to engage on less restrictive terms in certain activities than were previously permitted. These expanded activities

include securities underwriting and dealing, insurance underwriting and sales, and merchant banking activities. To become a financial holding company, the Company must certify that the Bank is both “well capitalized” and “well managed” (as defined by federal law), and has at least a “satisfactory” Community Reinvestment Act (“CRA”) rating. The GLBA also imposes certain privacy requirements on all financial institutions and their treatment of consumer information. At this time, the Company has not elected to become a financial holding company, as the Company does not engage in any non-banking activities which would require us to be a financial holding company.

There are a number of restrictions imposed on the Company and the Bank by law and regulatory policy that are designed to minimize potential loss to the depositors of the Bank and the Deposit Insurance Fund maintained by the FDIC (as discussed in more detail below) in the event the Bank should become insolvent. For example, under the Dodd-Frank Act (as discussed in more detail below), a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so absent such policy. The Federal Reserve also has the authority under the BHCA to require a bank holding company to terminate any activity or to relinquish control of a non-bank subsidiary upon the Federal Reserve’s determination that such activity or control constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company.

Any capital loan by the Company to the Bank is subordinate in right of payment to deposits and certain other indebtedness of the Bank. In addition, in the event of the Company’s bankruptcy, any commitment by the Company to a federal bank regulatory agency to maintain the capital of the Bank will be assumed by the bankruptcy trustee and entitled to a priority of payment.

The Federal Deposit Insurance Act (“FDIA”) provides that, in the event of the “liquidation or other resolution” of an insured depository institution, the claims of depositors of the institution (including the claims of the FDIC as a subrogee of insured depositors) and certain claims for administrative expenses of the FDIC as a receiver will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the Company, with respect to any extensions of credit they have made to such insured depository institution.

### **Supervision and Regulation of the Bank**

The operations and investments of the Bank are also limited by federal and state statutes and regulations. The Bank is subject to supervision and regulation by the Alabama State Banking Department and the FDIC. The Bank is also subject to various requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types, amount and terms and conditions of loans it may originate, and limits on the types of other activities in which the Bank may engage and the investments it may make.

The Bank is also subject to federal laws that limit the amount of transactions between the Bank and its nonbank affiliates, including the Company. Under these provisions, transactions (such as a loan or investment) by the Bank with nonbank affiliates are generally limited to 10% of the Bank’s capital and surplus for all covered transactions with any one affiliate, or 20% of capital and surplus for all covered transactions with all affiliates. Any extensions of credit to affiliates, with limited exceptions, must be secured by eligible collateral in specified amounts. The Bank is also prohibited from purchasing any “low quality” assets from an affiliate. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) imposed additional requirements on transactions with affiliates, including an expansion of the definition of “covered transactions” and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained.



## **Securities and Exchange Commission**

The Company is also under the jurisdiction of the Securities and Exchange Commission (“SEC”) for matters relating to the offering and sale of its securities and is subject to the SEC’s rules and regulations relating to periodic reporting, reporting to shareholders, proxy solicitations and insider-trading regulations.

## **Monetary Policy**

The earnings of the Company are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The monetary policies of the Federal Reserve have a significant effect upon the operating results of commercial banks such as the Bank. The Federal Reserve has a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States government securities and through its regulation of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member banks’ deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

## **Deposit Insurance**

The Bank’s deposits are insured up to applicable limits by the Deposit Insurance Fund (the “DIF”) of the FDIC. The DIF is the successor to the Bank Insurance Fund and the Savings Association Insurance Fund, which were merged in 2006. Under the FDIC’s risk-based assessment system in effect through March 31, 2011, insured institutions were assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution’s assessment rate depended upon the category to which it is assigned, and certain potential adjustments established by FDIC regulations, with less risky institutions paying lower assessments.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act changed the assessment base for federal deposit insurance from the amount of insured deposits held by the depository institution to the depository institution’s average total consolidated assets during an assessment period less average tangible equity during that assessment period. It also eliminated the ceiling and increased the floor on the size of the DIF. The Dodd-Frank Act established a minimum designated reserve ratio (“DRR”) of 1.35 percent of the estimated insured deposits, required the FDIC to adopt a restoration plan should the reserve ratio fall below 1.35 percent, and provided for dividends to the industry should the reserve ratio exceed 1.50 percent.

On February 7, 2011, the Board of Directors of the FDIC approved a final rule on assessments, dividend assessment base and large bank pricing (the “Final Rule”), which became effective on April 1, 2011. The Final Rule implements the changes to the deposit insurance assessment system mandated by the Dodd-Frank Act, including, among other things, changing the assessment base for insured depository institutions from adjusted domestic deposits to the average consolidated total assets during an assessment period less average tangible equity capital during that assessment period. Tangible equity is defined in the Final Rule as Tier 1 Capital and is calculated monthly, unless, like the Bank, the insured depository institution has less than \$1 billion in assets, in which case the insured depository institution will calculate the Tier 1 Capital on an end-of-quarter basis. Parents or holding companies of other insured depository institutions are required to report separately from their subsidiary depository institutions.

The Final Rule retains the unsecured debt adjustment, which lowers an insured depository institution’s assessment rate for any unsecured debt on its balance sheet. In general, the unsecured debt adjustment in the Final Rule equals the initial base assessment rate plus 40 basis points and is capped at the lesser of 5 basis points or 50 percent of the depository institution’s initial base assessment rate. The Final Rule also contains a brokered deposit adjustment for assessments. The Final Rule provides an exemption to the brokered deposit adjustment to financial institutions that are “well capitalized” and have composite CAMEL ratings of 1 or 2. CAMEL ratings are confidential ratings used by the federal and state regulators for assessing the soundness of financial institutions. These ratings range from 1 to 5, with a rating of 1 being the highest rating.

The Final Rule also creates a new rate schedule that intends to provide more predictable assessment rates to financial institutions. The revenue under the new rate schedule will be approximately the same. Moreover, it indefinitely suspends the requirement that the FDIC pay dividends from the DIF when the reserve ratio reaches 1.5 percent of insured deposits, to increase the probability that the reserve ratio in the DIF will reach a sufficient level to withstand a future crisis. In lieu of dividend payments, the FDIC has adopted progressively lower assessment rate schedules that become effective when the reserve ratio exceeds 1.15 percent, 2 percent and 2.5 percent.

The Dodd-Frank Act permanently raised the limit for federal deposit insurance to \$250,000, increased the cash limit of Securities Investor Protection Corporation protection from \$100,000 to \$250,000, and provided temporary unlimited federal deposit insurance for noninterest-bearing demand transaction accounts at all insured depository institutions that expired on December 31, 2012.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. This payment is established quarterly and, for each of the four quarters in calendar year 2013, equaled 0.64 basis points of assessable deposits.

The FDIC has authority to increase insurance assessments. A significant increase in insurance assessments would likely have an adverse effect on our operating expenses and results of operations. Management cannot predict what insurance assessment rates will be in the future.

Deposit insurance may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

### **Dividend Restrictions**

Under applicable Alabama law, the Company is not permitted to pay dividends on its capital stock if, following the payment of the dividend, (1) it would be unable to pay its debts as they become due in the usual course of business or (2) its total assets would be less than the sum of its total liabilities and (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution. Further, it is the policy of the Federal Reserve that bank holding companies should pay dividends only out of current earnings and only if future retained earnings would be consistent with the Company's capital, asset quality and financial condition.

Since it has no significant independent sources of income, the ability of the Company to pay dividends is dependent on its ability to receive dividends from the Bank. Under Alabama law, a state-chartered bank must annually transfer to surplus at least 10% of its "net earnings" (defined as the remainder of all earnings from current operations plus actual recoveries on loans and investments and other assets, less all current operating expenses, actual losses, accrued dividends on preferred stock, and all federal, state and local taxes) until the bank's surplus is at least 20% of its capital. Until the bank's surplus reaches this level, a bank may not declare a dividend in excess of 90% of its net earnings. Once a bank's surplus equals or exceeds 20% of its capital, if the total of all dividends declared by the bank in a calendar year will exceed the sum of its net earnings for that year and its retained net earnings for the preceding two years (less any required transfers to surplus), then the bank must obtain prior written approval from the Superintendent of the Alabama State Banking Department. The Bank may not pay any dividends or make any withdrawals or transfers from surplus without the prior written approval of the Superintendent. The FDIC prohibits payment of cash dividends if, as a result, the institution would be undercapitalized or the Bank is in default with respect to any assessment due to the FDIC, including a deposit insurance assessment. These restrictions could materially influence the Company's and the Bank's ability to pay dividends.



## Capital Adequacy Guidelines

In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation (“Basel III”). Basel III requires bank holding companies and their bank subsidiaries to maintain a higher level of capital than previously required, with a greater emphasis on common equity. The Dodd-Frank Act adopted the Basel III capital framework for the United States financial system and mandated that the federal bank regulatory agencies adopt rules and regulations to implement the Basel III requirements.

Among other things, the Dodd-Frank Act requires the Federal Reserve to apply consolidated capital requirements to a bank holding company that are no less stringent than those currently applied to depository institutions. In July 2013, the federal banking agencies, including the Federal Reserve and the FDIC, adopted a final rule (the “Basel III Final Rule”) implementing these standards. Under the Basel III Final Rule, trust preferred securities are excluded from Tier I capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than \$15 billion in assets, subject to certain limits. The Dodd-Frank Act additionally requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness. Under the Basel III Final Rule, which implements this requirement, the Bank must maintain a capital conservation buffer consisting of additional common equity Tier 1 capital equal to 2.5% of risk-weighted assets above each of the required minimum capital levels in order to avoid limitations on paying dividends, engaging in share repurchases and paying certain discretionary bonuses. This new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019.

The Federal Reserve and the FDIC have promulgated substantially similar risk-based capital guidelines applicable to the banking organizations they supervise. These guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks, to account for off-balance sheet exposures, and to minimize disincentives for holding liquid assets. Under those guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items.

Bank assets are given risk-weights of 0%, 20%, 50% or 100%. In addition, certain off-balance sheet items are assigned certain credit conversion factors to convert them to asset equivalent amounts to which an appropriate risk-weighting will apply. Those computations result in the total risk-weighted assets. Most loans are assigned to the 100% risk category, except for performing first mortgage loans fully secured by residential property, which carry a 50% risk-weighting. Most investment securities (including, primarily, general obligation claims of states or other political subdivisions of the United States) are assigned to the 20% category. Exceptions include municipal or state revenue bonds, which have a 50% risk-weighting, and direct obligations of the U.S. Treasury or obligations backed by the full faith and credit of the U.S. Government, which have a 0% risk-weighting. In converting off-balance sheet items, direct credit substitutes, including general guarantees and standby letters of credit backing financial obligations, are given a 100% risk-weighting. Transaction-related contingencies such as bid bonds, standby letters of credit backing non-financial obligations and undrawn commitments (including commercial credit lines with an initial maturity of more than one year) have a 50% risk-weighting. Short-term commercial letters of credit have a 20% risk-weighting, and certain short-term unconditionally cancelable commitments have a 0% risk-weighting.

Under the Basel III Final Rule, beginning on January 1, 2015, the minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) will be 8%. The required ratio of “Tier 1 Capital” (consisting generally of shareholders’ equity and qualifying preferred stock, less certain goodwill items and other intangible assets) to risk-weighted assets is currently 4% but increases to 6% in January 2015. While there is currently no required ratio of “Common Equity Tier 1 Capital” (which generally consists of common stock, retained earnings, certain qualifying capital instruments issued by consolidated subsidiaries, and AOCI, subject to certain adjustments) to risk-weighted assets, a required minimum

ratio of 4.5% takes effect in January 2015 as well. The remainder of total capital, or “Tier 2 Capital,” may consist of (a) the allowance for loan losses of up to 1.25% of risk-weighted assets, (b) preferred stock not qualifying as Tier 1 Capital, (c) hybrid capital instruments, (d) perpetual debt, (e) mandatory convertible securities and (f) certain subordinated debt and intermediate-term preferred stock up to 50% of Tier 1 Capital. Total Capital is the sum of Tier 1 Capital and Tier 2 Capital (which is included only to the extent of Tier 1 Capital), less reciprocal holdings of other banking organizations’ capital instruments, investments in unconsolidated subsidiaries, and any other deductions as determined by the FDIC. At December 31, 2013, the Company’s and the Bank’s Tier 1 and Total Capital ratios were 17.93% and 19.20%, respectively, for the Company and 18.07% and 19.34%, respectively, for the Bank.

In addition, the Federal Reserve and FDIC have established minimum leverage ratio requirements for banking organizations they supervise, calculated as the ratio of Tier 1 Capital to adjusted average consolidated assets. For banks and bank holding companies that meet certain specified criteria, including having the highest regulatory rating and not experiencing significant growth or expansion, these requirements provide for a minimum leverage ratio of Tier 1 Capital to adjusted average quarterly assets equal to 3%. Other banks and bank holding companies generally are required to maintain a minimum leverage ratio between 4% and 5%. Under the Basel III Final Rule, the required minimum leverage ratio for all banks will be 4%. At December 31, 2013, the Company’s and the Bank’s leverage ratios were 10.88% and 10.97%, respectively.

As an additional means to identify problems in the financial management of depository institutions, the FDIA requires federal bank regulatory agencies to establish certain non-capital safety and soundness standards for institutions for which they are the primary federal regulator. The standards relate generally to operations and management, asset quality, interest rate exposure and executive compensation. The agencies are authorized to take action against institutions that failed to meet such standards.

### **Prompt Corrective Action**

In addition to the required minimum capital levels described above, federal law establishes a system of “prompt corrective actions” that Federal banking agencies are required to take, and certain actions that they have discretion to take, based upon the capital category into which a Federally regulated depository institution falls. Regulations set forth detailed procedures and criteria for implementing prompt corrective action in the case of any institution which is not adequately capitalized. Under the regulations, an institution will be deemed “well capitalized” if its leverage ratio, Common Equity Tier 1 ratio, Tier 1 Capital ratio and Total Risk-Based Capital ratio meet or exceed 5%, 6.5%, 8% and 10%, respectively. An institution will be deemed to be “adequately capitalized” or better if its leverage, Common Equity Tier 1, Tier 1 Capital, and Total Risk-Based Capital ratios meet or exceed the minimum federal regulatory capital requirements, and “undercapitalized” if it fails to meet these minimum capital requirements. An institution is “significantly undercapitalized” if its leverage, Common Equity Tier 1, Tier 1, and Total risk-based capital ratios fall below 3%, 3%, 4% and 6%, respectively, and “critically undercapitalized” if the institution has a ratio of tangible equity to total assets that is equal to or less than 2%.

The prompt corrective action rules require an undercapitalized institution to file a written capital restoration plan, along with a performance guaranty by its holding company or a third party. In addition, an undercapitalized institution becomes subject to certain automatic restrictions, including a prohibition on payment of dividends, a limitation on asset growth and expansion in certain cases, a limitation on the payment of bonuses or raises to senior executive officers, and a prohibition on the payment of certain “management fees” to any “controlling person.” Institutions that are classified as undercapitalized are also subject to certain additional supervisory actions, including: increased reporting burdens and regulatory monitoring; a limitation on the institution’s ability to make acquisitions, open new branch offices, or engage in new lines of business; obligations to raise additional capital; restrictions on transactions with affiliates; and restrictions on interest rates paid by the institution on deposits. In certain cases, bank regulatory agencies may require replacement of senior executive officers or directors, or sale of the institution to a willing purchaser. If an institution is deemed to be “critically undercapitalized” and continues in that category for 90 days, the statute requires, with certain narrowly limited exceptions, that the institution be placed in receivership.

As of December 31, 2013, the Company and the Bank were classified as “well capitalized.” This classification is primarily for the purpose of applying the federal prompt corrective action provisions and is not intended to be and should not be interpreted as a representation of overall financial condition or prospects of the Bank.

### **Community Reinvestment Act**

The CRA requires that banks meet the credit needs of all of their assessment area (as established for these purposes in accordance with applicable regulations based principally on the location of branch offices), including those of low-income areas and borrowers. The CRA also requires the FDIC to assess all financial institutions that it regulates to determine whether these institutions are meeting the credit needs of the communities that they serve. Under the CRA, institutions are assigned a rating of “outstanding,” “satisfactory,” “needs to improve” or “unsatisfactory.” The Bank’s record in meeting the requirements of the CRA is made publicly available and is taken into consideration in connection with any applications with Federal regulators to engage in certain activities, including approval of a branch or other deposit facility, mergers and acquisitions, office relocations, or expansions into non-banking activities. As of December 31, 2013, the bank maintains a “satisfactory” CRA rating.

### **USA Patriot Act**

Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and “know your customer” standards in their dealings with foreign financial institutions and foreign customers. Under the USA PATRIOT Act, financial institutions must establish anti-money laundering programs meeting the minimum standards specified by the Act and implementing regulations. The USA PATRIOT Act also requires the Federal banking regulators to consider the effectiveness of a financial institution’s anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions.

The Bank has implemented the required internal controls to ensure proper compliance with the USA PATRIOT Act.

### **Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) comprehensively revised the laws affecting corporate governance, auditing and accounting, executive compensation and corporate reporting for entities, such as the Company, with equity or debt securities registered under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Among other things, Sarbanes-Oxley and its implementing regulations established new membership requirements and additional responsibilities for the Company’s audit committee, imposed restrictions on the relationship between the Company and its outside auditors (including restrictions on the types of non-audit services our auditors may provide to the Company), imposed additional responsibilities for the Company’s external financial statements on the Company’s chief executive officer and chief financial officer, and expanded the disclosure requirements for the Company’s corporate insiders. The requirements are intended to allow stockholders to more easily and efficiently monitor the performance of companies and directors. The Company and its Board of Directors have, as appropriate, adopted or modified the Company’s policies and practices in order to comply with these regulatory requirements and to enhance the Company’s corporate governance practices.

Pursuant to Sarbanes-Oxley, the Company has adopted a Code of Business Conduct and Ethics applicable to its Board, executives and employees. This Code of Conduct can be found on the Company’s website at <http://www.firstusbank.com> under the tabs “About Us – Investor Relations.”

## **Privacy of Customer Information**

The GLBA and the implementing regulations issued by the various federal regulatory agencies require financial institutions (including banks, insurance agencies and broker/dealers) to adopt policies and procedures regarding the disclosure of nonpublic personal information about their customers with non-affiliated third parties. In general, financial institutions are required to explain to customers their policies and procedures regarding the disclosure of such nonpublic personal information, and, unless otherwise required or permitted by law, financial institutions are prohibited from disclosing such information except as provided in their policies and procedures. Specifically, the GLBA established certain information security guidelines that require each financial institution, under the supervision and ongoing oversight of its Board of Directors or an appropriate committee thereof, to develop, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, to protect against anticipated threats or hazards to the security or integrity of such information and to protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

## **The Consumer Financial Protection Bureau**

The Dodd-Frank Act created the Consumer Financial Protection Bureau (the “CFPB”), which is an independent bureau with broad authority to regulate the consumer finance industry, including regulated financial institutions like the Bank, as well as non-banks and others involved in extending credit to consumers. The CFPB has authority through rulemaking, orders, policy statements, guidance and enforcement actions to administer and enforce federal consumer finance laws, to oversee several entities and market segments not previously under the supervision of a federal regulator, and to impose its own regulations and pursue enforcement actions when it determines that a practice is unfair, deceptive or abusive. Many consumer laws previously enforced by other federal banking agencies are now the CFPB’s responsibility. The federal consumer finance laws and all of the functions and responsibilities associated with them were transferred to the CFPB on July 21, 2011. While the CFPB has the exclusive power to interpret, administer and enforce federal consumer finance laws, the Dodd-Frank Act provides that the FDIC continues to have examination and enforcement powers over the Bank relating to the matters within the jurisdiction of the CFPB because the Bank has less than \$10 billion in assets. The Dodd-Frank Act also gives state attorneys general the ability to enforce federal consumer protection laws.

## **Mortgage Loan Origination**

The Dodd-Frank Act also authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages, including a determination of the borrower’s ability to repay. Under the Dodd-Frank Act and the implementing final rule adopted by the CFPB (the “ATR/QM Rule”), a financial institution may not make a residential mortgage loan to a consumer unless it first makes a “reasonable and good faith determination” that the consumer has a “reasonable ability” to repay the loan. In addition, the ATR/QM Rule limits prepayment penalties and permits borrowers to raise certain defenses to foreclosure if they receive any loan other than a “qualified mortgage” as defined by the CFPB. For this purpose, the ATR/QM Rule defines a “qualified mortgage” to include a loan with a borrower debt-to-income ratio of less than or equal to 43% or, alternatively, a loan eligible for purchase by Fannie Mae or Freddie Mac while they operate under Federal conservatorship or receivership, and loans eligible for insurance or guarantee by the Federal Housing Administration, Veterans Administration or United States Department of Agriculture. Additionally, a qualified mortgage may not: (i) contain excess upfront points and fees; (ii) have a term greater than 30 years; or (iii) include interest-only or negative amortization payments. The ATR/QM Rule specifies the types of income and assets that may be considered in the ability-to-repay determination, the permissible sources for verification and the required methods of calculating the loan’s monthly payments. The ATR/QM Rule became effective January 10, 2014, and the Company continues to evaluate the expected impact of the rule on our mortgage production operations.

In addition, Section 941 of the Dodd-Frank Act amended the Exchange Act to require sponsors of asset-backed securities (ABS) to retain at least 5 percent of the credit risk of the assets underlying the securities and to prohibit

sponsors from transferring or hedging that credit risk. The federal banking agencies, including the Federal Reserve and the FDIC, issued a proposed rule in April 2011 to implement this requirement, followed by a revised notice of proposed rulemaking published in September 2013 (as revised, the “Proposed Risk Retention Rule”). Among other things, the Proposed Risk Retention Rule provides that the securitizer must bear the risk in any securitization transaction, and loan originators are only required to retain risk in limited circumstances and at their option. The Proposed Risk Retention Rule also provides for an exemption to the risk retention requirements for “Qualified Residential Mortgages” (“QRMs”) and ties the definition of QRMs to the definition of “qualified mortgage” established by the CFPB for purposes of evaluating a consumer’s ability to repay a mortgage loan. The federal banking agencies are considering whether to add additional factors to the QRM determination, however, including borrower credit history and a 70 percent loan-to-value (LTV) cap. Finally, the Proposed Risk Retention Rule adopts the “fair value” measurement system for risk retention instruments. The comment period for the Proposed Risk Retention Rule ended on October 30, 2013, and no final rule has yet been issued. The Company continues to monitor the status of this rule and will be able to more effectively determine its impact on the Company’s mortgage origination business when a final rule is issued.

### **Mortgage Loan Servicing**

On January 17, 2013, the CFPB issued a series of final rules as part of an ongoing effort to address mortgage servicing reforms and create uniform standards for the mortgage servicing industry. The rules contain additional requirements for communications with borrowers, address the maintenance of customer account records, govern procedures for responding to written borrower requests and complaints of errors, and provide guidance regarding servicing delinquent loans, foreclosure proceedings and loss mitigation efforts, among other measures. These rules became effective on January 10, 2014 and will likely lead to increased costs to service loans across the mortgage industry. The Company is continuing to evaluate the full impact of these rules and their effect on the servicing of the Company’s mortgage loans.

### **The Volcker Rule**

On December 10, 2013, five federal financial regulatory agencies, including the Federal Reserve and the FDIC, adopted final rules (the “Final Rules”) implementing the so-called “Volcker Rule” embodied in Section 13 of the Bank Holding Company Act, which was added by Section 619 of the Dodd-Frank Act. The Final Rules complete the process begun in October 2011, when the agencies introduced proposed implementing rules for comment. In general, the Final Rules prohibit banking entities from (1) engaging in short-term proprietary trading for their own accounts, and (2) having certain ownership interests in, and relationships with, hedge funds or private equity funds. The Final Rules are intended to provide greater clarity with respect to both the extent of those primary prohibitions and of the related exemptions and exclusions.

The Final Rules also require each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include (for the largest entities) making regular reports about those activities to regulators. Community and small banks, including the Bank, are afforded some relief under the Final Rules. If such banks are engaged only in exempted proprietary trading, such as trading in U.S. government, agency, state and municipal obligations, they are exempt entirely from compliance program requirements. Moreover, even if a community or small bank engages in proprietary trading or covered fund activities under the Final Rules, they need only incorporate references to the Volcker Rule into their existing policies and procedures. The Final Rules are effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2015. Beginning June 30, 2014, banking entities with \$50 billion or more in trading assets and liabilities must report quantitative metrics; on April 30, 2016, banking entities with at least \$25 billion but less than \$50 billion must report; and on December 31, 2016, banking entities with at least \$10 billion but less than \$25 billion must report.

On January 15, 2014, the federal banking agencies issued an interim final rule (the “Interim Rule”) that exempts certain collateralized debt obligations backed by trust-preferred securities, also known as “TruPS



CDOs,” from the broad restrictions of the Final Rules. Specifically, the Interim Rule provides that the covered fund restrictions of the Final Rules are inapplicable to a banking entity’s owning an interest in, or sponsoring, any issuer of TruPS CDOs, provided that: (1) the TruPS CDOs were issued before May 19, 2010, by a holding company with \$15 billion or less in total consolidated assets, and (2) the banking entity acquired the interest in the TruPS CDOs on or before December 10, 2013, or acquired the interest in the course of a merger with or acquisition of a banking entity that itself acquired the interest on or before that date.

The Company is currently evaluating the Final Rules and the Interim Rule, which are lengthy and detailed, but does not at this time expect the Final Rules or Interim Rule to have a material impact on its operations.

### **Other Provisions of the Dodd-Frank Act**

The Dodd-Frank Act, which became law on July 21, 2010, implements far-reaching changes across the financial regulatory landscape. In addition to the reforms and provisions previously mentioned, the Dodd-Frank Act also:

- Requires bank holding companies and banks to be both well-capitalized and well-managed in order to acquire banks located outside their home state and requires any bank holding company electing to be treated as a financial holding company to be both well-managed and well-capitalized;
- Eliminates all remaining restrictions on interstate banking by authorizing national and state banks to establish de novo branches in any state that would permit a bank chartered in that state to open a branch at that location;
- Repeals Regulation Q, the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts;
- Enhances insider transaction limitations by strengthening loan restrictions to insiders and applying the various limits to a greater number of types of transactions, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. The law also restricts certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution’s board of directors; and
- Strengthens the previous limits on a depository institution’s credit exposure to one borrower (whether a person or group of related persons) in an amount exceeding certain thresholds, by expanding the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.

While designed primarily to reform the financial regulatory system, the Dodd-Frank Act also contains a number of corporate governance provisions that will affect public companies with securities registered under the Exchange Act. The Dodd-Frank Act requires the SEC to adopt rules that may affect the Company’s executive compensation policies and disclosure. It also exempts “smaller reporting companies,” like USBI, from the requirement, originally enacted under Section 404(b) of the Sarbanes-Oxley Act of 2002, that the company’s independent auditor also attest to and report on management’s assessment of internal control over financial reporting.

Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, many of the new requirements called for have yet to be implemented and will likely be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various agencies, the full extent of the impact such requirements will have on financial institutions’ operations is unclear. The Dodd-Frank Act could require the Company to make material expenditures, particularly in the form of personnel training costs and additional compliance expenses, or otherwise adversely affect the Company’s business, financial condition,



results of operations or cash flow. It could also require the Company to change certain of the Company's business practices, adversely affect the Company's ability to pursue business opportunities that the Company might otherwise consider pursuing, cause business disruptions and/or have other impacts that are as of yet unknown to the Company. Failure to comply with these laws or regulations, even if inadvertent, could result in negative publicity, fines or additional expenses, any of which could have an adverse effect on the Company's business, financial condition, results of operations, or cash flow.

### **Federal Home Loan Bank Membership**

The Bank is a member of the Federal Home Loan Bank of Atlanta ("FHLBA"). Each member of the FHLBA is required to maintain a minimum investment in the Class B stock of the FHLBA. The Board of Directors of the FHLBA can increase the minimum investment requirements in the event it has concluded that additional capital is required to allow it to meet its own regulatory capital requirements. Any increase in the minimum investment requirements outside of specified ranges requires the approval of the Federal Housing Finance Agency. Because the extent of any obligation to increase the Bank's investment in the FHLBA depends entirely upon the occurrence of a future event, the Company is unable to determine the extent of future required potential payments to the FHLBA at this time. Additionally, in the event that the Bank fails, the right of the FHLBA to seek repayment of funds loaned to the Bank will take priority (a "super lien") over the claims of all other creditors.

### **Other Laws and Regulations**

The Company and the Bank are subject to a variety of laws and regulations that are not limited to banking organizations. For example, in lending to commercial and consumer borrowers, and in owning and operating its own property, the Bank is subject to regulations and potential liabilities under state and federal environmental laws.

The Company and the Bank are heavily regulated by regulatory agencies at the federal and state levels. Like most of the Company's and the Bank's competitors, the Company and the Bank have faced and expect to continue to face increased regulation and regulatory and political scrutiny, which creates significant uncertainty for the Company and the Bank, as well as the financial services industry in general.

### **Future Legislation and Regulation**

Regulators have increased their focus on the regulation of the financial services industry in recent years. Proposals that could substantially intensify the regulation of the financial services industry have been and are expected to continue to be introduced in the U.S. Congress, in state legislatures and by applicable regulatory authorities. These proposals may change banking statutes and regulation and the Company's operating environment in substantial and unpredictable ways. If enacted, these proposals could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any of these proposals will be enacted and, if enacted, the effect that these proposals, or any implementing regulations, would have on the Company's business, results of operations or financial condition.

### **Website Information**

The Bank's website address is <http://www.firstusbank.com>. USBI does not maintain a separate website. USBI makes available free of charge on the Bank's website, under the tabs "About Us" – "Investor Relations," its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to those reports filed or furnished pursuant to Section 13(a) of the Securities Exchange Act of 1934 ("Exchange Act") as soon as reasonably practicable after such material is electronically filed with the SEC. These reports are also available on the SEC's website, <http://www.sec.gov>. USBI will provide paper copies of

these reports to shareholders free of charge upon written request. USBI is not including the information contained on or available through the Bank's website as a part of, or incorporating such information into, this Annual Report on Form 10-K.

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

*Making or continuing an investment in common stock issued by USBI involves certain risks that you should carefully consider. The risks and uncertainties described below are not the only risks that may have a material adverse effect on the Company. Additional risks and uncertainties also could adversely affect our business and results of operations. If any of the following risks actually occur, our business, financial condition or results of operations could be negatively affected, the market price of your common stock could decline and you could lose all or a part of your investment. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause the Company's actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of USBI.*

#### **Difficult conditions in the financial services markets may materially and adversely affect the business and results of operations of the Company.**

Dramatic declines in the housing market during recent years, along with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions, and, in some cases, to fail. Many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally, and a continuation of these trends could have a material adverse effect on the Company's business and operations. Further negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact the Company's charge-offs and provisions for loan and credit losses. Continuing economic deterioration that affects household and/or corporate incomes could also result in reduced demand for credit or fee-based products and services. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on the Company and others in the financial services industry.

#### **The Company's business activities have been and may continue to be adversely affected by current conditions in the financial markets and economic conditions generally.**

Over the past few years, the capital and credit markets have experienced unprecedented levels of volatility and disruption. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain companies without regard to those companies' underlying financial strength. As a consequence of the recession from which the United States is currently emerging, business activities across a wide range of industries continue to face serious difficulties due to a lack of consumer spending and liquidity in the global credit markets. Unemployment has also significantly impeded the economic recovery. A sustained weakness or weakening in business and economic conditions generally or specifically in the principal markets in which the Company does business could have one or more of the following adverse effects on the Company's business:

- A decrease in the demand for loans and other products and services offered by the Company;
- A decrease in the value of the Company's loans held for sale or other assets secured by consumer or commercial real estate;
- An impairment of certain intangible assets, such as goodwill;

- An increase in the number of clients and counterparties who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to the Company. An increase in the number of delinquencies, bankruptcies or defaults could result in a higher level of nonperforming assets, net charge-offs, provision for loan losses and valuation adjustments on loans held for sale.

Overall, for the past few years, the general business environment has had an adverse effect on the Company's business, and there can be no assurance that the economy will recover in the near term. Until conditions improve, the Company's business, financial condition and results of operations could be adversely affected by external economic forces.

**Any litigation, regulatory investigations, proceedings, inquiries or changes could have a significant impact on the Company.**

The financial services industry has experienced unprecedented market value declines caused primarily by the current recession and real estate market deterioration. As a result of these adverse market conditions, financial institutions now face a heightened risk of litigation, proceedings, inquiries or regulatory changes. Such actions or changes could result in significant costs and thereby adversely affect the Company's financial condition and results of operations.

**The banking industry is highly competitive, which could result in loss of market share and adversely affect our business.**

The Company encounters strong competition in making loans, acquiring deposits and attracting customers for investment services. The Company competes with commercial banks, online banks, credit unions, finance companies, mutual funds, insurance companies, investment banking companies, brokerage firms and other financial intermediaries operating in Alabama and elsewhere in various segments of the financial services market. Many of these competitors, some of which are affiliated with large bank holding companies, have substantially greater resources and lending limits. In addition, many of the Company's non-bank competitors are not subject to the same extensive federal regulations that govern bank holding companies and federally-insured banks, and, as a result, may be able to offer certain products and services at a lower cost than the Company is able to offer, which could adversely affect the Company's business.

**The Company is subject to extensive governmental regulation, and the costs of complying with such regulation could have an adverse impact on the Company's operations.**

The financial services industry is extensively regulated and supervised under both federal and state laws. We are subject to the regulation and supervision of the Federal Reserve, the FDIC and the Alabama State Banking Department. These regulations are intended primarily to protect depositors, the public and the FDIC insurance funds and are not intended to protect shareholders. Additionally, the Company is subject to regulation, supervision and examination by other regulatory authorities, such as the SEC, the National Association of Securities Dealers, Inc. and state securities and insurance regulators. The Company is subject to changes in federal and state laws, as well as regulations and governmental policies, income tax laws and accounting principles. Regulations affecting banks and other financial institutions are undergoing continuous change, and the ultimate effect of such changes cannot be predicted. Regulations and laws may be modified at any time, and new legislation may be enacted that could affect the Company. The Company cannot assure you that any changes in regulations or new laws will not adversely affect the Company's performance or results of operations. The Company's regulatory position is discussed in greater detail under "Item 1. Business – Supervision and Regulation."

**Governmental responses to recent market disruptions may be inadequate and may have unintended consequences.**

In response to recent market disruptions, legislators and financial regulators have taken a number of steps to stabilize the financial markets. In recent years, these measures have included the enactment and implementation

of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009, the provision of direct and indirect assistance to financial institutions, assistance by the banking regulatory authorities in arranging acquisitions of weakened banks and broker-dealers, implementation of programs by the Federal Reserve to provide liquidity to the commercial paper markets, and the expansion of deposit insurance coverage. More recently, President Obama signed into law the Dodd-Frank Act, which provides for sweeping changes to financial sector regulation and oversight, including new substantive authorities and practices in government regulation and supervision, and a restructuring of the regulatory system, including the creation of new federal agencies, offices, and councils.

Although many of these legislative measures and regulatory efforts have been in place for several years, their aggregate effect on the financial markets remains uncertain. Implementation of the provisions of the Dodd-Frank Act through rulemaking by federal regulatory authorities has resulted in a continuous series of significant changes to the banking industry as a whole, which could adversely affect the Company's business, financial condition, results of operations and prospects.

In addition, the Company competes with a number of financial services companies that are not subject to the same degree of regulatory oversight to which the Company is subject. The impact of the existing regulatory framework and any future changes to it could negatively affect the Company's ability to compete with these institutions, which could have a material and adverse effect on the Company's results of operations and prospects.

**Changes to the deposit insurance assessment regime could increase the cost to the Bank of holding deposits and thereby adversely affect the Company's financial results.**

The Dodd-Frank Act changed the method of calculation for FDIC insurance assessments. Under the previous system, the assessment base was domestic deposits minus certain allowable exclusions, such as pass-through reserve balances. Under the Dodd-Frank Act, assessments for any calculation period are based on the depository institution's average consolidated total assets, less its average amount of tangible equity, during that period. On February 7, 2011, the FDIC approved a final rule to implement these changes. In addition to changing the assessment base, the final rule defines and limits certain assessment adjustments, such as those based on unsecured debt or brokered deposits. It also creates a new base assessment rate schedule in an attempt to provide more predictable assessment rates to insured financial institutions while collecting approximately the same amount of revenue as under the old rate schedule. The FDIC has authority to increase insurance assessments, and any significant increase in insurance assessments would likely have an adverse effect on the Bank and thereby negatively impact the Company's results of operations.

**The cost of complying with the regulations and policies of the Consumer Financial Protection Bureau could adversely affect the Company's business.**

The Dodd-Frank Act created the CFPB, a new regulatory entity with broad powers to supervise and enforce consumer protection laws. The CFPB has extensive rulemaking authority for a wide range of consumer protection laws that apply to banks and other types of lenders, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. It also has examination and enforcement authority over all banks with more than \$10 billion in assets. Institutions with less than \$10 billion in assets, like the Bank, are examined for compliance with consumer laws by their primary bank regulators, but these regulators defer to the CFPB's rules and interpretations in evaluating a bank's compliance with consumer protection laws. Therefore, although the CFPB does not directly supervise the Bank, the actions of the CFPB significantly impact the Bank's operations.

The CFPB has set forth numerous rules and guidance documents since its inception concerning a wide range of consumer protection laws, many of which are directly applicable to the Company's operations. For example, the CFPB recently imposed new requirements regarding the origination and servicing of residential mortgage loans, limitations on the manner in which loan originators may be compensated, mandatory disclosures on documentation given to borrowers, and an obligation on the part of lenders to verify a borrower's "ability to

repay” a residential mortgage loan before extending credit, among others. The CFPB likely will continue to make rules relating to consumer protection, and it is difficult to predict which products and services offered by the Company will be subject to these rules or how these rules will be implemented. However, compliance with CFPB regulations likely will result in additional operating and compliance costs that could have a material adverse effect on the Company’s business, financial condition and results of operations.

**Rapid and significant changes in market interest rates may adversely affect the Company’s performance.**

Most of the Company’s assets and liabilities are monetary in nature and are therefore subject to significant risks from changes in interest rates. The Company’s profitability depends to a large extent on net interest income, and changes in interest rates can impact the Company’s net interest income as well as the valuation of the Company’s assets and liabilities. The Company’s results of operations are affected by changes in interest rates and the Company’s ability to manage interest rate risks. Changes in market interest rates, changes in the relationships between short-term and long-term market interest rates and changes in the relationships between different interest rate indices can affect the interest rates charged on interest-earning assets differently than the interest rates paid on interest-bearing liabilities. These differences could result in an increase in interest expense relative to interest income or a decrease in the Company’s interest rate spread. For a more detailed discussion of these risks and the Company’s management strategies for these risks, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.” The Company’s net interest margin depends on many factors that are partly or completely out of the Company’s control, including competition, federal economic monetary and fiscal policies and general economic conditions. Despite the implementation of strategies to manage interest rate risks, changes in interest rates may have a material adverse impact on the Company’s profitability.

**The performance of the Company’s investment portfolio is subject to fluctuations due to changes in interest rates and market conditions.**

Changes in interest rates can negatively affect the performance of most of the Company’s investments. Interest rate volatility can reduce gains or create losses in the Company’s investment portfolios. Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions and other factors beyond the Company’s control. Fluctuations in interest rates affect returns on, and the market value of, investment securities. The fair market value of the securities in the Company’s portfolio and the investment income from these securities also fluctuate depending on general economic and market conditions. In addition, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. The potential effect of these factors is heightened due to the current conditions in the financial markets and economic conditions generally.

**Changes in the policies of monetary authorities and other government action could adversely affect the Company’s profitability.**

The Company’s results of operations are affected by credit policies of monetary authorities, particularly the Federal Reserve. The instruments of monetary policy employed by the Federal Reserve include open market operations in United States government securities, changes in the discount rate or the federal funds rate on bank borrowings and changes in reserve requirements against bank deposits. In view of changing conditions in the national economy and in the money markets, particularly in light of the continuing threat of terrorist attacks, the current political unrest in the Middle East and Eastern Europe and the volatile conditions in the financial markets and economic conditions generally, the Company cannot predict future changes in interest rates, deposit levels, loan demand or our business and earnings. Furthermore, the actions of the United States government and other governments in responding to such conditions may result in currency fluctuations, exchange controls, market disruption and other adverse effects.



**If loan losses are greater than anticipated, the Company's earnings may be adversely affected.**

As a lender, the Company is exposed to the risk that customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. Credit losses are inherent in the business of making loans and could have a material adverse effect on our operating results. The Company's credit risk with respect to its real estate and construction loan portfolio relates principally to the creditworthiness of individuals and the value of the real estate serving as security for the repayment of loans, and the credit risk with respect to its commercial and consumer loan portfolio relates principally to the general creditworthiness of businesses and individuals within the local markets in which the Company operates. The Company makes various assumptions and judgments about the collectability of its loan portfolio and provides an allowance for potential loan losses based on a number of factors. The Company believes that the allowance for loan losses is adequate. However, if estimates, assumptions or judgments used in calculating this allowance are incorrect, the allowance for loan losses may not be sufficient to cover actual loan losses. The actual amount of future provisions for loan losses cannot be determined at this time and may vary from the amounts of past provisions.

**The Company's profitability and liquidity may be affected by changes in economic conditions in the areas where the Company's operations or loans are concentrated.**

The Company's success depends to a certain extent on the general economic conditions of the geographic markets served by the Bank and its subsidiaries in the states of Alabama and Mississippi. The local economic conditions in these areas have a significant impact on the Company's commercial, real estate and construction loans, the ability of borrowers to repay these loans and the value of the collateral securing these loans. Adverse changes in the economic conditions of the southeastern United States in general or any one or more of these local markets could negatively impact the financial results of the Company's banking operations and have a negative effect on profitability. For example, at present, significant unemployment in the timber industry has caused widespread economic distress in many of the areas served by the Company. A continuation of this trend or similar trends in other portions of the Company's loan portfolio could have a significant negative effect on the profitability of the Company.

**Further disruptions in the residential real estate market could adversely affect the Company's performance.**

Since 2008, the residential real estate market in the United States has experienced a variety of unfavorable economic conditions that have adversely affected the performance and market value of the Company's residential construction and mortgage loans. Across the United States, delinquencies, foreclosures and losses with respect to residential construction and mortgage loans have reached historically high levels and could increase in the future. In addition, housing prices and appraisal values in many markets have not returned to pre-recession levels and are even continuing to decline in some areas. An extended period of flat or declining housing values could result in additional increases in delinquencies and further losses on residential construction and mortgage loans.

**USBI cannot guarantee that it will pay dividends to shareholders in the future.**

Dividends from the Bank are USBI's primary source of funds for the payment of dividends to its shareholders, and there are various legal and regulatory limits regarding the extent to which the Bank may pay dividends or otherwise supply funds to USBI. The ability of the Bank to pay dividends, as well as USBI's ability to pay dividends to its shareholders, will continue to be subject to and limited by the results of operations of the Bank and by certain legal and regulatory restrictions. Further, any lenders making loans to USBI may impose financial covenants that may be more restrictive than the legal and regulatory requirements with respect to the payment of dividends to shareholders. There can be no assurance of whether or when USBI may pay dividends to its shareholders.



**Extreme weather could cause a disruption in the Company's operations, which could have an adverse impact on the Company's profitability.**

Some of the Company's operations are located in areas bordering the Gulf of Mexico, a region that is susceptible to hurricanes and other forms of extreme weather. Such weather events could disrupt the Company's operations and have a material adverse effect on its overall results of operations. Further, a hurricane or other extreme weather event in any of the Company's market areas could adversely impact the ability of borrowers to timely repay their loans and may adversely impact the value of any collateral held by the Company.

**The Company needs to stay current on technological changes in order to compete and meet customer demands.**

The financial services market, including banking services, is undergoing rapid changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and may enable financial institutions to reduce costs. The Company's future success may depend, in part, on its ability to use technology to provide products and services that provide convenience to customers and create additional efficiencies in operations.

**The Company faces security risks with respect to the receipt and storage of personal data about its customers and employees.**

A fundamental requirement for electronic commerce is the secure storage and transmission of personal information about customers and employees. Use of this information is regulated by various privacy and information security laws that are constantly changing. Compliance with these laws and regulations may result in cost increases due to necessary systems changes and the development of new processes. Although the Company has developed systems and processes that are designed to protect consumer information and prevent fraudulent transactions and other security breaches on the Bank's website and otherwise, failure to prevent or mitigate such fraud or breaches, or to discover such fraud or breaches that may go undetected for an extended period of time, may adversely affect the Company's business or results of operations, damage its reputation or subject it to legal or regulatory risk.

**Securities issued by USBI, including its common stock, are not insured.**

Securities issued by USBI, including its common stock, are not savings or deposit accounts or other obligations of any bank and are not insured by the DIF maintained by the FDIC or by any other governmental agency or instrumentality, or any private insurer, and are subject to investment risk, including the possible loss of principal.

**Future issuances of additional securities could result in dilution of your ownership.**

USBI may decide from time to time to issue additional securities in order to raise capital, support growth or fund acquisitions. Further, USBI may issue stock options or other stock grants to retain and motivate employees. Such issuances of securities by USBI would dilute the respective ownership interests of USBI shareholders.

**USBI's common stock price is volatile, which could result in substantial losses for individual shareholders.**

The market price of USBI's common stock has been volatile and likely will continue to be volatile. In particular, USBI's common stock may be subject to significant fluctuations in response to a variety of factors, including, but not limited to:

- general economic and business conditions;
- changing market conditions in the financial services industry;
- monetary and fiscal policies, laws and regulations and other activities of the government, agencies and similar organizations;

- actual or anticipated variations in quarterly operating results;
- failure to meet analyst predictions and projections;
- collectability of loans;
- cost and other effects of legal and administrative cases and proceedings, claims, settlements and judgments;
- additions or departures of key personnel;
- announcements of innovations or new services by the Company or its competitors;
- USBI's future sales of common stock or other securities; and
- other events or factors, many of which are beyond the Company's control.

Due to these factors, you may not be able to sell your stock at or above the price you paid for it, which could result in substantial losses.

**USBI's results of operations depend upon the results of operations of its subsidiaries.**

There are various regulatory restrictions on the ability of USBI's subsidiaries to pay dividends or to make other payments to USBI. In addition, USBI's right to participate in any distribution of assets of any of its subsidiaries upon a subsidiary's liquidation or otherwise will be subject to the prior claims of creditors of that subsidiary.

**The Company's performance and results of operations depend in part upon the soundness of other financial institutions.**

The Company's ability to engage in routine investment and banking transactions, as well as the quality and value of the Company's investments in equity securities and obligations of other financial institutions, could be adversely affected by the actions, financial condition and profitability of such other financial institutions with which the Company transacts, including, without limitation, the FHLBA and the Bank's correspondent banks. Financial services institutions are interrelated as a result of shared credits, trading, clearing, counterparty and other relationships. As a result, defaults by, or even rumors or questions about, one or more financial institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor or counterparty confidence in certain institutions and could lead to losses or defaults by other institutions, and in some cases, failure of such institutions. Any losses, defaults by, or failures of, the institutions with whom the Company transacts could adversely affect the Company's debt and equity holdings in such other institutions, the Bank's participation interests in loans originated by other institutions, and the Company's business, including its liquidity, financial condition and earnings.

**Liquidity risks could affect the Company's operations and jeopardize its financial condition.**

Liquidity is essential to the Company's business. An inability to raise funds through deposits, borrowings, the repayment or sale of loans and other sources could have a substantial negative effect on the Company's liquidity. The Company's funding sources include federal funds, purchased securities sold under repurchase agreements, core and non-core deposits, and short- and long-term debt. The Company maintains a portfolio of securities that can be used as a source of liquidity. There are other sources of liquidity available to the Company or the Bank should they be needed, including the ability to acquire additional non-core deposits. USBI may be able, depending upon market conditions, to issue and sell debt securities, and preferred or common securities in public or private transactions. The Company's access to funding sources in amounts adequate to finance or capitalize the Company's activities or on acceptable terms could be impaired by factors that affect the Company specifically or the financial services industry or economy in general, such as further disruption in the financial markets, negative views and expectations about the prospects for the financial services industry, continued

deterioration in credit markets, or the financial condition, liquidity or profitability of the financial institutions with which the Company transacts.

**The Company is dependent upon the services of its management team and board of directors, and the unexpected loss of key officers or directors may adversely affect the Company's operations.**

A departure of any of the Company's executive officers, other key personnel, or directors could adversely affect the Company's operations. With the exception of James F. House's Amended and Restated Executive Employment Agreement and Thomas S. Elley's Change in Control Agreement, the Company does not have employment agreements or non-competition agreements with any of its executive officers. In the absence of these types of agreements, the Company's executive officers are free to resign their employment at any time and accept an offer of employment from another company, including a competitor. Additionally, the community involvement of the Company's executive officers and directors and the Company's directors' diverse and extensive local business relationships are important to the Company's success. A material change in the composition of the Company's management team or board of directors could cause the Company's business to suffer.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

The Company, through the Bank, owns all of its offices, including its executive offices, without encumbrances, with the exception of the banking office in Columbiana, office space in Pelham and a parking lot in Brent, which are leased. ALC owns a commercial building in Jackson, Alabama, which houses its Jackson branch office, and ALC leases additional office space throughout Alabama and southeast Mississippi. The Company believes that its properties are sufficient for its operations at the current time.

**Item 3. Legal Proceedings.**

On September 27, 2007, Malcomb Graves Automotive, LLC ("Graves Automotive"), Malcomb Graves and Tina Graves filed a lawsuit in the Circuit Court of Shelby County, Alabama against USBI, the Bank, ALC and their respective directors and officers seeking an unspecified amount of compensatory and punitive damages. A former employee of ALC, Corey Mitchell, was named as a co-defendant, and ALC and the Bank filed a crossclaim against him seeking, among other relief, defense and indemnification for any damages suffered in the underlying lawsuit. The underlying complaint alleged that the defendants committed fraud in misrepresenting to Graves Automotive the amounts that Graves Automotive owed on certain loans and failing to credit Graves Automotive properly for certain loans. The defendants moved to compel arbitration, and the trial court denied the defendants' motion. The defendants appealed this decision, and, on September 29, 2010, the Alabama Supreme Court affirmed the trial court's denial of defendants' motion. Following the return of the case to the active docket, on November 30, 2010, ALC and the Bank moved to dismiss the lawsuit. In response to this motion to dismiss, on June 15, 2011, the Circuit Court dismissed all claims against USBI, the Bank and their respective directors and officers and all claims that were brought by Malcomb Graves and Tina Graves in their individual capacities. The Circuit Court also dismissed Graves Automotive's claims for conversion and negligent supervision against ALC and ordered Graves Automotive to re-plead its fraud allegations against ALC with more particularity. On September 15, 2011, Graves Automotive filed a third amended complaint in response to the Circuit Court's June 15, 2011 order. In its third amended complaint, Graves Automotive asserted claims against ALC for breach of contract, fraud, unjust enrichment and conversion. ALC moved to dismiss the third amended complaint on many of the same grounds as set forth in its previous motion to dismiss. On October 13, 2011, the Circuit Court dismissed Graves Automotive's conversion claim and again ordered Graves Automotive to re-plead its fraud claims with more particularity, this time within 60 days. On December 12, 2011, Graves Automotive

filed its fourth amended complaint, this time asserting only two counts, breach of contract and unjust enrichment. Despite removing the fraud claims, the fourth amended complaint still requests punitive damages. On January 11, 2012, ALC filed a motion to dismiss the fourth amended complaint and to strike Graves Automotive's request for punitive damages. This motion was heard on November 27, 2012, and the Circuit Court struck the punitive damages claim but allowed the breach of contract and unjust enrichment claims to go forward. Because Graves Automotive had been unable to produce any documents supporting these remaining claims, on September 30, 2013, the court entered an order requiring Graves Automotive to produce a number of categories of specific documents evidencing the unreimbursed work it had allegedly performed for ALC. After the deadline to produce the documents had passed, ALC filed a Motion to Dismiss for failure to comply with the discovery order or, in the alternative, Motion for Summary Judgment based upon Graves Automotive's inability to produce evidence supporting its claims. In response, Graves recently submitted an affidavit and produced a number of documents purportedly supporting its claims and damages. ALC is currently in the process of supplementing its Motion to Dismiss, or in the Alternative, Motion for Summary Judgment to address Graves Automotive's recent production. This motion is set for hearing on May 20, 2014. ALC also has made a nominal settlement offer to avoid the costs associated with additional litigation. ALC has yet to receive a response to this offer. ALC continues to deny the allegations against it in the lawsuit with respect to the remaining claims and intends to vigorously defend itself in this matter. Given the lack of discovery conducted, it is too early to assess the likelihood of a resolution of the remaining claims in this matter or the possibility of an unfavorable outcome.

On December 2, 2013, Wayne Allen Russell filed a lawsuit against the Bank in the Circuit Court of Tuscaloosa County, alleging that the Bank wrongfully foreclosed on a parcel of property owned by Russell that was subject to a mortgage in favor of the Bank. Mr. Russell alleges that the loan secured by the mortgage had been satisfied in full from the proceeds of a prior foreclosure of additional properties subject to the same mortgage. Mr. Russell seeks an unspecified amount of damages. The Bank denies Mr. Russell's allegations and will vigorously defend the lawsuit. However, given the lack of discovery conducted, it is too early to assess the likelihood of a resolution of this matter or the possibility of an unfavorable outcome.

USBI and its subsidiaries also are parties to other litigation, and the Company intends to vigorously defend itself in all such litigation. In the opinion of the Company, based on review and consultation with legal counsel, the outcome of such other litigation should not have a material adverse effect on the Company's consolidated financial statements or results of operations.

**Item 4. Mine Safety Disclosures.**

Not applicable.

## PART II

### Item 5. Market For Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

USBI’s common stock is listed on the Nasdaq Capital Market under the symbol “USBI.” As of March 14, 2014, USBI had approximately 820 shareholders of record.

The following table sets forth, for the calendar quarter indicated, the high and low sales prices per share for USBI’s common stock as reported on the Nasdaq Capital Market, and the cash dividends declared per share in each such quarter.

|                | High    | Low    | Dividends<br>Declared<br>Per Share |
|----------------|---------|--------|------------------------------------|
| <b>2012</b>    |         |        |                                    |
| First Quarter  | \$ 7.92 | \$3.95 | \$0.00                             |
| Second Quarter | 6.15    | 4.63   | 0.00                               |
| Third Quarter  | 6.49    | 4.81   | 0.00                               |
| Fourth Quarter | 6.22    | 5.00   | 0.00                               |
| <b>2013</b>    |         |        |                                    |
| First Quarter  | \$ 8.26 | \$5.10 | \$0.00                             |
| Second Quarter | 10.40   | 7.40   | 0.00                               |
| Third Quarter  | 10.00   | 7.86   | 0.00                               |
| Fourth Quarter | 8.89    | 7.25   | 0.00                               |

The last reported sales price of USBI’s common stock as reported on the Nasdaq Capital Market on March 14, 2014, was \$7.92.

Dividends are paid at the discretion of USBI’s Board of Directors, based on the Company’s operating performance and financial position, including earnings, capital and liquidity. Dividends from the Bank are USBI’s primary source of funds for the payment of dividends to its shareholders, and there are various legal and regulatory limits regarding the extent to which the Bank may pay dividends or otherwise supply funds to USBI. In addition, federal and state regulatory agencies have the authority to prevent USBI from paying a dividend to its shareholders. USBI can make no assurances that it will be able to or be permitted to pay dividends in the future. See Note 14, “Shareholders’ Equity,” in the “Notes to Consolidated Financial Statements” included in this Annual Report on Form 10-K.

The following table sets forth purchases made by or on behalf of USBI or any “affiliated purchaser,” as defined in Rule 10b-18(a)(3) of the Exchange Act, of shares of USBI’s common stock during the fourth quarter of 2013.

| Period              | Issuer Purchases of Equity Securities     |                                    |  |  |
|---------------------|---|------------------------------------|--|--|
|                     | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced<br>Programs <sup>(1)</sup> | Maximum Number (or<br>Approximate Dollar<br>Value) of Shares that May<br>Yet Be Purchased Under<br>the Programs <sup>(1)</sup> |
| October 1-31, 2013  | 1,550 <sup>(2)</sup>                      | \$8.58                             | 0  | 242,303  |
| November 1-30, 2013 | 0   | —                                  | 0  | 242,303  |
| December 1-31, 2013 | 0   | —                                  | 0  | 242,303  |
| Total               | <u>1,550</u>                              | <u>\$8.58</u>                      | <u>0</u>   | <u>242,303</u>   |

(1) On December 20, 2013, the Board of Directors extended the share repurchase program previously approved by the Board on January 19, 2006. Under the repurchase program, USBI was authorized to repurchase up to 642,785 shares of common stock before December 31, 2014.

(2) Shares were purchased in open-market transactions by an independent trustee for the United Security Bancshares, Inc. Employee Stock Ownership Plan (With 401(k) Provisions).

### Item 6. Selected Financial Data.

As a smaller reporting company, USBI is not required to provide this information.

## **Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation.**

### **Introduction and Overview**

United Security Bancshares, Inc., a Delaware corporation (“USBI”), is a bank holding company with its principal offices in Thomasville, Alabama. USBI operates one commercial banking subsidiary, First United Security Bank (the “Bank” or “FUSB”). As of December 31, 2013, the Bank operated and served its customers through nineteen banking offices located in Brent, Bucksville, Butler, Calera, Centreville, Coffeerville, Columbiana, Fulton, Gilbertown, Grove Hill, Harpersville, Jackson, Thomasville, Tuscaloosa and Woodstock, Alabama.

The Bank owns all of the stock of Acceptance Loan Company, Inc. (“ALC”), an Alabama corporation. ALC is a finance company organized for the purpose of making and purchasing consumer loans. ALC operates twenty-three finance company offices located in Alabama and southeast Mississippi. The headquarters of ALC is located in Jackson, Alabama. The Bank is the funding source for ALC.

The Bank provides a wide range of commercial banking services to small and medium-sized businesses, property managers, business executives, professionals and other individuals, while ALC’s business is consumer oriented.

FUSB Reinsurance, Inc. (“FUSB Reinsurance”), an Arizona corporation and a wholly-owned subsidiary of the Bank, reinsures or “underwrites” credit life and credit accident and health insurance policies sold to the Bank’s and ALC’s consumer loan customers. FUSB Reinsurance is responsible for the first level of risk on these policies up to a specified maximum amount, and a primary third-party insurer retains the remaining risk. The third-party insurer is also responsible for performing most of the administrative functions of FUSB Reinsurance on a contract basis.

Delivery of the best possible financial services to customers remains an overall operational focus of USBI and its subsidiaries (collectively, the “Company”). We recognize that attention to details and responsiveness to customers’ desires are critical to customer satisfaction. The Company continues to upgrade technology, both in its financial services and in the training of its 286 full-time equivalent employees, to ensure customer satisfaction and convenience.

The following discussion and financial information are presented to aid in an understanding of the current consolidated financial position, changes in financial position, results of operations and cash flows of the Company and should be read in conjunction with the Audited Consolidated Financial Statements and Notes thereto included herein. The emphasis of this discussion is on the years 2013 and 2012. All yields presented and discussed herein are based on the accrual basis and not on the tax-equivalent basis, unless otherwise indicated.

### **Forward-Looking Statements**

Statements contained in this Annual Report on Form 10-K that are not historical facts are forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995). In addition, the Company, through its senior management, from time to time makes forward-looking statements concerning its expected future operations and performance and other developments. The words “estimate,” “project,” “intend,” “anticipate,” “expect,” “believe” and similar expressions are indicative of forward-looking statements. Such forward-looking statements are necessarily estimates reflecting the Company’s best judgment based upon current information and involve a number of risks and uncertainties, and various factors could cause results to differ materially from those contemplated by such forward-looking statements. Such factors could include those identified from time to time in USBI’s Securities and Exchange Commission filings and other public announcements, including the factors described in this Annual Report on Form 10-K for the year ended December 31, 2013. Specifically, with respect to statements relating to loan demand, growth and earnings potential and the adequacy of the allowance for loan losses, these factors include, but are not limited to, the rate of growth (or lack thereof) in the economy, the relative



strength and weakness in the consumer and commercial credit sectors and in the real estate markets and collateral values. Readers are cautioned not to place undue reliance on any forward-looking statements made by or on behalf of the Company. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to revise forward-looking statements to reflect circumstances or events that occur after the dates the forward-looking statements are made, except as required by law.

In addition, the Company's business is subject to a number of general and market risks that would affect any forward-looking statements, including the risks discussed under Item 1A herein entitled "Risk Factors."

### **Critical Accounting Estimates**

The preparation of the Company's consolidated financial statements requires management to make subjective judgments associated with estimates. These estimates are necessary to comply with accounting principles generally accepted in the United States of America and general banking practices. These areas include accounting for the allowance for loan losses, other real estate owned and valuation of deferred tax assets.

#### *Allowance for Loan Losses*

The Company maintains the allowance for loan losses at a level deemed adequate by management to absorb probable losses from loans in the portfolio at the balance sheet date. In determining the adequacy of the allowance for loan losses, management considers numerous factors, including, but not limited to, management's estimate of: (a) loan loss experience, (b) the financial condition and liquidity of certain loan customers, and (c) collateral values of property securing certain loans. Because these factors and others involve the use of management's estimation and judgment, the allowance for loan losses is inherently subject to adjustment at future dates. Unfavorable changes in the factors used by management to determine the adequacy of the allowance, including increased loan delinquencies and subsequent charge-offs, or the availability of new information, could require additional provisions, in excess of normal provisions, to the allowance for loan losses in future periods. There can be no assurance that loan losses in future periods will not exceed the allowance for loan losses or that additions to the allowances will not be required.

#### *Other Real Estate Owned*

Other real estate owned ("OREO") consists of properties obtained through foreclosure or in satisfaction of loans, and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired, with any loss at the date of foreclosure recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other non-interest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal are reflected in non-interest expense. Significant judgments are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales and other estimates used to determine the fair value of OREO.

#### *Deferred Tax Asset Valuation*

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more likely than not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of a deferred tax asset is dependent upon the generation of future taxable income during the periods in

which the temporary differences that resulted in the deferred tax asset become deductible. Management's determination of the realization of deferred tax assets is based upon judgments regarding various future events and uncertainties, including the timing and amount of future income earned by subsidiaries and the implementation of various tax planning strategies to maximize realization of the deferred tax asset. Management believes that USBI's subsidiaries will be able to generate sufficient operating earnings to realize the deferred tax assets recorded as of December 31, 2013. However, the amount of deferred tax asset considered realizable could be reduced if estimates of future taxable income are reduced.

#### *Fair Value Measurements*

A portion of the Company's assets and liabilities is carried at fair value, with changes in fair value recorded either in earnings or accumulated other comprehensive income (loss). These include securities available for sale and impaired loans. Additionally, other real estate and certain other assets acquired in foreclosure are reported at the lower of the recorded investment or fair value of the property, less estimated cost to sell. Fair value is generally defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. While management uses judgment when determining the price at which willing market participants would transact when there has been a significant decrease in the volume or level of activity for the asset or liability in relation to "normal" market activity, management's objective is to determine the point within the range of fair value estimates that is most representative of a sale to a third-party investor under current market conditions. The value to the Company if the asset or liability was held to maturity is not included in the fair value estimates.

A fair value measure should reflect the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset and the risk of nonperformance. Fair value is measured based on a variety of inputs that the Company utilizes. Fair value may be based on quoted market prices for identical assets or liabilities traded in active markets (Level 1 valuations). If market prices are not available, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market are used (Level 2 valuations). Where observable market data is not available, the valuation is generated from model-based techniques that use significant assumptions not observable in the market, but observable based on Company-specific data (Level 3 valuations). These unobservable assumptions reflect the Company's own estimates for assumptions that market participants would use in pricing the asset or liability.

#### *Other Significant Accounting Policies*

Other significant accounting policies, not involving the same level of measurable uncertainties as those discussed above, are nevertheless important to an understanding of the consolidated financial statements. Policies related to revenue recognition, investment securities and long-lived assets require difficult judgments on complex matters that are often subject to multiple and recent changes in the authoritative guidance. Certain of these matters are among topics currently under re-examination by accounting standard setters and regulators. Specific conclusions have not been reached by these standard setters, and outcomes cannot be predicted with confidence. Also, see Note 2 to our consolidated financial statements, as it discusses accounting policies that we have selected from acceptable alternatives.

#### **Overview of 2013**

The following discussion should be read in conjunction with our consolidated financial statements, accompanying notes, and other schedules presented herein.

For the year ended December 31, 2013, net income of the Company was \$3.9 million, compared with \$2.2 million for the year ended December 31, 2012. Basic and diluted net income per common share was \$0.65 for the year ended December 31, 2013, compared with \$0.36 for 2012.

Other results for the Company as of and for the year ended December 31, 2013 were as follows:

- Total assets increased 0.5% to \$569.8 million, compared with \$567.1 million as of December 31, 2012.
- Deposits decreased 1.0% to \$484.3 million, compared with \$489.0 million as of December 31, 2012.
- Loans net of unearned interest and fees decreased 13.0% to \$310.3 million, compared with \$356.7 million as of December 31, 2012.
- As of December 31, 2013, the Company's total risk-based capital was 19.20%, significantly above a number of financial institutions in our peer group and well above the minimum requirement of 10%, to achieve the highest regulatory rating of "well-capitalized."
- Net interest income decreased 10.1% to \$30.7 million in 2013, compared with \$34.2 million in 2012.
- Provision for loan losses decreased to a credit of \$0.6 million for the year ended December 31, 2013, compared with a charge of \$4.3 million for the year ended December 31, 2012.
- Non-interest income decreased 12.6% to \$4.9 million in 2013, compared with \$5.6 million in 2012.
- Non-interest expense decreased 5.2% to \$30.8 million in 2013, compared with \$32.5 million in 2012. Impairment of OREO decreased \$2.1 million in 2013, compared to 2012.
- Shareholders' equity totaled \$70.1 million, or book value of \$11.63 per share, as of December 31, 2013, compared with \$68.6 million, or book value of \$11.40 per share, as of December 31, 2012.
- Return on average assets in 2013 was 0.70%, compared with 0.37% in 2012, and return on average shareholders' equity was 5.68% in 2013, compared with 3.27% in 2012.

These items are discussed in further detail throughout this "Management's Discussion and Analysis of Financial Condition and Results of Operations" section.

## Results of Operations

### Summary of Consolidated Operating Results for the Company

|  | Year Ended December 31, |                 |
|--|-------------------------|-----------------|
|  | 2013                    | 2012            |
|  | (Dollars in Thousands)  |                 |
| Interest Income . . . . .  | \$33,636                | \$38,753        |
| Interest Expense . . . . .   | 2,905                   | 4,556           |
| Net Interest Income . . . . .  | 30,731                  | 34,197          |
| Provision (Reduction in Reserve) for Loan Losses . . . . .                           | (642)                   | 4,338           |
| Net Interest Income After Provision (Reduction in Reserve) for Loan Losses . . . . . | 31,373                  | 29,859          |
| Non-Interest Income . . . . .  | 4,865                   | 5,565           |
| Non-Interest Expense . . . . .   | 30,802                  | 32,484          |
| Income Before Income Taxes . . . . .   | 5,436                   | 2,940           |
| Provision for Income Taxes . . . . .   | 1,509                   | 745             |
| Net Income . . . . .   | <u>\$ 3,927</u>         | <u>\$ 2,195</u> |

### Net Interest Income and Margin

Net interest income measures how well management has matched interest-earning assets and interest-bearing liabilities and is the Company's principal source of income. Fluctuations in interest rates materially affect net interest income. Although market rates were relatively stable during 2013, the yield on earning assets

declined by 53 basis points, while the cost of interest-bearing liabilities declined by 29 basis points, as longer-term time deposits repriced at lower rates, decreasing net interest margin by 26 basis points, from 6.21% in 2012 to 5.95% in 2013. The table, “Yields Earned on Average Interest-Earning Assets and Rates Paid on Average Interest-Bearing Liabilities,” summarizes the results of net interest income and net yield on earning-assets, comparing 2013 to 2012.

Net interest income decreased 10.1% to \$30.7 million in 2013, compared to an increase of 3.2% in 2012. The decrease in net interest income in 2013 was primarily due to a decline in interest-earning assets along with a decrease in the yield on earning assets. These decreases were somewhat offset by a decline in the cost of interest-bearing liabilities.

Interest income declined \$5.1 million in 2013; \$4.3 million was the result of decreased interest-earning assets, and \$0.8 million was due to the 53 basis point decline in the yield on interest-earning assets. Interest expense declined \$1.7 million in 2013; \$0.6 million resulted from decreased interest-bearing liabilities, and \$1.1 million was due to the 29 basis point decline in the cost of interest-bearing liabilities.

Overall, volume and yield changes in interest-earning assets and interest-bearing liabilities contributed to the decrease in net interest income during 2013. As to volume, the Company’s average earning assets decreased \$33.5 million during 2013, or 6.1%, while average interest-bearing liabilities decreased \$40.7 million, or 8.8%. The Company’s average loans declined by \$48.6 million, or 12.9%, during 2013, and average investment securities increased by \$12.2 million, or 7.1%. Average borrowings declined \$2.7 million, average time deposits declined \$44.4 million, average savings deposits increased \$1.4 million, and average interest-bearing demand deposits increased \$4.9 million.

Interest margins are affected by several factors, one of which is the relationship of rate-sensitive earning assets to rate-sensitive interest-bearing liabilities. This factor determines the effect that fluctuating interest rates will have on net interest income. Rate-sensitive earning assets and interest-bearing liabilities are those that can be repriced to current market rates within a relatively short time. The Company’s objective in managing interest rate sensitivity is to achieve reasonable stability in the interest margin throughout interest rate cycles by maintaining the proper balance of rate-sensitive assets and interest-bearing liabilities. For further analysis and discussion of interest rate sensitivity, refer to the section entitled “Liquidity and Interest Rate Sensitivity Management.”

The percentage of earning assets funded by interest-bearing liabilities also affects the Company’s interest margin. The Company’s earning assets are funded by interest-bearing liabilities, non-interest-bearing demand deposits and shareholders’ equity. The net return on earning assets funded by non-interest-bearing demand deposits and shareholders’ equity exceeds the net return on earning assets funded by interest-bearing liabilities. The Company’s percentage of earning assets funded by interest-bearing liabilities decreased to 81.8% in 2013, compared with 84.2% in 2012.

The Table, “Changes in Interest Earned and Interest Expense Resulting from Changes in Volume and Changes in Rates,” summarizes the impact of changes in both the volume of interest-earning assets and interest-bearing liabilities, and the average rate earned or incurred on interest-earning assets and interest-bearing liabilities. As indicated by this table, the decrease in net interest income in 2013 is primarily attributable to decreases in the volume of interest-earning assets. One of the major challenges we face at the Bank and ALC is investing in quality interest-earning assets. Average loans have declined over the last two years at the Bank and ALC. Difficult economic conditions and fierce competition among lenders for quality loans will continue to affect our ability to grow loans. Reducing non-performing assets and attracting and retaining quality loan customers at the Bank and ALC remain the primary focus of management.

**Yields Earned on Average Interest-Earning Assets and Rates Paid on Average Interest-Bearing Liabilities**

|  | Year Ended December 31,                    |                 |              |                  |                 |              |
|--|--|-----------------|--------------|------------------|-----------------|--------------|
|  | 2013                                       |                 |              | 2012             |                 |              |
|  | Average Balance                            | Interest        | Yield/Rate % | Average Balance  | Interest        | Yield/Rate % |
|  | (Dollars in Thousands, Except Percentages) |                 |              |                  |                 |              |
| <b>ASSETS</b>                                  |  |                 |              |                  |                 |              |
| Interest-Earning Assets:                       |  |                 |              |                  |                 |              |
| Loans (Note A) . . . . .                       | \$328,085                                  | \$30,394        | 9.26%        | \$376,644        | \$35,373        | 9.39%        |
| Taxable Investments . . . . .                  | 170,309                                    | 2,682           | 1.57%        | 157,457          | 2,801           | 1.78%        |
| Non-Taxable Investments . . . . .              | 14,089                                     | 549             | 3.90%        | 14,716           | 575             | 3.91%        |
| Federal Funds Sold . . . . .                   | 4,411                                      | 11              | 0.25%        | 1,585            | 4               | 0.25%        |
| Total Interest-Earning Assets . . . . .        | <u>516,894</u>                             | <u>33,636</u>   | <u>6.51%</u> | <u>550,402</u>   | <u>38,753</u>   | <u>7.04%</u> |
| Non-Interest-Earning Assets:                   |  |                 |              |                  |                 |              |
| Other Assets . . . . .                         | 44,937                                     |                 |              | 48,595           |                 |              |
| Total . . . . .                                | <u>\$561,831</u>                           |                 |              | <u>\$598,997</u> |                 |              |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>    |  |                 |              |                  |                 |              |
| Interest-Bearing Liabilities:                  |  |                 |              |                  |                 |              |
| Demand Deposits . . . . .                      | \$126,442                                  | \$ 606          | 0.48%        | \$121,498        | \$ 707          | 0.58%        |
| Savings Deposits . . . . .                     | 69,243                                     | 162             | 0.23%        | 67,803           | 223             | 0.33%        |
| Time Deposits . . . . .                        | 224,070                                    | 2,116           | 0.94%        | 268,496          | 3,503           | 1.30%        |
| Borrowings . . . . .                           | 2,876                                      | 21              | 0.73%        | 5,573            | 123             | 2.21%        |
| Total Interest-Bearing Liabilities . . . . .   | <u>422,631</u>                             | <u>2,905</u>    | <u>0.69%</u> | <u>463,370</u>   | <u>4,556</u>    | <u>0.98%</u> |
| Non-Interest-Bearing Liabilities:              |  |                 |              |                  |                 |              |
| Demand Deposits . . . . .                      | 62,838                                     |                 |              | 59,443           |                 |              |
| Other Liabilities . . . . .                    | 7,270                                      |                 |              | 9,127            |                 |              |
| Shareholders' Equity . . . . .                 | 69,092                                     |                 |              | 67,057           |                 |              |
| Total . . . . .                                | <u>\$561,831</u>                           |                 |              | <u>\$598,997</u> |                 |              |
| Net Interest Income (Note B) . . . . .         |  | <u>\$30,731</u> |              |                  | <u>\$34,197</u> |              |
| Net Yield on Interest-Earning Assets . . . . . |  |                 | <u>5.95%</u> |                  |                 | <u>6.21%</u> |

Note A —For the purpose of these computations, non-accruing loans are included in the average loan amounts outstanding. These loans amounted to \$14.8 million and \$22.7 million for 2013 and 2012, respectively.

Note B —Loan fees of \$3.6 million and \$3.7 million for 2013 and 2012, respectively, are included in interest income amounts above.

**Changes in Interest Earned and Interest Expense Resulting from Changes in Volume and Changes in Rates**

The following table sets forth the effect that varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates had on changes in net interest income for 2013 versus 2012 and 2012 versus 2011.

|  | 2013 Compared to 2012<br>Increase (Decrease)<br>Due to Change In: |                 |                  | 2012 Compared to 2011<br>Increase (Decrease)<br>Due to Change In: |                 |                  |
|--|---|-----------------|------------------|---|-----------------|------------------|
|  | Volume  | Average<br>Rate | Net              | Volume  | Average<br>Rate | Net              |
|  | (Dollars in Thousands)  |                 |                  |   |                 |                  |
| Interest Earned On:                                  |   |                 |                  |   |                 |                  |
| Loans . . . . .                                      | \$(4,560)   | \$ (419)        | \$(4,979)        | \$(2,717)   | \$ 1,026        | \$(1,691)        |
| Taxable Investments . . . . .                        | 229   | (348)           | (119)            | 435   | (1,980)         | (1,545)          |
| Non-Taxable Investments . . . . .                    | (25)  | (1)             | (26)             | (347)   | (14)            | (361)            |
| Federal Funds . . . . .                              | 7   | —               | 7                | —   | 4               | 4                |
| Total Interest-Earning Assets . . . . .              | <u>(4,349)</u>  | <u>(768)</u>    | <u>(5,117)</u>   | <u>(2,629)</u>  | <u>(964)</u>    | <u>(3,593)</u>   |
| Interest Expense On:                                 |   |                 |                  |   |                 |                  |
| Demand Deposits . . . . .                            | 29  | (130)           | (101)            | 11  | (318)           | (307)            |
| Savings Deposits . . . . .                           | 5   | (66)            | (61)             | 82  | (210)           | (128)            |
| Time Deposits . . . . .                              | (580)   | (807)           | (1,387)          | (330)   | (1,062)         | (1,392)          |
| Other Borrowings . . . . .                           | (60)  | (42)            | (102)            | (584)   | (51)            | (635)            |
| Total Interest-Bearing Liabilities . . . . .         | <u>(606)</u>  | <u>(1,045)</u>  | <u>(1,651)</u>   | <u>(821)</u>  | <u>(1,641)</u>  | <u>(2,462)</u>   |
| Increase (Decrease) in Net Interest Income . . . . . | <u>\$(3,743)</u>  | <u>\$ 277</u>   | <u>\$(3,466)</u> | <u>\$(1,808)</u>  | <u>\$ 677</u>   | <u>\$(1,131)</u> |

**Provision for Loan Losses**

The provision for loan losses is an expense used to establish the allowance for loan losses. Actual loan losses, net of recoveries, are charged directly to the allowance for loan losses. The expense recorded each year is a reflection of actual net losses experienced during the year and management’s judgment as to the adequacy of the allowance to absorb losses inherent in the portfolio. The provision for loan losses for the Company was a credit of \$0.6 million and a charge of \$4.3 million for the years ended December 31, 2013 and 2012, respectively. The reduction in provision expense resulted from significant recoveries experienced in 2013 related to certain loans that were previously charged off, coupled with an improvement in the credit quality and other inherent risks of the loan portfolio at December 31, 2013.

Net charge-offs for the Company totaled \$9.2 million in 2013, compared with \$7.3 million in 2012. Net charge-offs at the Bank were \$6.6 million in 2013, compared to \$4.2 million in 2012. The increase in net charge-offs from both a Company and Bank perspective resulted primarily from continued economic weakness in the markets in which the Bank operates, particularly with respect to the real estate market. The real estate market continues to adversely impact real estate values and the ability of borrowers to perform, particularly when performance is based on real estate sales. At ALC, net charge-offs totaled \$2.6 million in 2013, a reduction from \$3.1 million in 2012. This decrease resulted from management’s ongoing efforts to shift ALC’s loan portfolio to focus more heavily on consumer loans and less heavily on real estate related loans.

The ratio of the allowance for loan losses to loans, net of unearned income for the Company, decreased to 3.03% as of December 31, 2013, compared with 5.40% as of December 31, 2012. For the Bank, this ratio decreased to 2.62% as of December 31, 2013 from 5.60% as of December 31, 2012. These decreases resulted from continued problem asset resolution by Bank management during 2013, lower levels of non-accrual loans, and a continuing shift in the portfolio away from higher risk real estate loans. At ALC, the ratio decreased to



4.43% as of December 31, 2013 from 4.68% as of December 31, 2012. We believe that growing the loan portfolio at the Bank and ALC with quality customers, along with continued efforts to reduce non-performing loans, should result in continued reduction of the allowance for loan losses as a percentage of loans.

Based on our evaluation of the portfolio, management believes that the allowance for loan losses is adequate to absorb losses inherent in the loan portfolio as of December 31, 2013. While we believe that the methodologies and calculations we use for estimating the allowance for loan losses (which are reviewed from time to time by our regulators) are adequate, our conclusions are based on estimates and judgments and are therefore approximate and imprecise. Factors beyond our control, such as changes in economic conditions impacting the national economy or the local markets in which we operate, may negatively and materially affect asset quality and the adequacy of the allowance for loan losses, as well as the resulting provision for loan losses.

For additional information regarding the Company’s allowance for loan losses, see “Loans and Allowance for Loan Losses.”

### Non-Interest Income

Non-interest income represents fees and income derived from sources other than interest-earning assets. Total non-interest income decreased \$0.7 million, or 12.6%, in 2013 compared to 2012. The following table presents the major components of non-interest income for the years indicated.

|  | <u>2013</u>                   | <u>2012</u>    |
|--|-------------------------------|----------------|
|  | <u>(Dollars in Thousands)</u> |                |
| Service Charges and Other Fees on Deposit Accounts ..... | \$1,720                       | \$2,522        |
| Credit Life Insurance Commissions and Fees .....         | 806                           | 955            |
| Bank-Owned Life Insurance .....                          | 436                           | 461            |
| Other Income .....                                       | <u>1,903</u>                  | <u>1,627</u>   |
| Total Non-Interest Income .....                          | <u>\$4,865</u>                | <u>\$5,565</u> |

#### *Service Charges and Other Fees on Deposit Accounts*

Service charges and fees on deposit accounts decreased \$0.8 million, or 31.8%, in 2013, compared to 2012. The decrease in service charges was due primarily to the reversal of approximately \$0.6 million in service charges that were designated to be refunded to customers in the fourth quarter of 2013 for a product that was discontinued. The discontinued product provided identification theft protection services to Bank customers, and the refunded service charges were initially recorded as non-interest income from the first quarter 2011 through the third quarter 2013. The remaining \$0.2 million reduction in service charges and other fees resulted primarily from reductions in overdraft and non-sufficient funds charges attributable to a changes in regulations that prohibit the Bank from assessing these charges for certain non-recurring electronic transactions. Absent the one-time charge to refund customers that occurred during the fourth quarter of 2013, service charges and fees on deposit accounts generally represent the largest component of non-interest income. Revenues from this source have generally declined in recent years. Management continues to search for new sources of fee income from new financial services and products; however, income from these non-interest sources is expected to continue to decline as a percentage of total revenue for the foreseeable future.

#### *Other Income*

Other income increased approximately \$0.3 million, or 17%, in 2013 compared with 2012. Other income includes fee income generated by the Bank for ancillary services, such as letters of credit, ATMs, debit and credit cards and wire transfers. In addition, other income is generated at ALC for services including ALC’s auto club program and certain real estate rental. The increase in other income was primarily attributable to a non-recurring fee of approximately \$0.5 million received by the Bank in connection with the early payoff of a mortgage-backed

pool in the Company's investment portfolio. This increase was partially offset by a decrease in revenues associated with ALC's auto club program totaling approximately \$0.1 million. Given the nature of these fees, there is uncertainty as to the level of revenue that will be sustained from these sources in the future.

### Non-Interest Expense

Non-interest expense decreased \$1.7 million, or 5.2%, to \$30.8 million in 2013, from \$32.5 million in 2012. The following table presents the major components of non-interest expense for the years indicated.

|   | <u>Year Ended December 31,</u> |                 |
|---|--------------------------------|-----------------|
|   | <u>2013</u>                    | <u>2012</u>     |
|   | (Dollars in Thousands)         |                 |
| Salaries and Employee Benefits .....                | \$16,261                       | \$14,590        |
| Occupancy .....                                     | 1,949                          | 1,899           |
| Furniture and Equipment .....                       | 1,197                          | 1,293           |
| Legal, Accounting and Other Professional Fees ..... | 1,355                          | 1,361           |
| Stationery and Supplies .....                       | 492                            | 510             |
| Telephone/Communication .....                       | 622                            | 631             |
| Advertising .....                                   | 257                            | 307             |
| Collection and Recovery .....                       | 708                            | 499             |
| Other Real Estate/Foreclosure Expense:              |                                |                 |
| Write-downs .....                                   | 2,352                          | 4,866           |
| Carrying Costs .....                                | 769                            | 1,325           |
| Total Other Real Estate/Foreclosure Expense .....   | 3,121                          | 6,191           |
| FDIC Insurance Assessments .....                    | 722                            | 787             |
| Other .....   | 4,118                          | 4,416           |
| Total Non-Interest Expense .....                    | <u>\$30,802</u>                | <u>\$32,484</u> |
| Efficiency Ratio .....                              | 86.5%                          | 81.7%           |
| Total Non-Interest Expense to Average Assets .....  | 5.5%                           | 5.4%            |

#### *Salaries and Employee Benefits*

Salaries and employee benefits expense increased \$1.7 million, or 11.5%, in 2013, compared to an increase of 0.7% in 2012. The increase was primarily due to cost of living adjustments and annual merit increases, salaries paid to new officers hired in 2013, increases in group health insurance expenses, and increases in accruals for incentive payouts. The Company provides employees who meet established employment requirements with a benefits package that includes medical, life and disability insurance plans, as well as an employee stock ownership plan, the United Security Bancshares, Inc. Stock Ownership Plan (With 401(k) Provisions) (the "401(k) Plan"). The Bank's matching contributions to the 401(k) Plan totaled approximately \$0.3 million in both 2013 and 2012. No discretionary match was made by the Bank to the 401(k) Plan in 2013 or 2012. Salaries and employee benefits also includes the accrual for the long-term incentive compensation plan which totaled approximately \$0.3 million in 2013 and \$0.4 million in 2012.

#### *Other Real Estate/Foreclosure Expense*

Other real estate write-downs for the Company decreased \$2.5 million in 2013 compared to 2012, a decline of 51.7%. Other real estate write-downs were \$1.4 million at the Bank and \$0.9 million at ALC in 2013, compared to \$3.6 million at the Bank and \$1.3 million at ALC in 2012. The reduction in impairment at both the Bank and ALC resulted from management's ongoing efforts to sell OREO, along with stabilizing real estate values in certain markets as compared with the prior year.

Cost of carrying other real estate includes costs such as property taxes, maintenance, and security. Carrying costs for the Company decreased \$0.6 million in 2013 compared to 2012, a decline of 42.0%. Carrying costs were \$0.7 million and \$0.1 million at the Bank and ALC, respectively, in 2013, compared with \$1.0 million and \$0.3 million at the Bank and ALC respectively, in 2012. The decrease in carrying costs at both the Bank and ALC resulted from continued efforts to sell OREO properties during 2013. Based on these efforts, the balance of OREO was reduced to \$9.3 million as of December 31, 2013 compared with \$13.3 million as of December 31, 2012.

Although management continues efforts to work through problem assets and sell OREO, there continues to be uncertainty with respect to economic conditions and real estate values in certain of the markets in which both the Bank and ALC operate. If the national or local economy weakens or if real estate values decline further in our primary markets, additional write-downs of existing OREO could be required, and the level of acquisition of properties into OREO could increase, resulting in increased carrying cost.

### **Provision for Income Taxes**

Income tax expense was \$1.5 million in 2013, compared to \$0.7 million in 2012, resulting in an effective tax rate of 27.8% and 25.3%, respectively. The increase in income tax expense resulted primarily from increased pre-tax earnings.

The calculation of the income tax provision requires the use of estimates and judgments by management. As part of the Company's overall business strategy, management must take into account tax laws and regulations that apply to specific tax issues faced by the Company each year. This analysis includes an evaluation of the amount and timing of the realization of income tax assets or liabilities. As of December 31, 2013, the Company reported a net deferred tax asset of \$10.8 million, compared with \$9.5 million as of December 31, 2012.

Management's determination of the realization of the net deferred tax asset is based upon an evaluation of the four possible sources of taxable income: 1) the future reversals of taxable temporary differences; 2) future taxable income, exclusive of reversing temporary differences and carryforwards; 3) taxable income in prior carryback years; and 4) tax-planning strategies. In making a conclusion, management has evaluated the available positive and negative evidence impacting these sources of taxable income. The primary sources of positive and negative evidence impacting taxable income are summarized below:

#### *Positive Evidence*

- History of earnings – The Company has a strong history of generating earnings and has demonstrated positive earnings in 18 of the last 20 years. The Company has a full 20-year carryforward period for federal tax purposes and eight years for the State of Alabama to absorb and use any operating losses triggered as a result of reversing deductible differences, such as loan charge-offs or sales of other real estate.
- Creation of future taxable income – The Company has projected future taxable income that will be sufficient to absorb the remaining deferred tax assets after the reversal of future taxable temporary differences. The taxable income forecasting process utilizes the forecasted pre-tax earnings and adjusts for book-tax differences that will be exempt from taxation, primarily tax-exempt interest income and bank-owned life insurance, as well as temporary book-tax differences, including the allowance for loan losses. The projections relied upon for this process are consistent with those used for the Company's financial forecasting process. Management believes that the projections resulting from the taxable income forecasting process are sound, however; there can be no assurance that such taxable income will be realized due to unanticipated changes in economic and competitive factors.
- Strong capital position – As of December 31, 2013, the Company had a Tier 1 leverage ratio of 10.88%, calculated as a percentage of 2013 average assets, which is substantially above the 5.00%

minimum standard to be considered well capitalized under regulatory guidelines. Also, the total risk-based capital ratio of 19.20% substantially exceeds the 10.00% minimum standard to be considered well capitalized.

- Ability to implement tax-planning strategies – The Company has the ability to implement tax planning strategies to maximize the realization of deferred tax assets, such as the sale of assets. As an example, during the year ended December 31, 2013, the Company’s portfolio of securities available for sale had \$2.4 million of gross unrealized pre-tax gains that could accelerate the recognition of the associated taxable temporary differences, which management would consider to be a tax planning strategy to maximize the realization of the deferred tax assets that may expire unutilized.
- The largest losses experienced were in one type of loan, real estate development. Except in unusual circumstances, the Company no longer invests in these types of loans and is focused on managing this segment of the loan portfolio aggressively. Of the loan loss provision expensed in 2012, 25.0%, or \$1.1 million, was in the loan category of real estate development loans, raw land or residential lots. In 2013, recoveries of previously charged-off amounts in this category, coupled with an improvement in the credit quality and other inherent risks of the loan portfolio at December 31, 2013, resulted in a credit to the loan loss provision.

#### *Negative Evidence*

- Cumulative loss position – As of December 31, 2013, the Company was in a three-year cumulative loss position. Excluding goodwill impairment in 2011, as this item is nondeductible for income tax purposes, the cumulative continuing operations pre-tax loss position for 2011 through 2013 was \$2.6 million. The cumulative loss primarily resulted from the unprecedented provision for loan losses and net recoveries of \$22.5 million during these periods. Based on our current evaluation of the loan portfolio under current economic conditions, management believes that the provision for loan losses will continue to return to more normalized levels in future periods. During 2013, the Company experienced a reduction in the reserve of \$0.6 million, as compared with a provision for loan losses of \$4.3 million and \$18.8 million in 2012 and 2011, respectively.

The Company believes that the positive evidence, when considered in its entirety, outweighs the negative evidence of recent pre-tax losses. See Note 2 “Summary of Significant Accounting Policies” and Note 11 “Income Taxes” to the consolidated financial statements for additional information about income taxes.

#### **Balance Sheet Analysis**

##### **Loans and Allowance for Loan Losses**

Total loans outstanding, net of unearned interest, decreased by \$46.4 million in 2013, with the loan portfolio totaling \$310.3 million as of December 31, 2013. Total loans at the Bank declined 14.9% to \$239.7 million in 2013. Loans at ALC declined 6.0% to \$70.6 million in 2013. For 2013, on an average basis, loans represented 63.5% of the Company’s earning assets and provided 91% of the Company’s interest income. More stringent underwriting standards at the Bank and ALC, and difficult economic conditions, have led to decreased lending activity. Although loan growth is a major focus for management in the coming years, quality loan growth will remain a major challenge.

Real estate loans decreased 14.9% to \$218.2 million in 2013. The Bank’s real estate loan portfolio is comprised of construction loans to both businesses and individuals for commercial and residential development, commercial buildings, both rental property and owner occupied, with most of this activity being commercial. Real estate loans also consist of other loans secured by real estate, such as one-to-four family dwellings, including mobile homes, loans on land only, multi-family dwellings, non-farm, non-residential real estate and home equity loans. Real estate loans at the Bank declined \$31.7 million, or 14.2%, in 2013 to a balance of \$191.6 million as of December 31, 2013. Real estate loans at ALC are primarily secured by residential properties,

mobile homes and land. These loans declined 19.5% to \$26.6 million as of year-end 2013. Real estate loans remain the largest component of the Company's loan portfolio, comprising 69.2% of total loans outstanding, down from 70.9% at year-end 2012. Real estate lending will likely be the largest segment of the Bank's loan portfolio for the foreseeable future. However, management will focus on growing owner-occupied and income-generating commercial real estate loans with decreased reliance on development lending in 2014.

Consumer loans represent the second largest component of the Company's loan portfolio. These loans include loans to individuals for household, family and other personal expenditures, including credit cards and other related credit plans. Consumer loans increased by \$1.9 million at ALC and declined by \$4.6 million at the Bank during 2013. ALC's consumer loans represent 83.2% of the total consumer loans, with a balance at year-end 2013 of \$48.9 million. These loans at the Bank amounted to \$9.9 million as of December 31, 2013. The increase at ALC was the result of a shift of emphasis away from real estate loans to consumer loans. The decline in consumer loans at the Bank resulted from an overall tightening of underwriting standards.

Commercial, financial and agricultural loans decreased by 38.6% during 2013 to \$37.8 million as of December 31, 2013. Loans to tax exempt entities, such as municipalities and counties, increased \$0.3 million in 2013 and increased \$9.2 million in 2012. All other commercial loans declined by \$5.3 million in 2013. All of the commercial loans were originated at the Bank.

The allowance for loan losses is maintained at a level that, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the portfolio and changes in its risk profile, credit concentrations, historical trends and economic conditions. This evaluation also considers the balance of impaired loans. Losses on individually-identified impaired loans may be measured based on the present value of expected future cash flows discounted at each loan's original effective market interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through the provision and added to the allowance for loan losses. Large pools of smaller balance, homogeneous loans are subjected to a collective evaluation for impairment, considering delinquency and repossession statistics, historical charge-off trends, trends in the economy and other factors. Though management believes the allowance for loan losses to be adequate, taking into consideration the views of regulators, the current economic environment and the amount of subjective judgment involved in the calculation, there can be no assurance that the allowance for loan losses is sufficient, and ultimate losses may vary from their estimates. Estimates are reviewed periodically, and, as adjustments become necessary, they are reported in earnings during the periods in which they become known.

The Bank's loan policy requires immediate recognition of a loss if significant doubt exists as to the repayment of the principal balance of a loan. Consumer installment loans at the Bank are generally recognized as losses if they become 90 days delinquent. Consumer installment loans at ALC are generally recognized as losses if they become 120 days delinquent. Exceptions are made specifically for loans that are secured by real estate and if the borrower is in a repayment plan under the bankruptcy statutes. At the time of the plan approval, any amount above the cash flow value of the plan is charged off, and as long as the loans are paying in accordance with the bankruptcy plan, the remainder is not charged off.

A credit review of the Bank's individual loans is conducted periodically. A risk rating is assigned to each loan and is reviewed at least annually. In assigning risk, management takes into consideration the capacity of the borrower to repay, collateral values, current economic conditions and other factors. Management also monitors the credit quality of the loan portfolio through the use of an annual outside comprehensive loan review. Based on the underwriting standards in the loan policy, the Bank does not actively market mortgages to subprime borrowers. However, over time, some of the Bank's customers could migrate into categories that might demonstrate some of the same characteristics as subprime borrowers. With current underwriting standards and ongoing monitoring of credit quality within the portfolio, the volume of such customers is inconsequential.

The Bank utilizes a written loan policy, which guides lending personnel in applying consistent underwriting standards. This policy is intended to aid loan officers and lending personnel in making sound credit decisions and to assure compliance with state and federal regulations. The policy is comprehensive in scope and includes guidance on both desirable and undesirable loans. It includes individual loan officer lending limits as well as documentation requirements for various loan types. The lending function is managed by utilizing various committees, consisting of management and board members. The Executive Loan Committee, made up of senior management, has lending authority up to \$2.0 million. Loan requests exceeding \$2.0 million require approval of the Directors' Loan Committee, made up of four outside directors and the Chief Executive Officer ("CEO"). Loans in excess of \$10.0 million require the approval of the Board of Directors. The Problem Asset Review Committee, composed of the CEO, the Chief Credit Officer ("CCO"), the Executive Vice President ("EVP"), Commercial Division, and the EVP, Retail Division, with attendance of the Vice President, Special Assets Manager, meets monthly to review problem assets. Impaired loans in excess of \$0.5 million are reviewed monthly to assist the CCO in calculating and evaluating the adequacy of the allowance for loan losses. OREO with balances of \$500,000 and over are also reviewed at the monthly meetings, along with non-performing loans \$250,000 and greater. This same committee reviews non-performing loans \$50,000 and over on a quarterly basis.

The Credit Policy Committee, chaired by the CCO, consisting of the CEO, the EVP, Commercial Division, the EVP, Retail Division, and one Senior Lender, meets weekly to review loan downgrades, upgrades, charge-offs, and any loan policy changes.

ALC's management oversees its loan portfolio by establishing credit criteria and underwriting standards through a loan committee comprised of members of ALC's Board of Directors and ALC's district and office managers. This Committee is aided by a formal loan policy, which is reviewed at least annually with revisions made as directed by ALC's Board of Directors and Management. ALC's individual branches are supervised by three district managers who report to the ALC COO. Because of the very nature of ALC's business, many of the borrowers served by ALC could be deemed to demonstrate some of the same characteristics as subprime borrowers. Although the Company believes that serving the communities in which ALC is located includes service to these customers, ALC's management and loan officers remain diligent in making careful loan decisions based on the credit criteria and underwriting standards established by the loan committee.

The following table shows the Company's loan distribution as of December 31, 2013 and 2012.

|   | <b>Year Ended December 31,</b> |                  |
|---|--------------------------------|------------------|
|   | <b>2013</b>                    | <b>2012</b>      |
|   | <b>(Dollars in Thousands)</b>  |                  |
| Real Estate . . . . .                                   | \$218,233                      | \$256,354        |
| Installment (Consumer) . . . . .                        | 59,428                         | 62,521           |
| Commercial, Financial and Agricultural . . . . .        | 37,772                         | 42,903           |
| Less: Unearned Interest, Commissions and Fees . . . . . | (5,110)                        | (5,100)          |
| Total . . . . .   | <u>\$310,323</u>               | <u>\$356,678</u> |



The amounts of total loans (excluding consumer loans) outstanding as of December 31, 2013, which, based on the remaining scheduled repayments of principal, are due in (1) one year or less, (2) more than one year but within five years and (3) more than five years, are shown in the following table.

|  | Maturing               |                                       |                     | Total            |
|--|------------------------|---------------------------------------|---------------------|------------------|
|  | Within<br>One Year     | After One<br>but Within<br>Five Years | After Five<br>Years |                  |
|  | (Dollars in Thousands) |                                       |                     |                  |
| Commercial, Financial and Agricultural ..... | \$ 27,083              | \$ 10,227                             | \$ 462              | \$ 37,772        |
| Real Estate-Mortgage .....                   | 86,689                 | 105,355                               | 26,189              | 218,233          |
| Total .....                                  | <u>\$113,772</u>       | <u>\$115,582</u>                      | <u>\$26,651</u>     | <u>\$256,005</u> |

Variable rate loans totaled approximately \$41.0 million and are included in the one-year category.

### Non-Performing Assets

At ALC, accruing loans past due 90 days or more as of December 31, 2013 increased to \$1.7 million, an increase of \$0.1 million compared to 2012. These loans are closely monitored, and, if any deterioration in the borrowers' ability to pay occurs, they are placed on non-accrual status. There were no accruing loans past 90 days or more as of December 31, 2013 or 2012 at the Bank.

Impaired loans totaled \$32.6 million and \$54.3 million as of December 31, 2013 and 2012, respectively. The decrease in impaired loans as of December 31, 2013 resulted from paydowns of \$8.9 million, charge-offs of \$10.1 million, transfers to OREO or repossessions of \$1.5 million, and upgrades of \$1.0 million. The decline in real estate values from 2007 levels and the severely depressed real estate market have affected the value of the underlying collateral and the borrowers' ability to service the debt on these loans. There was approximately \$3.3 million and \$11.1 million in the allowance for loan losses specifically allocated to these impaired loans as of December 31, 2013 and 2012, respectively. Loans totaling \$18.1 million and \$28.1 million for 2013 and 2012, respectively, although considered impaired under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 310, have no measurable impairment, and no allowance for loan losses is specifically allocated to these loans. The average recorded investment in impaired loans for 2013 and 2012 was approximately \$42.5 million and \$54.2 million, respectively. Income recognized on impaired loans amounted to approximately \$1.6 million in 2013 and \$2.5 million in 2012.

Non-performing assets as a percentage of loans net of unearned interest and other real estate was 6.7% as of December 31, 2013, compared to 10.4% as of December 31, 2012. Non-performing assets decreased \$16.9 million in 2013 compared to 2012, loans on non-accrual decreased \$13.1 million and loans past due 90 days or more and still accruing increased \$0.1 million. Other real estate acquired in settlement of loans consisted of 7 residential properties and 29 commercial properties totaling \$8.5 million at the Bank and 32 residential properties and 14 commercial properties totaling \$0.8 million at ALC. Management is making every effort to dispose of these properties in a timely manner, but the severely depressed real estate market in many of our market areas is negatively impacting this process. Management reviews these loans and reports to the Bank's Board of Directors monthly.

Loans are considered restructured loans if concessions have been granted to borrowers that are experiencing financial difficulty. The concessions granted generally involve the modification of terms of the loan, such as changes in payment schedule or interest rate, which generally would not otherwise be considered. Restructured loans can involve loans remaining on non-accrual, moving to non-accrual or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Non-accrual restructured loans are included and treated with all other non-accrual loans. In addition, all accruing restructured loans are being reported as troubled debt restructurings. Generally, restructured loans remain on non-accrual until the customer has attained

a sustained period of repayment performance under the modified loan terms (generally a minimum of six months). However, performance prior to the restructuring, or significant events that coincide with the restructuring, are considered in assessing whether the borrower can meet the new terms and whether the loan should be returned to or maintained on non-accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan remains on non-accrual. Based on the above, the Company had \$5.7 million and \$12.4 million of non-accruing loans that were restructured and remained on non-accrual status as of December 31, 2013 and 2012, respectively. In addition, the Company had \$2.0 million of restructured loans that were restored to accrual status based on a sustained period of repayment performance as of December 31, 2013, compared to \$0.1 million as of December 31, 2012.

The following table presents information on non-performing loans and real estate acquired in settlement of loans.

|   | <b>Consolidated</b>           |                              |
|---|-------------------------------|------------------------------|
|   | <b>December 31,<br/>2013</b>  | <b>December 31,<br/>2012</b> |
|   | <b>(Dollars in Thousands)</b> |                              |
| <b>Non-Performing Assets:</b>                     |                               |                              |
| Loans Accounted for on a Non-Accrual Basis .....  | \$10,565                      | \$23,618                     |
| Accruing Loans Past Due 90 Days or More .....     | 1,661                         | 1,571                        |
| Real Estate Acquired in Settlement of Loans ..... | 9,310                         | 13,286                       |
| <b>Total</b> .....                                | <u>\$21,536</u>               | <u>\$38,475</u>              |
| <b>Non-Performing Assets as a Percent of Net</b>  |                               |                              |
| Loans and Other Real Estate .....                 | <u>6.74%</u>                  | <u>10.40%</u>                |
|   | <b>FUSB</b>                   |                              |
|   | <b>December 31,<br/>2013</b>  | <b>December 31,<br/>2012</b> |
|   | <b>(Dollars in Thousands)</b> |                              |
| <b>Non-Performing Assets:</b>                     |                               |                              |
| Loans Accounted for on a Non-Accrual Basis .....  | \$10,372                      | \$23,351                     |
| Real Estate Acquired in Settlement of Loans ..... | 8,464                         | 11,089                       |
| <b>Total</b> .....                                | <u>\$18,836</u>               | <u>\$34,440</u>              |
| <b>Non-Performing Assets as a Percent of Net</b>  |                               |                              |
| Loans and Other Real Estate .....                 | <u>7.59%</u>                  | <u>11.77%</u>                |
|   | <b>ALC</b>                    |                              |
|   | <b>December 31,<br/>2013</b>  | <b>December 31,<br/>2012</b> |
|   | <b>(Dollars in Thousands)</b> |                              |
| <b>Non-Performing Assets:</b>                     |                               |                              |
| Loans Accounted for on a Non-Accrual Basis .....  | \$ 193                        | \$ 267                       |
| Accruing Loans Past Due 90 Days or More .....     | 1,661                         | 1,571                        |
| Real Estate Acquired in Settlement of Loans ..... | 846                           | 2,197                        |
| <b>Total</b> .....                                | <u>\$2,700</u>                | <u>\$4,035</u>               |
| <b>Non-Performing Assets as a Percent of Net</b>  |                               |                              |
| Loans and Other Real Estate .....                 | <u>3.78%</u>                  | <u>5.22%</u>                 |

Summarized below is information concerning income on those loans with deferred interest or principal payments resulting from deterioration in the financial condition of the borrower.

|  | December 31,           |          |
|--|------------------------|----------|
|  | 2013                   | 2012     |
|  | (Dollars in Thousands) |          |
| Total Loans Accounted for on a Non-Accrual Basis . . . . .                   | \$10,565               | \$23,618 |
| Interest Income That Would Have Been Recorded Under Original Terms . . . . . | 550                    | 1,058    |
| Interest Income Reported and Recorded During the Year . . . . .              | 61                     | 158      |

**Allocation of Allowance for Loan Losses**

The following table shows an allocation of the allowance for loan losses for the two years indicated.

|  | December 31,                               |  |                      |  |
|--|--|--|----------------------|--|
|  | 2013                                       |  | 2012                 |  |
|  | Allocation Allowance                       | Percent of Loans in Each Category to Total Loans | Allocation Allowance | Percent of Loans in Each Category To Total Loans |
|  | (Dollars in Thousands, Except Percentages) |  |                      |  |
| Commercial, Financial and Agricultural . . . . . | \$ 592                                     | 12%  | \$ 977               | 12%  |
| Real Estate . . . . .                            | 5,944                                      | 69   | 15,334               | 71   |
| Installment (Consumer) . . . . .                 | 2,860                                      | 19   | 2,967                | 17   |
| Total . . . . .                                  | <u>\$9,396</u>                             | <u>100%</u>                                      | <u>\$19,278</u>      | <u>100%</u>                                      |

In establishing the allowance for loan losses, management created the following risk groups for evaluating the loan portfolio:

- Large classified loans and impaired loans are evaluated individually, with specific reserves allocated based on management’s review, consistent with ASC Topic 310.
- The allowance for large pools of smaller-balance, homogeneous loans is based on such factors as changes in the nature and volume of the portfolio, overall portfolio quality, adequacy of the underlying collateral value, loan concentrations, historical charge-off trends and economic conditions that may affect the borrowers’ ability to pay, consistent with ASC Topic 450.

Net charge-offs as shown in the “Summary of Loan Loss Experience” table below indicate the trend for the last two years.

## Summary of Loan Loss Experience

This table summarizes the Company's loan loss experience for each of the two years indicated.

|   | December 31,           |                 |
|---|------------------------|-----------------|
|   | 2013                   | 2012            |
|   | (Dollars in Thousands) |                 |
| Balance of Allowance for Loan Loss at Beginning of Period           | \$ 19,278              | \$22,267        |
| Charge-Offs:  |                        |                 |
| Commercial, Financial and Agricultural                              | (537)                  | (1,277)         |
| Real Estate-Mortgage  | (9,265)                | (4,307)         |
| Installment (Consumer)  | (3,329)                | (3,449)         |
| Other   | —                      | (17)            |
|   | (13,131)               | (9,050)         |
| Recoveries:   |                        |                 |
| Commercial, Financial and Agricultural                              | 141                    | 156             |
| Real Estate-Mortgage  | 2,776                  | 671             |
| Installment (Consumer)  | 970                    | 894             |
| Other   | 4                      | 2               |
|   | 3,891                  | 1,723           |
| Net Charge-Offs   | (9,240)                | (7,327)         |
| Provision (Reduction in Reserve) for Loan Losses                    | (642)                  | 4,338           |
| Balance of Allowance for Loan Loss at End of Period                 | <u>\$ 9,396</u>        | <u>\$19,278</u> |
| Ratio of Net Charge-Offs During Period to Average Loans Outstanding | 2.77%                  | 1.95%           |

## Investment Securities

Assets of the Bank include investment securities which are classified as either available-for-sale or held-to-maturity. Available-for-sale securities, which are carried at fair value, include mortgage-backed securities, obligations of states, counties and political subdivisions, U.S. treasury and government sponsored agency securities and other securities. Investment securities held-to-maturity, which are carried at amortized cost, consist of obligations of states, counties and political subdivisions and U.S. government sponsored agency securities. Total investment securities increased from \$113.7 million as of December 31, 2012 to \$170.8 million as of December 31, 2013.

Because of their liquidity, credit quality and yield characteristics, the majority of the purchases of taxable securities have been purchases of agency-guaranteed mortgage-backed obligations and collateralized mortgage obligations ("CMOs"). The mortgage-backed obligations in which the Bank invests represent an undivided interest in a pool of residential or commercial mortgages or may be collateralized by a pool of residential mortgages ("mortgage-backed securities"). The Company does not invest in mortgage-backed securities that contain Alt-A type mortgages or subprime mortgages.

Mortgage-backed securities and CMOs present some degree of additional risk in that mortgages collateralizing these securities can be refinanced, thereby affecting the future yield and market value of the portfolio. Management expects the annual repayment of the underlying mortgages to vary as a result of monthly repayment of principal and/or interest required under terms of the underlying promissory notes. Further, the actual rate of repayment is subject to changes depending upon the terms of the underlying mortgages, the relative level of mortgage interest rates and the structure of the securities. When relative interest rates decline to levels below that of the underlying mortgages, acceleration of principal repayment is expected as some borrowers on the underlying mortgages refinance to lower rates. When the underlying rates on mortgage loans are comparable to market rates, repayment more closely conforms to scheduled amortization in accordance with terms of the

promissory note with additional repayment as a result of sales of homes collateralizing the mortgage loans constituting the security. Although maturities of the underlying mortgage loans may range up to 30 years, scheduled principal and normal prepayments substantially shorten the average maturities.

Interest rate risk contained in the overall securities portfolio is formally monitored on a monthly basis. Management assesses each month how risk levels in the investment portfolio affect overall company-wide interest rate risk. Expected changes in forecasted yield, earnings and market value of the bond portfolio are generally attributable to fluctuations in interest rates, as well as volatility caused by general uncertainty over the economy, inflation and future interest rate trends.

The composition of the Bank's investment portfolio reflects the Bank's investment strategy of maximizing portfolio yields commensurate with risk and liquidity considerations. The primary objectives of the Bank's investment strategy are to maintain an appropriate level of liquidity and to provide a tool to assist in controlling the Bank's interest rate position, while at the same time producing adequate levels of interest income. As of December 31, 2013, the investment portfolio had an estimated average maturity of 3.5 years.

Available-for-sale securities are carried at their estimated fair value with unrealized gains or losses recognized, net of taxes, in accumulated other comprehensive income (loss), a separate component of shareholders' equity. At December 31, 2013, available-for-sale securities totaled \$135.8 million, which represented 79.5% of the securities portfolio, compared to \$92.6 million, or 81.4%, at December 31, 2012. There were net unrealized gains (tax effected) of \$0.5 million and \$3.1 million in the available-for-sale securities portfolio as of December 31, 2013 and December 31, 2012, respectively. Estimated fair values of the securities in the available-for-sale portfolio and the resulting unrealized gains and losses vary significantly as interest rates change. The unrealized gains and losses in the securities portfolio are not expected to have a material impact on the Bank's liquidity or other funding needs.

Held-to-maturity securities are carried at amortized cost and represent those securities that the Bank both intends and has the ability to hold to maturity. At December 31, 2013, held to maturity securities totaled \$35.1 million and represented 20.5% of the total portfolio, compared with \$21.1 million, or 18.6%, at the end of 2012.

The following table sets forth the amortized costs of investment securities, as well as their fair value and related unrealized gains or losses of available-for-sale securities on the dates indicated.

|   | <u>Available-for-Sale</u>     |                 |
|---|-------------------------------|-----------------|
|   | <u>December 31,</u>           |                 |
|   | <u>2013</u>                   | <u>2012</u>     |
|   | <u>(Dollars in Thousands)</u> |                 |
| Mortgage-Backed Securities:                                 |                               |                 |
| Residential . . . . .                                       | \$ 82,840                     | \$46,260        |
| Commercial . . . . .  | 30,677                        | 27,857          |
| Obligations of States and Political Subdivisions . . . . .  | 16,230                        | 13,395          |
| U.S. Treasury Securities . . . . .                          | 4,161                         | 80              |
| Obligations of U.S. Government Sponsored Agencies . . . . . | 1,000                         | —               |
| Total Book Value . . . . .                                  | <u>134,908</u>                | <u>87,592</u>   |
| Net Unrealized Gains . . . . .                              | <u>846</u>                    | <u>5,022</u>    |
| Total Market Value . . . . .                                | <u>\$135,754</u>              | <u>\$92,614</u> |

|   | <u>Held-to-Maturity</u> |                 |
|---|-------------------------|-----------------|
|   | <u>December 31,</u>     |                 |
|   | <u>2013</u>             | <u>2012</u>     |
| Obligations of U.S. Government Sponsored Agencies ..... | \$35,050                | \$21,136        |
| Total Book Value .....                                  | <u>\$35,050</u>         | <u>\$21,136</u> |

### Investment Securities Maturity Schedule

Available-for-sale securities are stated at fair value and tax equivalent market yields. Held-to-maturity securities are stated at amortized cost.

|   | <u>Available-for-Sale</u>                      |                    |                      |                   |                       |                  |                  |              |
|---|--|--------------------|----------------------|-------------------|-----------------------|------------------|------------------|--------------|
|   | <u>Stated Maturity as of December 31, 2013</u> |                    |                      |                   |                       |                  |                  |              |
|   | <u>Within One</u>                              |                    | <u>After One But</u> |                   | <u>After Five But</u> |                  | <u>After</u>     |              |
|   | <u>Year</u>                                    | <u>Within Five</u> |                      | <u>Within Ten</u> |                       | <u>Ten Years</u> |                  |              |
|   | <u>Amount</u>                                  | <u>Yield</u>       | <u>Amount</u>        | <u>Yield</u>      | <u>Amount</u>         | <u>Yield</u>     | <u>Amount</u>    | <u>Yield</u> |
|   | <u>(Dollars in Thousands, Except Yields)</u>   |                    |                      |                   |                       |                  |                  |              |
| Investment Securities Available-for-Sale:   |  |                    |                      |                   |                       |                  |                  |              |
| Obligations of U.S. Government Sponsored    |  |                    |                      |                   |                       |                  |                  |              |
| Agencies .....                              | \$ 80  | 0.25%              | \$ 1,001             | 1.09%             | \$ 3,748              | 1.89%            | \$ —             | 0.00%        |
| Obligations of State and Political          |  |                    |                      |                   |                       |                  |                  |              |
| Subdivisions .....                          | 201  | 5.42               | 2,386                | 5.32              | 969                   | 4.84             | 13,471           | 5.88         |
| Mortgage-Backed Securities:                 |  |                    |                      |                   |                       |                  |                  |              |
| Residential .....                           | —  | 0.00               | 8,209                | 3.22              | 56,485                | 2.17             | 18,739           | 2.81         |
| Commercial .....                            | —  | 0.00               | 710                  | 1.49              | 1,772                 | 4.49             | 27,983           | 1.73         |
| Total .....                                 | <u>\$281</u>                                   | <u>3.94%</u>       | <u>\$12,306</u>      | <u>3.36%</u>      | <u>\$62,974</u>       | <u>2.26%</u>     | <u>\$ 60,193</u> | <u>3.00%</u> |
| Total Securities With Stated Maturity ..... |  |                    |                      |                   |                       |                  | <u>\$135,754</u> | <u>2.69%</u> |

|   | <u>Held-to-Maturity</u>                        |                    |                      |                   |                       |                  |                 |              |
|---|--|--------------------|----------------------|-------------------|-----------------------|------------------|-----------------|--------------|
|   | <u>Stated Maturity as of December 31, 2013</u> |                    |                      |                   |                       |                  |                 |              |
|   | <u>Within One</u>                              |                    | <u>After One But</u> |                   | <u>After Five But</u> |                  | <u>After</u>    |              |
|   | <u>Year</u>                                    | <u>Within Five</u> |                      | <u>Within Ten</u> |                       | <u>Ten Years</u> |                 |              |
|   | <u>Amount</u>                                  | <u>Yield</u>       | <u>Amount</u>        | <u>Yield</u>      | <u>Amount</u>         | <u>Yield</u>     | <u>Amount</u>   | <u>Yield</u> |
|   | <u>(Dollars in Thousands, Except Yields)</u>   |                    |                      |                   |                       |                  |                 |              |
| Investment Securities Held-to-Maturity:     |  |                    |                      |                   |                       |                  |                 |              |
| Obligations of U.S. Government Sponsored    |  |                    |                      |                   |                       |                  |                 |              |
| Agencies .....                              | \$—  | 0.00%              | \$—                  | 0.00%             | \$15,197              | 0.87%            | \$19,853        | 1.85%        |
| Total .....                                 | <u>\$—</u>                                     | <u>0.00%</u>       | <u>\$—</u>           | <u>0.00%</u>      | <u>\$15,197</u>       | <u>0.87%</u>     | <u>\$19,853</u> | <u>1.85%</u> |
| Total Securities With Stated Maturity ..... |  |                    |                      |                   |                       |                  | <u>\$35,050</u> | <u>1.43%</u> |



## Condensed Portfolio Maturity Schedule

| <u>Maturity Summary as of December 31, 2013</u>        | <u>Dollar Amount</u>      | <u>Portfolio Percentage</u> |
|--|---------------------------|-----------------------------|
|  | (Dollars<br>in Thousands) |                             |
| Maturing in three months or less . . . . .             | \$ 281                    | 0.16%                       |
| Maturing after three months through one year . . . . . | —                         | —                           |
| Maturing after one year through three years . . . . .  | 3,895                     | 2.28                        |
| Maturing after three years to five years . . . . .     | 8,411                     | 4.92                        |
| Maturing after five years to fifteen years . . . . .   | 117,556                   | 68.83                       |
| Maturing in over fifteen years . . . . .               | 40,661                    | 23.81                       |
| Total . . . . .  | <u>\$170,804</u>          | <u>100.00%</u>              |

## Condensed Portfolio Repricing Schedule

| <u>Repricing Summary as of December 31, 2013</u>       | <u>Dollar Amount</u>      | <u>Portfolio Percentage</u> |
|--|---------------------------|-----------------------------|
|  | (Dollars<br>in Thousands) |                             |
| Repricing in thirty days or less . . . . .             | \$ 13,737                 | 8.04%                       |
| Repricing in thirty-one days to one year . . . . .     | 528                       | 0.31                        |
| Repricing after one year through three years . . . . . | 8,060                     | 4.72                        |
| Repricing after three years to five years . . . . .    | 8,960                     | 5.25                        |
| Repricing after five years to fifteen years . . . . .  | 116,226                   | 68.04                       |
| Repricing in over fifteen years . . . . .              | 23,293                    | 13.64                       |
| Total . . . . .  | <u>\$170,804</u>          | <u>100.00%</u>              |

## Security Gains

Non-interest income from securities transactions was a gain for each of the years ended December 31, 2013 and 2012. Transactions affecting the Bank’s investment portfolio are directed by the Bank’s asset and liability management activities and strategies. Although short-term losses may occur from time to time, the “pruning” of the portfolio is designed to maintain the strength of the investment portfolio.

No available-for-sale securities were sold in 2013. In 2012, net gains realized on securities available-for-sale were approximately \$0.8 million.

Volumes of sales, as well as other information regarding investment securities, are discussed further in Note 3, “Investment Securities,” in the “Notes to Consolidated Financial Statements.”

## Deposits

Total deposits were \$484.3 million and \$489.0 million as of December 31, 2013 and 2012, respectively. Core deposits, which exclude time deposits of \$100,000 or more, provide for a relatively stable funding source that supports earning assets. Core deposits totaled \$391.3 million, or 80.8% of total deposits, as of December 31, 2013, and totaled \$380.1 million, or 77.7% of total deposits, as of December 31, 2012.

Deposits, in particular core deposits, have historically been the Company’s primary source of funding and have enabled the Company to successfully meet both short-term and long-term liquidity needs. Management anticipates that such deposits will continue to be the Company’s primary source of funding in the future, although economic and competitive factors could affect this funding source. The Company’s loan-to-deposit ratio was 62.1% as of December 31, 2013 and 69.0% as of December 31, 2012.

Time deposits in excess of \$100,000 decreased 14.6% to \$93.0 million as of December 31, 2013, compared with \$108.9 million as of December 31, 2012. Included in these large deposits was \$15.2 million in brokered certificates of deposit as of December 31, 2013, compared with \$21.9 million as of December 31, 2012. Management has used brokered deposits as a funding source when rates and terms are more attractive than other funding sources.

The sensitivity of the Bank's deposit rates to changes in market interest rates is reflected in the average interest rate paid on interest-bearing deposits. During 2013, although market interest rates remained relatively stable, the Bank's average rate on interest-bearing deposits declined from 0.97% in 2012 to 0.69%, as longer-term certificates of deposit matured and repriced at lower rates.

Management, as part of an overall program to emphasize the growth of transaction deposit accounts, continues to promote online banking and an online bill paying program, as well as enhance the telephone-banking product. In addition, continued effort is being placed on deposit promotions, direct-mail campaigns and cross-selling efforts.

### Average Daily Amount of Deposits and Rates

The average daily amount of deposits and rates paid on such deposits are summarized for the periods in the following table.

|  | December 31,     |              |                  |              |
|--|------------------|--------------|------------------|--------------|
|  | 2013             |              | 2012             |              |
|  | Amount           | Rate         | Amount           | Rate         |
| (Dollars in Thousands, Except Percentages)   |                  |              |                  |              |
| Non-Interest Bearing Demand Deposit Accounts | \$ 62,838        |              | \$ 59,443        |              |
| Interest-Bearing Demand Deposit Accounts     | 126,442          | 0.48%        | 121,498          | 0.58%        |
| Savings Deposits                             | 69,243           | 0.23         | 67,803           | 0.33         |
| Time Deposits                                | 224,070          | 0.94         | 268,496          | 1.30         |
| Total  | <u>\$482,593</u> | <u>0.69%</u> | <u>\$517,240</u> | <u>0.97%</u> |

Maturities of time certificates of deposit of \$100,000 or more outstanding as of December 31, 2013 are summarized as follows:

| <u>Maturities</u>              | <u>Time<br/>Certificates of<br/>Deposit</u><br>(Dollars in<br>Thousands) |
|--------------------------------|--|
| Three Months or Less           | \$15,754   |
| Over Three Through Six Months  | 15,515   |
| Over Six Through Twelve Months | 25,062   |
| Over Twelve Months             | <u>36,676</u>  |
| Total                          | <u>\$93,007</u>  |

### Other Borrowings

Other interest-bearing liabilities consist of federal funds purchased, securities sold under agreements to repurchase and Federal Home Loan Bank ("FHLB") advances. This category continues to be utilized as an alternative source of funds. During 2013, the average other interest-bearing liabilities represented 0.7% of the average total interest-bearing liabilities, compared to 1.2% in 2012. The advances from the FHLB are an alternative to funding sources with similar maturities, such as certificates of deposit. These advances generally offer more attractive rates when compared to other mid-term financing options. Securities sold under agreements

to repurchase averaged \$1.0 million in 2013 and \$0.7 million in 2012. For additional information and discussion of these borrowings, refer to Notes 9 and 10, “Short-Term Borrowings” and “Long-Term Debt,” respectively, in the “Notes to Consolidated Financial Statements.”

The following table shows information for the last two years regarding the Bank’s short- and long-term borrowings consisting of treasury, tax and loan deposits, federal funds purchased, securities sold under agreements to repurchase and other borrowings from the FHLB.

|   | <b>Short-Term Borrowings<br/>Maturity Less Than One<br/>Year</b> | <b>Long-Term Borrowings<br/>Maturity One Year or<br/>Greater</b> |
|---|--|--|
|   | (Dollars in Thousands, Except Percentages)                       |  |
| Year-Ended December 31:                         |  |  |
| 2013 .....                                      | \$1,231  | \$ 5,000   |
| 2012 .....                                      | 638  | —  |
| Weighted Average Interest Rate at Year-End:     |  |  |
| 2013 .....                                      | 0.25%  | 0.57%  |
| 2012 .....                                      | 1.50   | —  |
| Maximum Amount Outstanding at Any Month’s End:  |  |  |
| 2013 .....                                      | \$1,777  | \$ 5,000   |
| 2012 .....                                      | 1,332  | 20,000   |
| Average Amount Outstanding During the Year:     |  |  |
| 2013 .....                                      | \$ 986   | \$ 1,890   |
| 2012 .....                                      | 654  | 4,918  |
| Weighted Average Interest Rate During the Year: |  |  |
| 2013 .....                                      | 1.02%  | 0.58%  |
| 2012 .....                                      | 1.50   | 2.30   |

### Shareholders’ Equity

The Company has historically placed great emphasis on maintaining its strong capital base. As of December 31, 2013, shareholders’ equity totaled \$70.1 million, or 12.3% of total assets, compared with \$68.6 million, or 12.1% of total assets as of December 31, 2012. Management believes that this level of equity is an indicator of the financial soundness of the Company, and the Company’s ability to sustain future profitability and growth.

In connection with USBI’s Non-Employee Directors’ Deferred Compensation Plan, no shares were purchased in 2013 and 2012. The plan permits non-employee directors to invest their directors’ fees and to receive the adjusted value of the deferred amounts in cash and/or shares of USBI’s common stock. For more information related to this plan, see Note 13, “Long-Term Incentive Compensation Plan,” in the “Notes to Consolidated Financial Statements.”

USBI initiated a share repurchase program in January 2006, under which the Company was authorized to repurchase up to 642,785 shares of common stock before December 31, 2007. In December 2007, and each year since, the Board of Directors extended the expiration date of the share repurchase program for an additional year. Currently, the share repurchase program is set to expire on December 31, 2014. There are 242,303 shares available for repurchase under this plan, at management’s discretion.

The Company’s Board of Directors evaluates dividend payments based on the Company’s level of earnings and our desire to maintain a strong capital base, as well as regulatory requirements relating to the payment of dividends. There were no cash dividends declared during 2013 or 2012.

USBI and the Bank are required to comply with capital adequacy standards established by the Federal Reserve and the FDIC. Currently, there are two basic measures of capital adequacy: a risk-based measure and a

leverage measure. The risk-based capital standards are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Assets and off-balance sheet items are assigned to risk categories, each with a specified risk weight factor. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The banking regulatory agencies also have adopted regulations that supplement the risk-based guidelines to include a minimum leverage ratio of 3% of Tier 1 Capital (as defined below) to total assets, less goodwill (the “leverage ratio”). Depending upon the risk profile of the institution and other factors, the regulatory agencies may require a leverage ratio of 1% or 2% higher than the minimum 3% level.

The minimum standard for the ratio of total capital to risk-weighted assets is 8%. At least 50% of that capital level must consist of common equity, undivided profits and non-cumulative perpetual preferred stock, less goodwill and certain other intangibles (“Tier 1 Capital”). The remainder (“Tier II Capital”) may consist of a limited amount of other preferred stock, mandatory convertible securities, subordinated debt and a limited amount of the allowance for loan losses. The sum of Tier 1 Capital and Tier II Capital is “total risk-based capital.”

### Risk-Based Capital Requirements

|  | December 31, 2013                     |  |  |  |
|--|---------------------------------------|--|--|--|
|  | Minimum<br>Regulatory<br>Requirements | Well-<br>Capitalized<br>Regulatory<br>Requirements | The<br>Company’s<br>Ratio at<br>December 31,<br>2013 | The Bank’s<br>Ratio at<br>December 31,<br>2013 |
| Total Capital to Risk-Adjusted Assets . . . . .  | 8.00%                                 | 10.00%   | 19.20%   | 19.34%   |
| Tier I Capital to Risk-Adjusted Assets . . . . . | 4.00%                                 | 6.00%  | 17.93%   | 18.07%   |
| Tier I Leverage Ratio . . . . .                  | 3.00%                                 | 5.00%  | 10.88%   | 10.97%   |
|  | December 31, 2012                     |  |  |  |
|  | Minimum<br>Regulatory<br>Requirements | Well-<br>Capitalized<br>Regulatory<br>Requirements | The<br>Company’s<br>Ratio at<br>December 31,<br>2012 | The Bank’s<br>Ratio at<br>December 31,<br>2012 |
| Total Capital to Risk-Adjusted Assets . . . . .  | 8.00%                                 | 10.00%   | 17.05%   | 17.17%   |
| Tier I Capital to Risk-Adjusted Assets . . . . . | 4.00%                                 | 6.00%  | 15.75%   | 15.88%   |
| Tier I Leverage Ratio . . . . .                  | 3.00%                                 | 5.00%  | 10.51%   | 10.60%   |

The Company and the Bank exceeded the ratios required for well-capitalized institutions, as defined by federal banking regulation, in addition to meeting the minimum regulatory ratios, as of both December 31, 2013 and 2012.

In July 2013, the Federal Reserve approved the final rules implementing the Basel Committee on Banking Supervision’s capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The final rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and require a minimum leverage ratio of 4.0%. The final rules also implement strict eligibility criteria for regulatory capital instruments. The phase-in period for the final rules will begin for the Company on January 1, 2015, with full compliance with all of the final rules’ requirements phased in over a multi-year schedule. Management is currently evaluating the provisions of the final rules and their expected impact on the Company.

## Ratio Analysis

The following table presents the Company's operating and equity performance ratios for each of the last two years.

|  | December 31, |        |
|--|--------------|--------|
|  | 2013         | 2012   |
| Return on Average Assets . . . . .               | 0.70%        | 0.37%  |
| Return on Average Equity . . . . .               | 5.68%        | 3.27%  |
| Cash Dividend Payout Ratio . . . . .             | N/A          | N/A    |
| Average Equity to Average Assets Ratio . . . . . | 12.30%       | 11.19% |

## Liquidity and Interest Rate Sensitivity Management

The primary functions of asset and liability management are to (1) assure adequate liquidity, (2) maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities, (3) maximize the profit of the Bank and (4) reduce risks to the Bank's capital. Liquidity management involves the ability to meet day-to-day cash flow requirements of the Bank's customers, whether they are depositors wishing to withdraw funds or borrowers requiring funds to meet their credit needs. Without proper liquidity management, the Bank would not be able to perform a primary function under its role as a financial intermediary and would not be able to meet the needs of the communities that it serves. Interest rate risk management focuses on the maturity structure and repricing characteristics of its assets and liabilities when changes occur in market interest rates. Effective interest rate sensitivity management ensures that both assets and liabilities respond to changes in interest rates within an acceptable time frame, thereby minimizing the effect of such interest rate movements on short- and long-term net interest margin and net interest income.

The asset portion of the balance sheet provides liquidity primarily from two sources. These are principal payments and maturities of loans and maturities and principal payments from the investment portfolio. Other short-term investments, such as federal funds sold, are additional sources of liquidity. Loans maturing or repricing in one year or less amounted to \$131.9 million as of December 31, 2013.

Investment securities forecasted to mature or reprice over the twelve months ending December 31, 2014 are estimated to be approximately \$11.1 million, or about 6.5%, of the investment portfolio as of December 31, 2013. For comparison, principal payments on investment securities totaled \$32.1 million in 2013.

Although the majority of the securities portfolio has legal final maturities longer than 10 years, a substantial percentage of the portfolio provides monthly principal and interest payments and consists of securities that are readily marketable and easily convertible into cash on short notice. As of December 31, 2013, the bond portfolio had an expected average maturity of 3.5 years, and approximately 72.0% of the \$170.8 million in bonds was expected to be repaid within 5 years. However, management does not rely solely upon the investment portfolio to generate cash flows to fund loans, capital expenditures, dividends, debt repayment and other cash requirements. These activities are also funded by cash flows from loan payments, as well as increases in deposits and short-term borrowings.

The liability portion of the balance sheet provides liquidity through interest-bearing and non-interest-bearing deposit accounts. Federal funds purchased, FHLB advances, securities sold under agreements to repurchase and short-term and long-term borrowings are additional sources of liquidity. Liquidity management involves the continual monitoring of the sources and uses of funds to maintain an acceptable cash position. Long-term liquidity management focuses on considerations related to the total balance sheet structure.

The Bank, as of December 31, 2013, had long-term debt and short-term borrowings that, on average, represented 0.5% of total liabilities and equity, compared to 0.93% at December 31, 2012.

As of December 31, 2013, the Bank had up to \$165.9 million in additional borrowing capacity from the FHLB and \$18.8 million in established federal funds lines.

Interest rate sensitivity is a function of the repricing characteristics of all of the Bank's assets and liabilities. These repricing characteristics are the time frames during which the interest-bearing assets and liabilities are subject to changes in interest rates, either at replacement or maturity, during the life of the instruments. Measuring interest rate sensitivity is a function of the differences in the volume of assets and the volume of liabilities that are subject to repricing in future time periods. These differences are known as interest sensitivity gaps and are usually calculated for segments of time and on a cumulative basis.

*Measuring Interest Rate Sensitivity:* Gap analysis is a technique used to measure interest rate sensitivity at a particular point in time, an example of which is presented below. Assets and liabilities are placed in gap intervals based on their repricing dates. Assets and liabilities for which no specific repricing dates exist are placed in gap intervals based on management's judgment concerning their most likely repricing behaviors.

A net gap for each time period is calculated by subtracting the liabilities repricing in that interval from the assets repricing. A positive gap – more assets repricing than liabilities – will benefit net interest income if rates are rising and will detract from net interest income in a falling rate environment. Conversely, a negative gap – more liabilities repricing than assets – will benefit net interest income in a declining interest rate environment and will detract from net interest income in a rising interest rate environment.

Gap analysis is the simplest representation of the Bank's interest rate sensitivity. However, it cannot reveal the impact of factors, such as administered rates, pricing strategies on consumer and business deposits, changes in balance sheet mix or the effect of various options embedded in balance sheet instruments, such as refinancing rates within the loan and bond portfolios.

The accompanying table shows the Bank's interest rate sensitivity position as of December 31, 2013, as measured by Gap analysis. Over the next 12 months, approximately \$4.4 million more interest-earning assets than interest-bearing liabilities can be repriced to current market rates at least once. This analysis indicates that the Bank has a positive gap within the next 12-month range.





*Average Change in Net Interest Margin from Level Interest Rate Forecast (basis points, pre-tax):*

|           | <u>6 Months</u> | <u>1 Year</u> | <u>2 Years</u> | <u>5 Years</u> |
|-----------|-----------------|---------------|----------------|----------------|
| +1% ..... | 3               | 2             | 1              | 9              |
| +2% ..... | -8              | -11           | -13            | 3              |
| +3% ..... | -26             | -31           | -33            | -9             |
| +4% ..... | -45             | -53           | -55            | -22            |
| -1% ..... | -6              | -8            | -10            | -10            |
| -2% ..... | -17             | -21           | -25            | -28            |
| -3% ..... | -21             | -27           | -33            | -35            |
| -4% ..... | -19             | -26           | -33            | -38            |

*Cumulative Change in Net Interest Income from Level Interest Rate Forecast (dollars, pre-tax):*

|           | <u>6 Months</u> | <u>1 Year</u> | <u>2 Years</u> | <u>5 Years</u> |
|-----------|-----------------|---------------|----------------|----------------|
| +1% ..... | \$ 89,025       | \$ 91,035     | \$ 129,534     | \$ 2,593,603   |
| +2% ..... | (217,518)       | (626,229)     | (1,446,772)    | 838,054        |
| +3% ..... | (735,575)       | (1,796,031)   | (3,828,223)    | (2,720,620)    |
| +4% ..... | (1,308,482)     | (3,073,968)   | (6,366,272)    | (6,346,732)    |
| -1% ..... | (159,064)       | (472,967)     | (1,180,556)    | (3,003,104)    |
| -2% ..... | (475,070)       | (1,193,286)   | (2,892,357)    | (8,075,411)    |
| -3% ..... | (617,591)       | (1,560,766)   | (3,771,149)    | (10,195,533)   |
| -4% ..... | (541,911)       | (1,477,255)   | (3,776,426)    | (10,835,587)   |

**Assessing Long-Term Interest Rate Risk – Market Value of Equity and Estimating Modified Durations for Assets and Liabilities**

On a monthly basis, the Bank calculates how changes in interest rates would impact the market value of its assets and liabilities, as well as changes in long-term profitability. The process is similar to assessing short-term risk but emphasizes and is measured over a five-year time period, which allows for a more comprehensive assessment of longer-term repricing and cash flow imbalances that may not be captured by short-term net interest margin simulation. The results of these calculations are representative of long-term interest rate risk, both in terms of changes in the present value of the Bank's assets and liabilities, as well as long-term changes in core profitability.

**Market Value of Equity and Estimated Modified Duration of Assets, Liabilities and Equity Capital:**

The table below is a summary of expected market value changes for the Company's assets, liabilities and equity capital, expressed both in dollar terms and as a percentage of tier one equity under the eight listed interest rate scenarios.

|   | <u>+1%</u>                                 | <u>+2%</u> | <u>+3%</u> | <u>+4%</u> | <u>-1%</u> | <u>-2%</u> | <u>-3%</u> | <u>-4%</u> |
|---|--|------------|------------|------------|------------|------------|------------|------------|
|   | (Dollars in Thousands, Except Percentages) |            |            |            |            |            |            |            |
| Asset Modified Duration .....   | 2.72%                                      | 2.74%      | 2.72%      | 2.70%      | 2.68%      | 2.59%      | 2.50%      | 2.43%      |
| Liability Modified Duration .....   | 2.83%                                      | 2.52%      | 2.32%      | 2.20%      | 3.02%      | 2.96%      | 2.99%      | 3.04%      |
| Modified Duration Mismatch .....  | -0.11%                                     | 0.22%      | 0.40%      | 0.50%      | -0.34%     | -0.37%     | -0.49%     | -0.61%     |
| Estimated Change in Market Value<br>of Equity (Pre-Tax) .....                   | \$ 640                                     | \$(2,535)  | \$(6,876)  | \$(11,438) | \$(1,950)  | \$(4,225)  | \$(8,427)  | \$(13,960) |
| Change in Market Value of Equity/<br>Tier One Equity Capital<br>(Pre-Tax) ..... | 0.86%                                      | -3.42%     | -9.27%     | -15.42%    | -2.63%     | -5.70%     | -11.36%    | -18.82%    |

**Contractual Obligations**

The Company has contractual obligations to make future payments on debt and lease agreements. Long-term debt is reflected on the consolidated statements of financial condition, whereas operating lease obligations for office space and equipment are not recorded in the consolidated statements of financial condition. The Company has not entered into any unconditional purchase obligations or other long-term obligations, other than as included in the following table. These types of obligations are more fully discussed in Note 10, “Long-Term Debt,” and Note 17, “Operating Leases,” of the “Notes to Consolidated Financial Statements.”

Many of the Bank’s lending relationships, including those with commercial and consumer customers, contain both funded and unfunded elements. The unfunded component of these commitments is not recorded in the consolidated statements of financial condition. These commitments are more fully discussed in Note 18, “Guarantees, Commitments and Contingencies,” of the “Notes to Consolidated Financial Statements.”

The following table summarizes the Company’s contractual obligations as of December 31, 2013.

|  | Payment Due by Period  |                       |                       |                        |                            |
|--|------------------------|-----------------------|-----------------------|------------------------|----------------------------|
|  | Total                  | Less than<br>One Year | One to<br>Three Years | Three to<br>Five Years | More than<br>Five<br>Years |
|  | (Dollars in Thousands) |                       |                       |                        |                            |
| Time Deposits . . . . .                | \$211,724              | \$137,200             | \$56,535              | \$17,989               | \$ —                       |
| Long-Term Debt* . . . . .              | 5,000                  | —                     | 5,000                 | —                      | —                          |
| Commitments to Extend Credit . . . . . | 28,875                 | 23,754                | —                     | —                      | 5,121                      |
| Operating Leases . . . . .             | 1,279                  | 401                   | 528                   | 277                    | 73                         |
| Standby Letters of Credit . . . . .    | 931                    | 931                   | —                     | —                      | —                          |
| Total . . . . .                        | <u>\$247,809</u>       | <u>\$162,286</u>      | <u>\$62,063</u>       | <u>\$18,266</u>        | <u>\$5,194</u>             |

\* Long-term debt consists of FHLB fixed rate advances totaling \$5.0 million.

**Off-Balance Sheet Obligations**

The Company does not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are considered material, other than “Operating Leases,” included in Note 17, and “Guarantees, Commitments and Contingencies,” included in Note 18 of the “Notes to Consolidated Financial Statements.”

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

As a smaller reporting company, USBI is not required to provide this information.

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

### **Management's Report on Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934). The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that:

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

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

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on its assessment and those criteria, management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2013.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. The Company's internal control over financial reporting is not subject to attestation by the Company's registered public accounting firm pursuant to the rules of the Securities and Exchange Commission that permit the Company, as a smaller reporting company, to provide only management's report on internal control over financial reporting.

## **Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders  
United Security Bancshares, Inc.

We have audited the accompanying consolidated statements of condition of United Security Bancshares, Inc. and subsidiaries (the “Company”) as of December 31, 2013 and 2012, and the related consolidated statements of operations, shareholders’ equity, comprehensive income (loss), and cash flows for each of the years in the two-year period ended December 31, 2013. The Company’s management is responsible for these consolidated financial statements. 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 consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, 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 consolidated financial position of the Company as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

/s/ Carr, Riggs & Ingram, LLC

Dothan, Alabama  
March 21, 2014

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(Dollars in Thousands, Except Share Data)

|  | December 31,<br>2013 | December 31,<br>2012 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| CASH AND DUE FROM BANKS .....  | \$ 10,276            | \$ 12,181            |
| INTEREST-BEARING DEPOSITS IN OTHER BANKS .....   | 37,444               | 41,945               |
| Total cash and cash equivalents .....  | 47,720               | 54,126               |
| FEDERAL FUNDS SOLD .....   | —                    | 5,000                |
| INVESTMENT SECURITIES AVAILABLE-FOR-SALE, at fair value .....  | 135,754              | 92,614               |
| INVESTMENT SECURITIES HELD TO MATURITY, at amortized cost .....  | 35,050               | 21,136               |
| FEDERAL HOME LOAN BANK STOCK, at cost .....  | 906                  | 936                  |
| LOANS, net of allowance for loan losses of \$9,396 and \$19,278, respectively .....  | 300,927              | 337,400              |
| PREMISES AND EQUIPMENT, net of accumulated depreciation of \$18,178 and \$17,760, respectively .....   | 8,928                | 8,903                |
| CASH SURRENDER VALUE OF BANK-OWNED LIFE INSURANCE .....  | 13,650               | 13,303               |
| ACCRUED INTEREST RECEIVABLE .....  | 2,702                | 3,101                |
| OTHER REAL ESTATE OWNED .....  | 9,310                | 13,286               |
| OTHER ASSETS .....   | 14,854               | 17,328               |
| <b>TOTAL ASSETS</b> .....  | <b>\$569,801</b>     | <b>\$567,133</b>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                      |                      |
| <b>DEPOSITS:</b>   |                      |                      |
| Demand, non-interest-bearing .....   | \$ 64,432            | \$ 57,747            |
| Demand, interest-bearing .....   | 137,285              | 124,219              |
| Savings .....  | 70,838               | 65,296               |
| Time, \$100 and over .....   | 93,007               | 108,927              |
| Other time .....   | 118,717              | 132,845              |
| Total deposits .....   | 484,279              | 489,034              |
| ACCRUED INTEREST EXPENSE .....   | 266                  | 413                  |
| OTHER LIABILITIES .....  | 8,930                | 8,401                |
| SHORT-TERM BORROWINGS .....  | 1,231                | 638                  |
| LONG-TERM DEBT .....   | 5,000                | —                    |
| <b>TOTAL LIABILITIES</b> .....   | <b>499,706</b>       | <b>498,486</b>       |
| <b>COMMITMENTS AND CONTINGENCIES (SEE NOTE 18)</b>   |                      |                      |
| <b>SHAREHOLDERS' EQUITY:</b>   |                      |                      |
| Common stock, par value \$.01 per share; 10,000,000 shares authorized; 7,327,560 shares issued; 6,028,091 shares and 6,023,622 shares outstanding for December 31, 2013 and 2012, respectively ..... | 73                   | 73                   |
| Surplus .....  | 9,284                | 9,284                |
| Accumulated other comprehensive income, net of tax .....   | 529                  | 3,139                |
| Retained earnings .....  | 81,214               | 77,287               |
| Treasury stock, 1,299,469 and 1,303,938 shares at cost for 2013 and 2012, respectively .....   | (20,992)             | (21,123)             |
| Noncontrolling interest .....  | (13)                 | (13)                 |
| <b>TOTAL SHAREHOLDERS' EQUITY</b> .....  | <b>70,095</b>        | <b>68,647</b>        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> .....  | <b>\$569,801</b>     | <b>\$567,133</b>     |

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



**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Dollars in Thousands, Except Share and Per Share Data)

|   | <u>December 31,</u><br><u>2013</u> | <u>December 31,</u><br><u>2012</u> |
|---|------------------------------------|------------------------------------|
| INTEREST INCOME:  |                                    |                                    |
| Interest and fees on loans . . . . .  | \$ 30,394                          | \$ 35,373                          |
| Interest on investment securities:  |                                    |                                    |
| Taxable . . . . .   | 2,540                              | 2,629                              |
| Tax-exempt . . . . .  | 549                                | 575                                |
| Other interest and dividends . . . . .  | 153                                | 176                                |
| Total interest income . . . . .   | <u>33,636</u>                      | <u>38,753</u>                      |
| INTEREST EXPENSE:   |                                    |                                    |
| Interest on deposits . . . . .  | 2,884                              | 4,433                              |
| Interest on short-term borrowings . . . . .   | 10                                 | 10                                 |
| Interest on long-term debt . . . . .  | 11                                 | 113                                |
| Total interest expense . . . . .  | <u>2,905</u>                       | <u>4,556</u>                       |
| NET INTEREST INCOME . . . . .   | 30,731                             | 34,197                             |
| PROVISION (REDUCTION IN RESERVE) FOR LOAN LOSSES . . . . .                              | <u>(642)</u>                       | <u>4,338</u>                       |
| Net interest income after provision (reduction in reserve) for loan<br>losses . . . . . | 31,373                             | 29,859                             |
| NON-INTEREST INCOME:  |                                    |                                    |
| Service and other charges on deposit accounts . . . . .                                 | 1,720                              | 2,522                              |
| Credit life insurance income . . . . .  | 806                                | 955                                |
| Other income . . . . .  | 2,339                              | 2,088                              |
| Total non-interest income . . . . .   | <u>4,865</u>                       | <u>5,565</u>                       |
| NON-INTEREST EXPENSE:   |                                    |                                    |
| Salaries and employee benefits . . . . .  | 16,261                             | 14,590                             |
| Occupancy expense . . . . .   | 1,949                              | 1,899                              |
| Furniture and equipment expense . . . . .   | 1,197                              | 1,293                              |
| Write-downs on other real estate . . . . .  | 2,352                              | 4,866                              |
| Other expense . . . . .   | 9,043                              | 9,836                              |
| Total non-interest expense . . . . .  | <u>30,802</u>                      | <u>32,484</u>                      |
| INCOME BEFORE INCOME TAXES . . . . .  | 5,436                              | 2,940                              |
| PROVISION FOR INCOME TAXES . . . . .  | 1,509                              | 745                                |
| NET INCOME . . . . .  | <u>\$ 3,927</u>                    | <u>\$ 2,195</u>                    |
| BASIC AND DILUTED WEIGHTED AVERAGE SHARES OUTSTANDING . . . .                           | <u>6,025,724</u>                   | <u>6,022,892</u>                   |
| BASIC AND DILUTED NET INCOME PER SHARE . . . . .  | <u>\$ 0.65</u>                     | <u>\$ 0.36</u>                     |
| DIVIDENDS PER SHARE . . . . .   | <u>\$ 0.00</u>                     | <u>\$ 0.00</u>                     |

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

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

(Dollars in Thousands, Except Per Share Data)

|   | December 31, 2012 and 2013 |         |  |                      |                               |                                 |                                  |
|---|----------------------------|---------|--|----------------------|-------------------------------|---------------------------------|----------------------------------|
|   | Common<br>Stock            | Surplus | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Retained<br>Earnings | Treasury<br>Stock, at<br>Cost | Non-<br>Controlling<br>Interest | Total<br>Shareholders'<br>Equity |
| BALANCE, December 31, 2011 . . . .                  | \$ 73                      | \$9,258 | \$ 3,004   | \$75,092             | \$(21,208)                    | \$(13)                          | \$66,206                         |
| Net income . . . . .                                | —                          | —       | —  | 2,195                | —                             | —                               | 2,195                            |
| Other comprehensive income . . . .                  | —                          | —       | 135  | —                    | —                             | —                               | 135                              |
| Treasury stock reissued (2,885<br>shares) . . . . . | —                          | —       | —  | —                    | 85                            | —                               | 85                               |
| Stock award under employment<br>contract . . . . .  | —                          | 26      | —  | —                    | —                             | —                               | 26                               |
| BALANCE, December 31, 2012 . . . .                  | \$ 73                      | \$9,284 | \$ 3,139   | \$77,287             | \$(21,123)                    | \$(13)                          | \$68,647                         |
| Net income . . . . .                                | —                          | —       | —  | 3,927                | —                             | —                               | 3,927                            |
| Other comprehensive loss . . . . .                  | —                          | —       | (2,610)  | —                    | —                             | —                               | (2,610)                          |
| Treasury stock reissued (4,469<br>shares) . . . . . | —                          | —       | —  | —                    | 131                           | —                               | 131                              |
| BALANCE, December 31, 2013 . . . .                  | \$ 73                      | \$9,284 | \$ 529   | \$81,214             | \$(20,992)                    | \$(13)                          | \$70,095                         |

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

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Dollars in Thousands)

|   | <u>December 31,</u><br><u>2013</u> | <u>December 31,</u><br><u>2012</u> |
|---|------------------------------------|------------------------------------|
| Net income .....  | \$ 3,927                           | \$2,195                            |
| Other comprehensive income:   |                                    |                                    |
| Change in unrealized holding (losses) gains on available-for-sale securities<br>arising during period, net of \$1.6 million and \$(0.08) million tax effect ..... | (2,610)                            | 135                                |
| Other comprehensive income (loss) .....   | (2,610)                            | 135                                |
| Total comprehensive income .....  | <u>\$ 1,317</u>                    | <u>\$2,330</u>                     |

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

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in Thousands)

|   | <u>December 31,</u><br><u>2013</u> | <u>December 31,</u><br><u>2012</u> |
|---|------------------------------------|------------------------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                    |                                    |                                    |
| Net income .....  | \$ 3,927                           | \$ 2,195                           |
| Adjustments to reconcile net income to cash provided by operating activities:   |                                    |                                    |
| Depreciation .....  | 717                                | 715                                |
| Provision (reduction in reserve) for loan losses .....                          | (642)                              | 4,338                              |
| Deferred income tax provision .....   | 308                                | 999                                |
| Gain on sale of securities, net .....   | (484)                              | (1)                                |
| Write-downs on other real estate .....  | 2,352                              | 4,866                              |
| Amortization of premium and discounts, net .....                                | 810                                | 1,183                              |
| Changes in assets and liabilities:  |                                    |                                    |
| Decrease in accrued interest receivable .....                                   | 399                                | 857                                |
| Decrease in other assets .....  | 1,588                              | 429                                |
| Decrease in accrued interest expense .....                                      | (147)                              | (377)                              |
| Increase in other liabilities .....   | 2,095                              | 937                                |
| Net cash provided by operating activities .....                                 | <u>10,923</u>                      | <u>16,141</u>                      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                    |                                    |                                    |
| Purchase of investment securities available-for-sale .....                      | (81,301)                           | (20,375)                           |
| Purchase of investment securities held-to-maturity .....                        | (23,191)                           | (26,188)                           |
| Purchase of Federal Home Loan Bank stock .....                                  | (225)                              | —                                  |
| Proceeds from sales of investment securities available-for-sale .....           | —                                  | 4,010                              |
| Proceeds from maturities and prepayments of securities available-for-sale ..... | 33,654                             | 44,952                             |
| Proceeds from maturities and prepayments of securities held-to-maturity .....   | 9,282                              | 6,225                              |
| Proceeds from redemption of Federal Home Loan Bank stock .....                  | 256                                | 1,925                              |
| Proceeds from the sale of other real estate .....                               | 4,020                              | 5,990                              |
| Net change in loan portfolio .....  | 34,719                             | 31,979                             |
| Net decrease (increase) in federal funds sold .....                             | 5,000                              | (5,000)                            |
| Purchase of premises and equipment, net .....                                   | (381)                              | (572)                              |
| Net cash (used in) provided by investing activities .....                       | <u>(18,167)</u>                    | <u>42,946</u>                      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                    |                                    |                                    |
| Net decrease in customer deposits .....   | (4,755)                            | (38,039)                           |
| Net increase in short-term borrowings .....                                     | 593                                | 282                                |
| Proceeds from Federal Home Loan Bank advances and other borrowings .....        | 5,000                              | —                                  |
| Repayment of Federal Home Loan Bank advances and other borrowings .....         | —                                  | (20,000)                           |
| Net cash provided by (used in) financing activities .....                       | <u>838</u>                         | <u>(57,757)</u>                    |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS .....                      | (6,406)                            | 1,330                              |
| CASH AND CASH EQUIVALENTS, beginning of year .....                              | <u>54,126</u>                      | <u>52,796</u>                      |
| CASH AND CASH EQUIVALENTS, end of year .....                                    | <u>\$ 47,720</u>                   | <u>\$ 54,126</u>                   |

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

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

DECEMBER 31, 2013 AND 2012

**1. DESCRIPTION OF BUSINESS**

United Security Bancshares, Inc. (“USBI”) and its wholly-owned subsidiary, First United Security Bank (the “Bank” or “FUSB”), provide commercial banking services to customers through nineteen banking offices located in Brent, Bucksville, Butler, Calera, Centreville, Coffeetown, Columbiana, Fulton, Gilbertown, Grove Hill, Harpersville, Jackson, Thomasville, Tuscaloosa and Woodstock, Alabama.

The Bank owns all of the stock of Acceptance Loan Company, Inc. (“ALC”), an Alabama corporation. ALC is a finance company organized for the purpose of making consumer loans and purchasing consumer loans from vendors. ALC has offices located within the communities served by the Bank, as well as offices outside the Bank’s market area in Alabama and southeast Mississippi. The Bank also owns all of the stock of FUSB Reinsurance, Inc. (“FUSB Reinsurance”), an Arizona corporation. FUSB Reinsurance is an insurance company that was created to underwrite credit life and accidental death insurance related to loans written by the Bank and ALC.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

The consolidated financial statements include the accounts of USBI, the Bank and its wholly-owned subsidiaries (collectively, the “Company”), and one variable interest entity (“VIE”). All significant intercompany balances and transactions have been eliminated. The Company consolidates an entity if the Company has a controlling financial interest in the entity. VIEs are consolidated if the Company has the power to direct the significant economic activities of the VIE that impact financial performance and has the obligation to absorb losses or the right to receive benefits that could potentially be significant (i.e., the Company is the primary beneficiary). The assessment of whether or not the Company is the primary beneficiary of a VIE is performed on an ongoing basis. Unconsolidated investments held by the Company are accounted for using the cost method. See Note 7, “Investment in Limited Partnerships,” for further discussion of the consolidated VIE and unconsolidated cost method investments.

**Use of Estimates**

The accounting principles and reporting policies of the Company, and the methods of applying these principles, conform with U.S. GAAP and with general practices within the financial services industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated statements of condition and revenues and expenses for the period included in the consolidated statements of operations and of cash flows. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant changes in the near-term relate to the accounting for the allowance for loan losses, the value of OREO and certain collateral-dependent loans, and deferred tax asset valuation. In connection with the determination of the allowance for loan losses and other real estate owned, in some cases, management obtains independent appraisals for significant properties, evaluates the overall portfolio characteristics and delinquencies and monitors economic conditions.

A substantial portion of the Company’s loans are secured by real estate in its primary market area. Accordingly, the ultimate collectability of a substantial portion of the Company’s loan portfolio and the recovery of a portion of the carrying amount of foreclosed real estate are susceptible to changes in economic conditions in the Company’s primary market.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**Cash and Cash Equivalents**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, instruments with an original maturity of less than 90 days from issuance and amounts due from banks.

Supplemental disclosures of cash flow information and non-cash transactions related to cash flows for the years ended December 31, 2013 and 2012 are as follows:

|   | <u>2013</u>                   | <u>2012</u> |
|---|-------------------------------|-------------|
|   | <b>(Dollars in Thousands)</b> |             |
| Cash Paid (Refunded) During the Period for:                 |                               |             |
| Interest . . . . .  | \$ 3,052                      | \$4,933     |
| Income Taxes . . . . .                                      | (2,252)                       | 97          |
| Non-Cash Transactions:                                      |                               |             |
| Other Real Estate Acquired in Settlement of Loans . . . . . | 2,396                         | 7,368       |
| Issuance of Treasury Stock as Compensation . . . . .        | 131                           | 85          |
| Stock Award Under Employment Contract . . . . .             | —                             | 26          |

**Revenue Recognition**

The main source of revenue for the Company is interest revenue, which is recognized on an accrual basis calculated by non-discretionary formulas based on written contracts, such as loan agreements or securities contracts. Loan origination fees are amortized into interest income over the term of the loan. Other types of non-interest revenue, such as service charges on deposits, are accrued and recognized into income as services are provided and the amount of fees earned is reasonably determinable.

**Reinsurance Activities**

The Company assumes insurance risk related to credit life and credit accident and health insurance written by a non-affiliated insurance company for its customers that choose such coverage through a quota share reinsurance agreement. Assumed premiums on credit life are deferred and earned over the period of insurance coverage using a pro rata method or the effective yield method, depending on whether the amount of insurance coverage generally remains level or declines. Assumed premiums for accident and health policies are earned on an average of the pro rata and the effective yield method.

Other liabilities include reserves for incurred but unpaid credit insurance claims for policies assumed under the quota share reinsurance agreement. These insurance liabilities are established based on acceptable actuarial methods. Such liabilities are necessarily based on estimates, and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liabilities are continually reviewed, and any adjustments are reflected in earnings currently.

**Investment Securities**

Securities may be held in three portfolios: trading account securities, held-to-maturity securities and securities available-for-sale. Trading account securities are carried at estimated fair value, with unrealized gains and losses included in operations. The Company held no securities in a trading account as of December 31, 2013 or 2012. Investment securities held-to-maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts. With regard to investment securities held-to-maturity, management has the intent and the Bank has the ability to hold such securities until maturity. Investment securities available-for-sale are carried at fair value, with any unrealized gains or losses excluded from



**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

operations and reflected, net of tax, as a separate component of shareholders' equity in accumulated other comprehensive income or loss. Investment securities available-for-sale are so classified because management may decide to sell certain securities prior to maturity for liquidity, tax planning or other valid business purposes. When the fair value of a security falls below carrying value, an evaluation must be made to determine if the unrealized loss is a temporary or other-than-temporary impairment. Impaired securities that are not deemed to be temporarily impaired are written down by a charge to operations to the extent that the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income or loss. The Company uses a systematic methodology to evaluate potential impairment of its investments that considers, among other things, the magnitude and duration of the decline in fair value, the financial health of and business outlook of the issuer and the Company's ability and intent to hold the investment until such time as the security recovers its fair value.

Interest earned on investment securities available-for-sale is included in interest income. Amortization of premiums and discounts on investment securities is determined by the interest method and included in interest income. Gains and losses on the sale of investment securities available-for-sale, computed principally on the specific identification method, are shown separately in non-interest income.

**Derivatives and Hedging Activities**

As part of the Company's overall interest rate risk management, the Company has used derivative instruments, which can include interest rate swaps, caps and floors. Accounting Standards Codification ("ASC") Topic 815, *Derivatives and Hedging*, requires all derivative instruments to be carried at fair value on the consolidated statements of condition. ASC Topic 815 provides special accounting provisions for derivative instruments that qualify for hedge accounting. To be eligible, the Company must specifically identify a derivative as a hedging instrument and identify the risk being hedged. The derivative instrument must be shown to meet specific requirements under ASC Topic 815.

The Company held no derivative instruments as of December 31, 2013 or 2012.

**Loans and Interest Income**

Loans are reported at principal amounts outstanding, adjusted for unearned income, net deferred loan origination fees and costs, purchase premiums and discounts, write-downs and the allowance for loan losses. Loan origination fees, net of certain deferred origination costs, and purchase premiums and discounts are recognized as an adjustment to yield of the related loans, on an effective yield basis.

Interest on all loans is accrued and credited to income based on the principal amount outstanding.

The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed against current income unless the collateral for the loan is sufficient to cover the accrued interest. Interest received on non-accrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. The policy for interest recognition on impaired loans is consistent with the non-accrual interest recognition policy. Generally, loans are restored to accrual status when the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**Allowance for Loan Losses**

The allowance for loan losses is determined based on various components for individually impaired loans and for homogeneous pools of loans. The allowance for loan losses is increased by a provision for loan losses, which is charged to expense and reduced by charge-offs, net of recoveries by portfolio segment. The methodology for determining charge-offs is consistently applied to each segment. The allowance for loan losses is maintained at a level that, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, and changes in its risk profile, credit concentrations, historical trends and economic conditions. This evaluation also considers the balance of impaired loans. Losses on individually identified impaired loans are measured based on the present value of expected future cash flows discounted at each loan's original effective market interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through the provision added to the allowance for loan losses. One-to-four family residential mortgages and consumer installment loans are subjected to a collective evaluation for impairment, considering delinquency and repossession statistics, loss experience and other factors. Though management believes the allowance for loan losses to be adequate, ultimate losses may vary from their estimates. However, estimates are reviewed periodically, and, as adjustments become necessary, they are reported in earnings during periods in which they become known.

**Premises and Equipment**

Premises and equipment are carried at cost less accumulated depreciation and amortization computed principally by the straight-line method over the estimated useful lives of the assets or the expected lease terms for leasehold improvements, whichever is shorter. Useful lives for all premises and equipment range between three and thirty years.

**Other Real Estate**

Other real estate consists of properties acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure. These properties are carried at the lower of cost or fair value based on appraised value, less estimated selling costs. Losses arising from the acquisition of properties are charged against the allowance for loan losses. Other real estate aggregated amounted to \$9.3 million and \$13.3 million as of December 31, 2013 and 2012, respectively. Transfers from loans to other real estate amounted to \$2.4 million in 2013 and \$7.4 million in 2012. There were no transfers from other real estate to loans in 2013. Transfers from other real estate to loans amounted to \$0.3 million in 2012. Other real estate disposed of amounted to \$4.9 million and \$7.3 million in 2013 and 2012, respectively.

**Income Taxes**

The Company accounts for income taxes on the accrual basis through the use of the asset and liability method. Under the asset and liability method, deferred taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the consolidated financial statement carrying amounts and the basis of existing assets and liabilities. The effect on deferred taxes of a change in tax rates would be recognized in income in the period that includes the enactment date.

In accordance with ASC Topic 740, *Income Taxes*, a tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

**Treasury Stock**

Treasury stock purchases and sales are accounted for using the cost method.

**Advertising Costs**

Advertising costs for promoting the Company are minimal and expensed as incurred.

**Reclassification**

Certain amounts in the 2012 consolidated financial statements have been reclassified to conform to the 2013 method of presentation.

**Subsequent Events**

The Company has evaluated subsequent events through the filing date of the consolidated financial statements. No subsequent events requiring recognition or disclosure were identified, and, therefore, none were incorporated into the consolidated financial statements presented herein.

**Net Income Per Share**

Basic net income per share is computed by dividing net income by the weighted average shares outstanding during the period. Diluted net income per share is computed based on the weighted average shares outstanding during the period plus the dilutive effect of all potentially dilutive instruments outstanding. There were no outstanding potentially dilutive instruments during the periods ended December 31, 2013 or 2012, and, therefore, basic and diluted weighted average shares outstanding were the same.

The following table represents the basic and diluted net income share calculations for the years ended December 31, 2013 and 2012.

|                             | <u>Net Income</u>                            | <u>Weighted<br/>Average<br/>Shares<br/>Outstanding</u> | <u>Basic and<br/>Diluted Net<br/>Income<br/>Per Share</u> |
|-----------------------------|--|--|---|
| <u>For the Years Ended:</u> | (Dollars in Thousands, Except Share Amounts) |  |   |
| December 31, 2013 .....     | <u>\$3,927</u>                               | <u>6,025,724</u>                                       | <u>\$0.65</u>   |
| December 31, 2012 .....     | <u>\$2,195</u>                               | <u>6,022,892</u>                                       | <u>\$0.36</u>   |

**Accounting Policies Recently Adopted and Pending Accounting Pronouncements**

In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)*. ASU 2014-04 clarifies when an “in substance repossession or foreclosure” occurs, that is, when a creditor should be considered to have received physical

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

possession of residential real estate property collateralizing a consumer mortgage loan, such that all or a portion of the loan should be derecognized and the real estate property recognized. ASU 2014-04 states that a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments of ASU 2014-04 also require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate properties that are in the process of foreclosure. The amendments of ASU 2014-04 are effective for interim and annual periods beginning after December 15, 2014, and may be applied using either a modified retrospective transition method or a prospective transition method as described in ASU 2014-04. The adoption of ASU 2014-04 is not expected to have a significant impact on the Company's consolidated financial position, results of operations or cash flows.

In January 2014, the FASB issued ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)*. ASU 2014-01 permits reporting entities that invest in qualified affordable housing projects to elect to account for those investments using the “proportional amortization method” if certain conditions are met. Under this method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The decision to apply the proportional amortization method of accounting is an accounting policy decision and should be applied consistently to all qualifying affordable housing project investments. ASU 2014-01 should be applied retrospectively to all periods presented and is effective for annual and interim reporting periods beginning after December 15, 2014. The Company does not have a significant amount of investments in qualified affordable housing projects that qualify for the low income housing tax credit. Such investments are currently either consolidated in the Company's financial statements or accounted for as cost method investments. The adoption of ASU 2014-01 is not expected to have a significant impact on the Company's consolidated financial position, results of operations or cash flows.

In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)*. ASU 2013-11 provides that an entity's unrecognized tax benefit, or a portion of its unrecognized tax benefit, should be presented in its financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with one exception. The exception states that to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position, or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU 2013-11 applies prospectively for all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or tax credit carryforward exists at the reporting date. ASU 2013-11 is effective for fiscal years, and interim periods within those years beginning after December 15, 2013. The adoption of ASU 2013-11 is not expected to have a significant impact on the Company's consolidated financial position, results of operations or cash flows.

In February 2013, the FASB issued ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires an entity to

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report the effect of significant reclassifications out of accumulated other comprehensive income on net income line items only for those items that are reported in their entirety in net income in the period of reclassification. For these items, entities are required to disclose the effect of the reclassification on each line item of net income that is affected by the reclassification adjustment. For items that are not reclassified in their entirety into net income, an entity is required to add a cross-reference to the note that includes additional information about the effect of the reclassification. For entities that only have reclassifications into net income in their entirety, this information may be presented either in the notes or parenthetically on the face of the statement that reports net income as long as the required information is reported in a single location. Entities that have one or more reclassification items that are not presented in their entirety in net income in the period of reclassification must present this information in the notes to the financial statements. ASU 2013-02 became effective for the Company's financial statements on January 1, 2013, and the adoption did not have a significant impact on the Company's consolidated financial position, results of operations or cash flows.

**3. INVESTMENT SECURITIES**

Details of investment securities available-for-sale and held-to-maturity as of December 31, 2013 and 2012 are as follows:

|  | <u>Available-for-Sale</u>             |  |                                 |                  |
|--|---------------------------------------|--|---------------------------------|------------------|
|  | <u>December 31, 2013</u>              |  |                                 |                  |
| <u>Amortized Cost</u>                                      | <u>Gross<br/>Unrealized<br/>Gains</u> | <u>Gross<br/>Unrealized<br/>Losses</u> | <u>Estimated Fair<br/>Value</u> |                  |
|  | (Dollars in Thousands)                |  |                                 |                  |
| Mortgage-backed securities:                                |                                       |  |                                 |                  |
| Residential .....  | \$ 82,840                             | \$1,479                                | \$ (885)                        | \$ 83,434        |
| Commercial .....   | 30,677                                | 143                                    | (355)                           | 30,465           |
| Obligations of states and political<br>subdivisions .....  | 16,230                                | 799                                    | (2)                             | 17,027           |
| Obligations of U.S. government sponsored<br>agencies ..... | 1,000                                 | 1                                      | —                               | 1,001            |
| U.S. treasury securities .....                             | 4,161                                 | —                                      | (334)                           | 3,827            |
| Total .....  | <u>\$134,908</u>                      | <u>\$2,422</u>                         | <u>\$(1,576)</u>                | <u>\$135,754</u> |
|  |                                       |  |                                 |                  |
|  | <u>Held-to-Maturity</u>               |  |                                 |                  |
|  | <u>December 31, 2013</u>              |  |                                 |                  |
| <u>Amortized Cost</u>                                      | <u>Gross<br/>Unrealized<br/>Gains</u> | <u>Gross<br/>Unrealized<br/>Losses</u> | <u>Estimated Fair<br/>Value</u> |                  |
|  | (Dollars in Thousands)                |  |                                 |                  |
| Obligations of U.S. government sponsored<br>agencies ..... | <u>\$35,050</u>                       | <u>\$—</u>                             | <u>\$(1,684)</u>                | <u>\$33,365</u>  |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

|   | Available-for-Sale     |                              |                               |                         |
|---|------------------------|------------------------------|-------------------------------|-------------------------|
|   | December 31, 2012      |                              |                               |                         |
|   | Amortized Cost         | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated Fair<br>Value |
|   | (Dollars in Thousands) |                              |                               |                         |
| Mortgage-backed securities:                               |                        |                              |                               |                         |
| Residential .....   | \$46,260               | \$3,004                      | \$—                           | \$49,264                |
| Commercial .....  | 27,857                 | 464                          | (32)                          | 28,289                  |
| Obligations of states and political<br>subdivisions ..... | 13,395                 | 1,586                        | —                             | 14,981                  |
| U.S. treasury securities .....                            | 80                     | —                            | —                             | 80                      |
| Total .....   | <u>\$87,592</u>        | <u>\$5,054</u>               | <u>\$ (32)</u>                | <u>\$92,614</u>         |

  

|  | Held-to-Maturity       |                              |                               |                         |
|--|------------------------|------------------------------|-------------------------------|-------------------------|
|  | December 31, 2012      |                              |                               |                         |
|  | Amortized Cost         | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated Fair<br>Value |
|  | (Dollars in Thousands) |                              |                               |                         |
| Obligations of U.S. government sponsored<br>agencies ..... | <u>\$21,136</u>        | <u>\$56</u>                  | <u>\$(7)</u>                  | <u>\$21,185</u>         |

The scheduled maturities of investment securities available-for-sale and held-to-maturity as of December 31, 2013 are presented in the following table:

|  | Available-for-Sale     |                         | Held-to-Maturity  |                         |
|--|------------------------|-------------------------|-------------------|-------------------------|
|  | Amortized Cost         | Estimated Fair<br>Value | Amortized<br>Cost | Estimated<br>Fair Value |
|  | (Dollars in Thousands) |                         |                   |                         |
| Maturing within one year .....         | \$ 280                 | \$ 281                  | \$ —              | \$ —                    |
| Maturing after one to five years ..... | 11,796                 | 12,306                  | —                 | —                       |
| Maturing after five to ten years ..... | 63,180                 | 62,974                  | 15,197            | 14,821                  |
| Maturing after ten years .....         | 59,652                 | 60,193                  | 19,853            | 18,544                  |
| Total .....                            | <u>\$134,908</u>       | <u>\$135,754</u>        | <u>\$35,050</u>   | <u>\$33,365</u>         |

For purposes of the maturity table, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on the weighted-average contractual maturities of underlying collateral. The mortgage-backed securities generally mature earlier than their weighted-average contractual maturities because of principal prepayments.

Management evaluates securities for other-than-temporary impairment no less frequently than quarterly and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) whether the Company does not intend to sell these securities, and it is not more likely than not that the Company will be required to sell the securities before recovery of their amortized cost bases. At December 31, 2013 and 2012, based on the aforementioned considerations, management did not record an other-than temporary impairment on any security that was in an unrealized loss position.



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The following table reflects the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2013 and 2012.

|  | Available-for-Sale     |                   |                   |                   |
|--|------------------------|-------------------|-------------------|-------------------|
|  | December 31, 2013      |                   |                   |                   |
|  | Less than 12 Months    |                   | 12 Months or More |                   |
|  | Fair Value             | Unrealized Losses | Fair Value        | Unrealized Losses |
|  | (Dollars in Thousands) |                   |                   |                   |
| Mortgage-backed securities:                            |                        |                   |                   |                   |
| Residential .....                                      | \$43,091               | \$ (885)          | \$—               | \$—               |
| Commercial .....                                       | 21,231                 | (337)             | 271               | (18)              |
| Obligations of states and political subdivisions ..... | 1,050                  | (2)               | —                 | —                 |
| U.S. treasury securities .....                         | 3,748                  | (334)             | —                 | —                 |
| Total .....  | <u>\$69,120</u>        | <u>\$(1,558)</u>  | <u>\$271</u>      | <u>\$(18)</u>     |

|   | Held-to-Maturity       |                   |                   |                   |
|---|------------------------|-------------------|-------------------|-------------------|
|   | December 31, 2013      |                   |                   |                   |
|   | Less than 12 Months    |                   | 12 Months or More |                   |
|   | Fair Value             | Unrealized Losses | Fair Value        | Unrealized Losses |
|   | (Dollars in Thousands) |                   |                   |                   |
| Obligations of U.S. government sponsored agencies ..... | <u>\$33,365</u>        | <u>\$(1,684)</u>  | <u>\$—</u>        | <u>\$—</u>        |

|   | Available-for-Sale     |                   |                   |                   |
|---|------------------------|-------------------|-------------------|-------------------|
|   | December 31, 2012      |                   |                   |                   |
|   | Less than 12 Months    |                   | 12 Months or More |                   |
|   | Fair Value             | Unrealized Losses | Fair Value        | Unrealized Losses |
|   | (Dollars in Thousands) |                   |                   |                   |
| U.S. treasury securities .....              | \$ 80                  | \$—               | \$ —              | \$—               |
| Mortgage-backed commercial securities ..... | 1,173                  | (3)               | 5,617             | (29)              |
| Total .....                                 | <u>\$1,253</u>         | <u>\$ (3)</u>     | <u>\$5,617</u>    | <u>\$(29)</u>     |

|   | Held-to-Maturity       |                   |                   |                   |
|---|------------------------|-------------------|-------------------|-------------------|
|   | December 31, 2012      |                   |                   |                   |
|   | Less than 12 Months    |                   | 12 Months or More |                   |
|   | Fair Value             | Unrealized Losses | Fair Value        | Unrealized Losses |
|   | (Dollars in Thousands) |                   |                   |                   |
| Obligations of U.S. government sponsored agencies ..... | <u>\$7,491</u>         | <u>\$(7)</u>      | <u>\$—</u>        | <u>\$—</u>        |

As of December 31, 2013, two debt securities had been in a loss position for more than twelve months, and 49 debt securities had been in a loss position for less than twelve months. The losses for all securities are considered to be a direct result of the effect that the current interest rate environment has on the value of debt securities and not related to the creditworthiness of the issuers. Further, the Company has the current intent and

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ability to retain its investments in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Therefore, the Company has not recognized any other-than-temporary impairments.

Investment securities available-for-sale with a carrying value of \$72.7 million and \$61.6 million as of December 31, 2013 and 2012, respectively, were pledged to secure public deposits and for other purposes.

Gains realized on sales of securities available-for-sale were approximately \$0.5 million and \$1,000 in 2013 and 2012, respectively. The gain on sale in 2013 resulted from a non-recurring fee received by the Bank in connection with early payoff of a mortgage-backed pool. Losses on sales of securities totaled approximately zero in both 2013 and 2012.

**4. LOANS AND ALLOWANCE FOR LOAN LOSSES**

As of December 31, 2013 and 2012, the composition of the loan portfolio by reporting segment and portfolio segment was as follows:

|   | <b>December 31, 2013</b>      |                 |                  |
|---|-------------------------------|-----------------|------------------|
|   | <b>FUSB</b>                   | <b>ALC</b>      | <b>Total</b>     |
|   | <b>(Dollars in Thousands)</b> |                 |                  |
| Real estate loans:  |                               |                 |                  |
| Construction, land development and other land loans . . . . . | \$ 11,348                     | \$ —            | \$ 11,348        |
| Secured by 1-4 family residential properties . . . . .        | 34,978                        | 26,621          | 61,599           |
| Secured by multi-family residential properties . . . . .      | 22,095                        | —               | 22,095           |
| Secured by non-farm, non-residential properties . . . . .     | 122,430                       | —               | 122,430          |
| Other . . . . .   | 761                           | —               | 761              |
| Commercial and industrial loans . . . . .                     | 37,772                        | —               | 37,772           |
| Consumer loans . . . . .                                      | 9,886                         | 48,938          | 58,824           |
| Other loans . . . . .   | 604                           | —               | 604              |
|   | <u>239,874</u>                | <u>75,559</u>   | <u>315,433</u>   |
| Total loans . . . . .   |                               |                 |                  |
| Less: Unearned interest, fees and deferred cost . . . . .     | 149                           | 4,961           | 5,110            |
| Allowance for loan losses . . . . .                           | 6,272                         | 3,124           | 9,396            |
| Net loans . . . . .   | <u>\$233,453</u>              | <u>\$67,474</u> | <u>\$300,927</u> |
|   |                               |                 |                  |
|   | <b>December 31, 2012</b>      |                 |                  |
|   | <b>FUSB</b>                   | <b>ALC</b>      | <b>Total</b>     |
|   | <b>(Dollars in Thousands)</b> |                 |                  |
| Real estate loans:  |                               |                 |                  |
| Construction, land development and other land loans . . . . . | \$ 30,635                     | \$ —            | \$ 30,635        |
| Secured by 1-4 family residential properties . . . . .        | 38,450                        | 33,047          | 71,497           |
| Secured by multi-family residential properties . . . . .      | 24,187                        | —               | 24,187           |
| Secured by non-farm, non-residential properties . . . . .     | 129,235                       | —               | 129,235          |
| Other . . . . .   | 801                           | —               | 801              |
| Commercial and industrial loans . . . . .                     | 42,903                        | —               | 42,903           |
| Consumer loans . . . . .                                      | 14,483                        | 47,001          | 61,484           |
| Other loans . . . . .   | 1,037                         | —               | 1,037            |
|   | <u>281,731</u>                | <u>80,048</u>   | <u>361,779</u>   |
| Total loans . . . . .   |                               |                 |                  |
| Less: Unearned interest, fees and deferred cost . . . . .     | 175                           | 4,926           | 5,101            |
| Allowance for loan losses . . . . .                           | 15,765                        | 3,513           | 19,278           |
| Net loans . . . . .   | <u>\$265,791</u>              | <u>\$71,609</u> | <u>\$337,400</u> |

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The Company grants commercial, real estate and installment loans to its customers. Although the Company has a diversified loan portfolio, 69.2% and 70.9% of the portfolio was concentrated in loans secured by real estate located primarily within a single geographic region of the United States as of December 31, 2013 and 2012, respectively.

**Portfolio Segments:**

The Company has divided the loan portfolio into eight portfolio segments, each with different risk characteristics and methodologies for assessing the risk described as follows:

*Construction, land development and other land loans* – Commercial construction, land and land development loans include the development of residential housing projects, loans for the development of commercial and industrial use property and loans for the purchase and improvement of raw land. These loans are secured in whole or in part by the underlying real estate collateral and are generally guaranteed by the principals of the borrowing entity.

*Secured by 1–4 family residential properties* – These loans include conventional mortgage loans on one-to-four family residential properties. These properties may serve as the borrower’s primary residence, vacation home or investment property. Also included in this portfolio are home equity loans and lines of credit. This type of lending, which is secured by a first or second mortgage on the borrower’s residence, allows customers to borrow against the equity in their home.

*Secured by multi-family residential properties* – These are mortgage loans secured by apartment buildings.

*Secured by non-farm, non-residential properties* – Commercial real estate loans include loans secured by commercial and industrial properties, office or mixed-use facilities, strip shopping centers or other commercial property. These loans are generally guaranteed by the principals of the borrowing entity.

*Other real estate loans* – Other real estate loans are loans primarily for agricultural production, secured by mortgages on farm land.

*Commercial and industrial loans* – Includes loans to commercial customers for use in the normal course of business. These credits may be loans and lines to financially strong borrowers, secured by inventories, equipment or receivables, and are generally guaranteed by the principals of the borrowing entity.

*Consumer loans* – Includes a variety of secured and unsecured personal loans, including automobile loans, loans for household and personal purposes and all other direct consumer installment loans.

*Other loans* – Other loans comprise credit cards, overdrawn checking accounts reclassified to loans and overdraft lines of credit.

**Related Party Loans:**

In the ordinary course of business, the Bank makes loans to certain officers and directors of the Company, including companies with which they are associated. These loans are made on the same terms as those prevailing for comparable transactions with others. Such loans do not represent more than normal risk of collectability, nor do they present other unfavorable features. The aggregate balances of such related party loans and commitments as of December 31, 2013 and 2012 were \$3.6 million and \$2.5 million, respectively. During the year ended December 31, 2013, new loans to these parties totaled \$1.7 million, and repayments by active related parties were \$0.6 million. During the year ended December 31, 2012, new loans to these related parties totaled \$0.3 million, and repayments by active related parties were \$0.7 million.

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**Allowance for Loan Losses:**

The following tables present changes in the allowance for loan losses by reporting segment and loan type as of December 31, 2013 and 2012:

|   | FUSB                   |                           |          |                            |       |             | Total     |
|---|------------------------|---------------------------|----------|----------------------------|-------|-------------|-----------|
|   | December 31, 2013      |                           |          |                            |       |             |           |
|   | Commercial             | Commercial<br>Real Estate | Consumer | Residential<br>Real Estate | Other | Unallocated |           |
|   | (Dollars in Thousands) |                           |          |                            |       |             |           |
| <b>Allowance for loan losses:</b>                             |                        |                           |          |                            |       |             |           |
| Beginning balance . . . . .                                   | \$ 977                 | \$ 14,216                 | \$ 168   | \$ 338                     | \$ 66 | \$ —        | \$ 15,765 |
| Charge-offs . . . . .   | 537                    | 8,055                     | 350      | 685                        | —     | —           | 9,627     |
| Recoveries . . . . .  | 141                    | 2,747                     | 96       | 8                          | 4     | —           | 2,996     |
| Provision . . . . .   | 11                     | (4,056)                   | 266      | 974                        | (57)  | —           | (2,862)   |
| Ending balance . . . . .                                      | 592                    | 4,852                     | 180      | 635                        | 13    | —           | 6,272     |
| Ending balance individually<br>evaluated for impairment . . . | 219                    | 2,839                     | —        | 11                         | —     | —           | 3,069     |
| Ending balance collectively<br>evaluated for impairment . . . | \$ 373                 | \$ 2,013                  | \$ 180   | \$ 624                     | \$ 13 | \$ —        | \$ 3,203  |
| <b>Loan receivables:</b>                                      |                        |                           |          |                            |       |             |           |
| Ending balance . . . . .                                      | 37,772                 | 156,634                   | 9,886    | 34,978                     | 604   | —           | 239,874   |
| Ending balance individually<br>evaluated for impairment . . . | 753                    | 28,813                    | —        | 2,985                      | —     | —           | 32,551    |
| Ending balance collectively<br>evaluated for impairment . . . | \$37,019               | \$127,821                 | \$9,886  | \$31,993                   | \$604 | \$ —        | \$207,323 |
|   | ALC                    |                           |          |                            |       |             |           |
|   | December 31, 2013      |                           |          |                            |       |             |           |
|   | Commercial             | Commercial<br>Real Estate | Consumer | Residential<br>Real Estate | Other | Unallocated | Total     |
|   | (Dollars in Thousands) |                           |          |                            |       |             |           |
| <b>Allowance for loan losses:</b>                             |                        |                           |          |                            |       |             |           |
| Beginning balance . . . . .                                   | \$ —                   | \$ —                      | \$ 2,733 | \$ 780                     | \$ —  | \$ —        | \$ 3,513  |
| Charge-offs . . . . .   | —                      | —                         | 2,979    | 525                        | —     | —           | 3,504     |
| Recoveries . . . . .  | —                      | —                         | 874      | 21                         | —     | —           | 895       |
| Provision . . . . .   | —                      | —                         | 2,039    | 181                        | —     | —           | 2,220     |
| Ending balance . . . . .                                      | —                      | —                         | 2,667    | 457                        | —     | —           | 3,124     |
| Ending balance individually<br>evaluated for impairment . . . | —                      | —                         | —        | —                          | —     | —           | —         |
| Ending balance collectively<br>evaluated for impairment . . . | \$ —                   | \$ —                      | \$ 2,667 | \$ 457                     | \$ —  | \$ —        | \$ 3,124  |
| <b>Loan receivables:</b>                                      |                        |                           |          |                            |       |             |           |
| Ending balance . . . . .                                      | —                      | —                         | 48,938   | 26,621                     | —     | —           | 75,559    |
| Ending balance individually<br>evaluated for impairment . . . | —                      | —                         | —        | —                          | —     | —           | —         |
| Ending balance collectively<br>evaluated for impairment . . . | \$ —                   | \$ —                      | \$48,938 | \$26,621                   | \$ —  | \$ —        | \$75,559  |

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| FUSB & ALC  |                           |                  |                            |                 |                |             |                  |
|---|---------------------------|------------------|----------------------------|-----------------|----------------|-------------|------------------|
| December 31, 2013   |                           |                  |                            |                 |                |             |                  |
| Commercial  | Commercial<br>Real Estate | Consumer         | Residential<br>Real Estate | Other           | Unallocated    | Total       |                  |
| (Dollars in Thousands)  |                           |                  |                            |                 |                |             |                  |
| <b>Allowance for loan losses:</b>                               |                           |                  |                            |                 |                |             |                  |
| Beginning balance . . . . .                                     | \$ 977                    | \$ 14,216        | \$ 2,901                   | \$ 1,118        | \$ 66          | \$ —        | \$ 19,278        |
| Charge-offs . . . . .   | 537                       | 8,055            | 3,329                      | 1,210           | —              | —           | 13,131           |
| Recoveries . . . . .  | 141                       | 2,747            | 970                        | 29              | 4              | —           | 3,891            |
| Provision . . . . .   | 11                        | (4,056)          | 2,305                      | 1,155           | (57)           | —           | (642)            |
| Ending balance . . . . .  | <u>592</u>                | <u>4,852</u>     | <u>2,847</u>               | <u>1,092</u>    | <u>13</u>      | <u>—</u>    | <u>9,396</u>     |
| Ending balance individually<br>evaluated for impairment . . .   | <u>219</u>                | <u>2,839</u>     | <u>—</u>                   | <u>11</u>       | <u>—</u>       | <u>—</u>    | <u>3,069</u>     |
| Ending balance collectively<br>evaluated for impairment . . .   | <u>\$ 373</u>             | <u>\$ 2,013</u>  | <u>\$ 2,847</u>            | <u>\$ 1,081</u> | <u>\$ 13</u>   | <u>\$ —</u> | <u>\$ 6,327</u>  |
| <b>Loan receivables:</b>  |                           |                  |                            |                 |                |             |                  |
| Ending balance . . . . .  | <u>37,772</u>             | <u>156,634</u>   | <u>58,824</u>              | <u>61,599</u>   | <u>604</u>     | <u>—</u>    | <u>315,433</u>   |
| Ending balance individually<br>evaluated for impairment . . .   | <u>753</u>                | <u>28,813</u>    | <u>—</u>                   | <u>2,985</u>    | <u>—</u>       | <u>—</u>    | <u>32,551</u>    |
| Ending balance collectively<br>evaluated for impairment . . .   | <u>\$37,019</u>           | <u>\$127,821</u> | <u>\$58,824</u>            | <u>\$58,614</u> | <u>\$604</u>   | <u>\$ —</u> | <u>\$282,882</u> |
| FUSB  |                           |                  |                            |                 |                |             |                  |
| December 31, 2012   |                           |                  |                            |                 |                |             |                  |
| Commercial  | Commercial<br>Real Estate | Consumer         | Residential<br>Real Estate | Other           | Unallocated    | Total       |                  |
| (Dollars in Thousands)  |                           |                  |                            |                 |                |             |                  |
| <b>Allowance for loan losses:</b>                               |                           |                  |                            |                 |                |             |                  |
| Beginning balance . . . . .                                     | \$ 889                    | \$ 16,533        | \$ 306                     | \$ 684          | \$ 78          | \$ 201      | \$ 18,691        |
| Charge-offs . . . . .   | 1,278                     | 3,395            | 199                        | 199             | 16             | —           | 5,087            |
| Recoveries . . . . .  | 156                       | 606              | 79                         | 24              | 2              | —           | 867              |
| Provision . . . . .   | 1,210                     | 472              | (18)                       | (171)           | 2              | (201)       | 1,294            |
| Ending balance . . . . .  | <u>977</u>                | <u>14,216</u>    | <u>168</u>                 | <u>338</u>      | <u>66</u>      | <u>—</u>    | <u>15,765</u>    |
| Ending balance individually<br>evaluated for impairment . . . . | <u>406</u>                | <u>10,818</u>    | <u>—</u>                   | <u>—</u>        | <u>—</u>       | <u>—</u>    | <u>11,224</u>    |
| Ending balance collectively<br>evaluated for impairment . . . . | <u>\$ 571</u>             | <u>\$ 3,398</u>  | <u>\$ 168</u>              | <u>\$ 338</u>   | <u>\$ 66</u>   | <u>\$ —</u> | <u>\$ 4,541</u>  |
| <b>Loan receivables:</b>  |                           |                  |                            |                 |                |             |                  |
| Ending balance . . . . .  | <u>42,903</u>             | <u>184,858</u>   | <u>14,483</u>              | <u>38,450</u>   | <u>1,037</u>   | <u>—</u>    | <u>281,731</u>   |
| Ending balance individually<br>evaluated for impairment . . . . | <u>1,085</u>              | <u>52,893</u>    | <u>—</u>                   | <u>325</u>      | <u>—</u>       | <u>—</u>    | <u>54,303</u>    |
| Ending balance collectively<br>evaluated for impairment . . . . | <u>\$41,818</u>           | <u>\$131,965</u> | <u>\$14,483</u>            | <u>\$38,125</u> | <u>\$1,037</u> | <u>\$ —</u> | <u>\$227,428</u> |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

| ALC   |            |                           |          |                            |       |             |           |
|---|------------|---------------------------|----------|----------------------------|-------|-------------|-----------|
| December 31, 2012                                       |            |                           |          |                            |       |             |           |
|   | Commercial | Commercial<br>Real Estate | Consumer | Residential<br>Real Estate | Other | Unallocated | Total     |
| (Dollars in Thousands)                                  |            |                           |          |                            |       |             |           |
| <b>Allowance for loan losses:</b>                       |            |                           |          |                            |       |             |           |
| Beginning balance                                       | \$ —       | \$ —                      | \$ 2,542 | \$ 1,034                   | \$ —  | \$ —        | \$ 3,576  |
| Charge-offs   | —          | —                         | 3,249    | 713                        | —     | —           | 3,962     |
| Recoveries  | —          | —                         | 815      | 40                         | —     | —           | 855       |
| Provision   | —          | —                         | 2,625    | 419                        | —     | —           | 3,044     |
| Ending balance  | —          | —                         | 2,733    | 780                        | —     | —           | 3,513     |
| Ending balance individually<br>evaluated for impairment | —          | —                         | —        | —                          | —     | —           | —         |
| Ending balance collectively<br>evaluated for impairment | \$ —       | \$ —                      | \$ 2,733 | \$ 780                     | \$ —  | \$ —        | \$ 3,513  |
| <b>Loan receivables:</b>                                |            |                           |          |                            |       |             |           |
| Ending balance  | —          | —                         | 47,001   | 33,047                     | —     | —           | 80,048    |
| Ending balance individually<br>evaluated for impairment | —          | —                         | —        | —                          | —     | —           | —         |
| Ending balance collectively<br>evaluated for impairment | \$ —       | \$ —                      | \$47,001 | \$33,047                   | \$ —  | \$ —        | \$ 80,048 |

| FUSB and ALC  |            |                           |          |                            |         |             |           |
|---|------------|---------------------------|----------|----------------------------|---------|-------------|-----------|
| December 31, 2012                                       |            |                           |          |                            |         |             |           |
|   | Commercial | Commercial<br>Real Estate | Consumer | Residential<br>Real Estate | Other   | Unallocated | Total     |
| (Dollars in Thousands)                                  |            |                           |          |                            |         |             |           |
| <b>Allowance for loan losses:</b>                       |            |                           |          |                            |         |             |           |
| Beginning balance                                       | \$ 889     | \$ 16,533                 | \$ 2,848 | \$ 1,718                   | \$ 78   | \$ 201      | \$ 22,267 |
| Charge-offs   | 1,278      | 3,395                     | 3,448    | 912                        | 16      | —           | 9,049     |
| Recoveries  | 156        | 606                       | 894      | 64                         | 2       | —           | 1,722     |
| Provision   | 1,210      | 472                       | 2,607    | 248                        | 2       | (201)       | 4,338     |
| Ending balance  | 977        | 14,216                    | 2,901    | 1,118                      | 66      | —           | 19,278    |
| Ending balance individually<br>evaluated for impairment | 406        | 10,818                    | —        | —                          | —       | —           | 11,224    |
| Ending balance collectively<br>evaluated for impairment | \$ 571     | \$ 3,398                  | \$ 2,901 | \$ 1,118                   | \$ 66   | \$ —        | \$ 8,054  |
| <b>Loan receivables:</b>                                |            |                           |          |                            |         |             |           |
| Ending balance  | 42,903     | 184,858                   | 61,484   | 71,497                     | 1,037   | —           | 361,779   |
| Ending balance individually<br>evaluated for impairment | 1,085      | 52,893                    | —        | 325                        | —       | —           | 54,303    |
| Ending balance collectively<br>evaluated for impairment | \$41,818   | \$131,965                 | \$61,484 | \$71,172                   | \$1,037 | \$ —        | \$307,476 |



**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**Credit Quality Indicators:**

The Bank has established a credit risk rating system to assess and manage the risk in the loan portfolio. It establishes a uniform framework and common language for assessing and monitoring risk in the portfolio.

The following is a guide for an 8-grade system of credit risk:

1. **Minimal Risk:** Borrowers in this category have the lowest risk of any resulting loss. Borrowers are of the highest quality, presently and prospectively.
2. **Better Than Average Risk:** Borrowers in the high end of medium range between borrowers who are definitely sound and those with minor risk characteristics.
3. **Moderate Risk:** Borrowers in this category have little chance of resulting in a loss. This category should include the average loan, under average economic conditions.
4. **Acceptable Risk:** Borrowers in this category have a limited chance of resulting in a loss.
5. **Special Mention (Potential Weakness):** Borrowers in this category exhibit potential credit weaknesses or downward trends deserving Bank management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Included in special mention assets could be workout or turnaround situations, as well as those borrowers previously rated 2-4 who have shown deterioration, for whatever reason, indicating a downgrading from the better grade. The special mention rating is designed to identify a specific level of risk and concern about a loan's and/or borrower's quality. Although a special mention asset has a higher probability of default than previously rated categories, its default is not imminent.

6. **Substandard (Definite Weakness – Loss Unlikely):** These are borrowers with defined weaknesses that jeopardize the orderly liquidation of debt. A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Normal repayment from the borrower is in jeopardy, although no loss of principal is envisioned. There is a distinct possibility that a partial loss of interest and/or principal will occur if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard.
7. **Doubtful:** Borrowers classified doubtful have all the weaknesses found in substandard borrowers with the added provision that the weaknesses make collection of debt in full, based on currently existing facts, conditions and values, highly questionable and improbable. Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors that may work to strengthen the assets, the loans' classification as estimated losses is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans. Management of borrowers classified doubtful may have demonstrated a history of failing to live up to agreements.
8. **Loss:** Borrowers deemed incapable of repayment of unsecured debt. Loans to such borrowers are considered uncollectible and of such little value that continuance as active assets of the Bank is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not prudent to defer writing off these worthless assets, even though partial recovery may be affected in the future.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

The table below illustrates the carrying amount of loans by credit quality indicator as of December 31, 2013.

|   | FUSB                   |                         |                  |               | Total            |
|---|------------------------|-------------------------|------------------|---------------|------------------|
|   | Pass<br>1-4            | Special<br>Mention<br>5 | Substandard<br>6 | Doubtful<br>7 |                  |
|   | (Dollars in Thousands) |                         |                  |               |                  |
| Loans secured by real estate:                       |                        |                         |                  |               |                  |
| Construction, land development and other land loans | \$ 3,992               | \$ 793                  | \$ 6,563         | \$—           | \$ 11,348        |
| Secured by 1-4 family residential properties        | 29,295                 | 1,497                   | 4,162            | 24            | 34,978           |
| Secured by multi-family residential properties      | 14,569                 | —                       | 7,526            | —             | 22,095           |
| Secured by non-farm, non-residential properties     | 92,880                 | 11,904                  | 17,595           | 51            | 122,430          |
| Other   | 761                    | —                       | —                | —             | 761              |
| Commercial and industrial loans                     | 31,164                 | 175                     | 6,433            | —             | 37,772           |
| Consumer loans                                      | 9,133                  | 105                     | 648              | —             | 9,886            |
| Other loans   | 600                    | 1                       | 3                | —             | 604              |
| Total   | <u>\$182,394</u>       | <u>\$14,475</u>         | <u>\$42,930</u>  | <u>\$ 75</u>  | <u>\$239,874</u> |

|  | ALC                    |                |                 |
|--|------------------------|----------------|-----------------|
|  | Performing             | Nonperforming  | Total           |
|  | (Dollars in Thousands) |                |                 |
| Loans secured by real estate:                |                        |                |                 |
| Secured by 1-4 family residential properties | \$26,061               | \$ 560         | \$26,621        |
| Consumer loans                               | 47,644                 | 1,294          | 48,938          |
| Total  | <u>\$73,705</u>        | <u>\$1,854</u> | <u>\$75,559</u> |

The table below illustrates the carrying amount of loans by credit quality indicator as of December 31, 2012.

|   | FUSB                   |                         |                  |               | Total            |
|---|------------------------|-------------------------|------------------|---------------|------------------|
|   | Pass<br>1-4            | Special<br>Mention<br>5 | Substandard<br>6 | Doubtful<br>7 |                  |
|   | (Dollars in Thousands) |                         |                  |               |                  |
| Loans secured by real estate:                       |                        |                         |                  |               |                  |
| Construction, land development and other land loans | \$ 12,653              | \$ 1,235                | \$16,747         | \$—           | \$ 30,635        |
| Secured by 1-4 family residential properties        | 31,772                 | 1,546                   | 5,132            | —             | 38,450           |
| Secured by multi-family residential properties      | 10,776                 | 3,132                   | 10,279           | —             | 24,187           |
| Secured by non-farm, non-residential properties     | 90,139                 | 8,630                   | 30,466           | —             | 129,235          |
| Other   | 801                    | —                       | —                | —             | 801              |
| Commercial and industrial loans                     | 40,607                 | 419                     | 1,877            | —             | 42,903           |
| Consumer loans                                      | 13,394                 | 188                     | 901              | —             | 14,483           |
| Other loans   | 1,036                  | —                       | 1                | —             | 1,037            |
| Total   | <u>\$201,178</u>       | <u>\$15,150</u>         | <u>\$65,403</u>  | <u>\$—</u>    | <u>\$281,731</u> |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

|  | ALC                    |               |          |
|--|------------------------|---------------|----------|
|  | Performing             | Nonperforming | Total    |
|  | (Dollars in Thousands) |               |          |
| Loans secured by real estate:                          |                        |               |          |
| Secured by 1-4 family residential properties . . . . . | \$32,036               | \$1,011       | \$33,047 |
| Consumer loans . . . . .                               | 46,175                 | 826           | 47,001   |
| Total . . . . .  | \$78,211               | \$1,837       | \$80,048 |

The following table provides an aging analysis of past due loans by class as of December 31, 2013.

|  | FUSB                    |                        |                            |                   |           |                |   |
|--|-------------------------|------------------------|----------------------------|-------------------|-----------|----------------|---|
|  | As of December 31, 2013 |                        |                            |                   |           |                |   |
|  | 30-59 Days<br>Past Due  | 60-89 Days<br>Past Due | Greater<br>Than<br>90 Days | Total Past<br>Due | Current   | Total<br>Loans | Recorded<br>Investment ><br>90 Days and<br>Accruing |
| (Dollars in Thousands)   |                         |                        |                            |                   |           |                |   |
| Loans secured by real estate:                                    |                         |                        |                            |                   |           |                |   |
| Construction, land development<br>and other land loans . . . . . | \$ —                    | \$ 38                  | \$ 2,000                   | \$ 2,038          | \$ 9,310  | \$ 11,348      | \$ —  |
| Secured by 1-4 family residential<br>properties . . . . .        | 271                     | 154                    | 1,801                      | 2,226             | 32,752    | 34,978         | —   |
| Secured by multi-family<br>residential properties . . . . .      | —                       | —                      | 1,286                      | 1,286             | 20,809    | 22,095         | —   |
| Secured by non-farm, non-<br>residential properties . . . . .    | 719                     | 93                     | 4,434                      | 5,246             | 117,184   | 122,430        | —   |
| Other . . . . .  | —                       | —                      | —                          | —                 | 761       | 761            | —   |
| Commercial and industrial loans . . . . .                        | 902                     | —                      | 480                        | 1,382             | 36,390    | 37,772         | —   |
| Consumer loans . . . . .   | 101                     | —                      | 26                         | 127               | 9,759     | 9,886          | —   |
| Other loans . . . . .  | 11                      | —                      | 8                          | 19                | 585       | 604            | —   |
| Total . . . . .  | \$2,004                 | \$285                  | \$10,035                   | \$12,324          | \$227,550 | \$239,874      | \$ —  |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

| ALC   |                        |                        |                         |                   |                 |                 |   |
|---|------------------------|------------------------|-------------------------|-------------------|-----------------|-----------------|---|
| As of December 31, 2013                                       |                        |                        |                         |                   |                 |                 |   |
|   | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater Than<br>90 Days | Total Past<br>Due | Current         | Total<br>Loans  | Recorded<br>Investment ><br>90 Days and<br>Accruing |
| (Dollars in Thousands)  |                        |                        |                         |                   |                 |                 |   |
| Loans secured by real estate:                                 |                        |                        |                         |                   |                 |                 |   |
| Construction, land development and other land loans . . . . . | \$ —                   | \$—                    | \$ —                    | \$ —              | \$ —            | \$ —            | \$ —  |
| Secured by 1-4 family residential properties . . . . .        | 403                    | 143                    | 507                     | 1,053             | 25,568          | 26,621          | 409   |
| Secured by multi-family residential properties . . . . .      | —                      | —                      | —                       | —                 | —               | —               | —   |
| Secured by non-farm, non-residential properties . . . . .     | —                      | —                      | —                       | —                 | —               | —               | —   |
| Other . . . . .   | —                      | —                      | —                       | —                 | —               | —               | —   |
| Commercial and industrial loans . . . . .                     | —                      | —                      | —                       | —                 | —               | —               | —   |
| Consumer loans . . . . .                                      | 684                    | 597                    | 1,258                   | 2,539             | 46,399          | 48,938          | 1,252   |
| Other loans . . . . .   | —                      | —                      | —                       | —                 | —               | —               | —   |
| Total . . . . .   | <u>\$1,087</u>         | <u>\$740</u>           | <u>\$1,765</u>          | <u>\$3,592</u>    | <u>\$71,967</u> | <u>\$75,559</u> | <u>\$1,661</u>                                      |

The following table provides an aging analysis of past due loans by class as of December 31, 2012.

| FUSB  |                        |                        |                         |                   |                  |                  |   |
|---|------------------------|------------------------|-------------------------|-------------------|------------------|------------------|---|
| As of December 31, 2012                                       |                        |                        |                         |                   |                  |                  |   |
|   | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater Than<br>90 Days | Total Past<br>Due | Current          | Total Loans      | Recorded<br>Investment ><br>90 Days and<br>Accruing |
| (Dollars in Thousands)  |                        |                        |                         |                   |                  |                  |   |
| Loans secured by real estate:                                 |                        |                        |                         |                   |                  |                  |   |
| Construction, land development and other land loans . . . . . | \$ 456                 | \$1,126                | \$10,329                | \$11,911          | \$ 18,724        | \$ 30,635        | \$ —  |
| Secured by 1-4 family residential properties . . . . .        | 1,027                  | 572                    | 1,106                   | 2,705             | 35,745           | 38,450           | —   |
| Secured by multi-family residential properties . . . . .      | —                      | —                      | 2,884                   | 2,884             | 21,303           | 24,187           | —   |
| Secured by non-farm, non-residential properties . . . . .     | 210                    | 32                     | 4,930                   | 5,172             | 124,063          | 129,235          | —   |
| Other . . . . .   | —                      | —                      | —                       | —                 | 801              | 801              | —   |
| Commercial and industrial loans . . . . .                     | 429                    | 59                     | 480                     | 968               | 41,935           | 42,903           | —   |
| Consumer loans . . . . .                                      | 407                    | 89                     | 66                      | 562               | 13,921           | 14,483           | —   |
| Other loans . . . . .   | —                      | —                      | —                       | —                 | 1,037            | 1,037            | —   |
| Total . . . . .   | <u>\$2,529</u>         | <u>\$1,878</u>         | <u>\$19,795</u>         | <u>\$24,202</u>   | <u>\$257,529</u> | <u>\$281,731</u> | <u>\$ —</u>   |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

| ALC   |                        |                        |                         |                   |                 |                 |   |
|---|------------------------|------------------------|-------------------------|-------------------|-----------------|-----------------|---|
| As of December 31, 2012                                       |                        |                        |                         |                   |                 |                 |   |
|   | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater Than<br>90 Days | Total Past<br>Due | Current         | Total Loans     | Recorded<br>Investment ><br>90 Days and<br>Accruing |
| (Dollars in Thousands)  |                        |                        |                         |                   |                 |                 |   |
| Loans secured by real estate:                                 |                        |                        |                         |                   |                 |                 |   |
| Construction, land development and Other land loans . . . . . | \$ —                   | \$—                    | \$ —                    | \$ —              | \$ —            | \$ —            | \$ —  |
| Secured by 1-4 family residential properties . . . . .        | 348                    | 173                    | 1,075                   | 1,596             | 31,451          | 33,047          | 851   |
| Secured by multi-family residential properties . . . . .      | —                      | —                      | —                       | —                 | —               | —               | —   |
| Secured by non-farm, non-residential properties . . . . .     | —                      | —                      | —                       | —                 | —               | —               | —   |
| Other . . . . .   | —                      | —                      | —                       | —                 | —               | —               | —   |
| Commercial and industrial loans . . . . .                     | —                      | —                      | —                       | —                 | —               | —               | —   |
| Consumer loans . . . . .                                      | 989                    | 609                    | 1,159                   | 2,757             | 44,244          | 47,001          | 720   |
| Other loans . . . . .   | —                      | —                      | —                       | —                 | —               | —               | —   |
| Total . . . . .   | <u>\$1,337</u>         | <u>\$782</u>           | <u>\$2,234</u>          | <u>\$4,353</u>    | <u>\$75,695</u> | <u>\$80,048</u> | <u>\$1,571</u>                                      |

The following table provides an analysis of non-accruing loans by class as of December 31, 2013 and 2012.

|   | Loans on Non-Accrual Status |                   |
|---|-----------------------------|-------------------|
|   | December 31, 2013           | December 31, 2012 |
| (Dollars in Thousands)  |                             |                   |
| Loans secured by real estate:                                 |                             |                   |
| Construction, land development and other land loans . . . . . | \$ 2,337                    | \$11,456          |
| Secured by 1-4 family residential properties . . . . .        | 1,952                       | 2,441             |
| Secured by multi-family residential properties . . . . .      | 1,286                       | 2,884             |
| Secured by non-farm, non-residential properties . . . . .     | 4,435                       | 5,809             |
| Commercial and industrial loans . . . . .                     | 479                         | 822               |
| Consumer loans . . . . .                                      | 76                          | 206               |
| Total loans . . . . .   | <u>\$10,565</u>             | <u>\$23,618</u>   |

**Impaired Loans:**

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the related loan agreement. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. All loans of \$500,000 or more that are classified as nonaccrual are identified for impairment analysis. The policy for recognizing income on impaired loans is consistent with the nonaccrual policy. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

As of December 31, 2013, the carrying amount of impaired loans consisted of the following:

|   | <u>December 31, 2013</u> |                  |                   |
|---|--------------------------|------------------|-------------------|
|   | <u>Carrying</u>          | <u>Unpaid</u>    | <u>Related</u>    |
| <u>Impaired loans with no related allowance recorded</u>      | <u>Amount</u>            | <u>Principal</u> | <u>Allowances</u> |
|   | (Dollars in Thousands)   |                  |                   |
| Loans secured by real estate                                  |                          |                  |                   |
| Construction, land development and other land loans . . . . . | \$ 4,590                 | \$ 4,590         | \$ —              |
| Secured by 1-4 family residential properties . . . . .        | 103                      | 103              | —                 |
| Secured by multi-family residential properties . . . . .      | 1,053                    | 1,053            | —                 |
| Secured by non-farm, non-residential properties . . . . .     | 11,844                   | 11,844           | —                 |
| Commercial and industrial . . . . .                           | 534                      | 534              | —                 |
| Total loans with no related allowance recorded . . . . .      | <u>\$18,124</u>          | <u>\$18,124</u>  | <u>\$ —</u>       |
| <br>  |                          |                  |                   |
| <u>Impaired loans with an allowance recorded</u>              |                          |                  |                   |
| Loans secured by real estate                                  |                          |                  |                   |
| Construction, land development and other land loans . . . . . | \$ 1,407                 | \$ 1,407         | \$ 232            |
| Secured by 1-4 family residential properties . . . . .        | 185                      | 185              | 11                |
| Secured by multi-family residential properties . . . . .      | 6,474                    | 6,474            | 2,005             |
| Secured by non-farm, non-residential properties . . . . .     | 6,376                    | 6,376            | 835               |
| Commercial and industrial . . . . .                           | 219                      | 219              | 219               |
| Total loans with an allowance recorded . . . . .              | <u>\$14,661</u>          | <u>\$14,661</u>  | <u>\$3,302</u>    |
| <br>  |                          |                  |                   |
| <u>Total impaired loans</u>                                   |                          |                  |                   |
| Loans secured by real estate                                  |                          |                  |                   |
| Construction, land development and other land loans . . . . . | \$ 5,997                 | \$ 5,997         | \$ 232            |
| Secured by 1-4 family residential properties . . . . .        | 288                      | 288              | 11                |
| Secured by multi-family residential properties . . . . .      | 7,527                    | 7,527            | 2,005             |
| Secured by non-farm, non-residential properties . . . . .     | 18,220                   | 18,220           | 835               |
| Commercial and industrial . . . . .                           | 753                      | 753              | 219               |
| Total impaired loans . . . . .                                | <u>\$32,785</u>          | <u>\$32,785</u>  | <u>\$3,302</u>    |

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As of December 31, 2012, the carrying amount of impaired loans consisted of the following:

|   | <b>December 31, 2012</b>   |   |                               |
|---|----------------------------|---|-------------------------------|
|   | <b>Carrying<br/>Amount</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowances</b> |
| <b>(Dollars in Thousands)</b>                                   |                            |   |                               |
| <b><u>Impaired loans with no related allowance recorded</u></b> |                            |   |                               |
| Loans secured by real estate                                    |                            |   |                               |
| Construction, land development and other land loans . . . . .   | \$ 2,645                   | \$ 2,645                                | \$ —                          |
| Secured by 1-4 family residential properties . . . . .          | 325                        | 325                                     | —                             |
| Secured by multi-family residential properties . . . . .        | 3,027                      | 3,027                                   | —                             |
| Secured by non-farm, non-residential properties . . . . .       | 21,471                     | 21,471                                  | —                             |
| Commercial and industrial . . . . .                             | 655                        | 655                                     | —                             |
| Total loans with no related allowance recorded . . . . .        | <u>\$28,123</u>            | <u>\$28,123</u>                         | <u>\$ —</u>                   |
| <b><u>Impaired loans with an allowance recorded</u></b>         |                            |   |                               |
| Loans secured by real estate                                    |                            |   |                               |
| Construction, land development and other land loans . . . . .   | \$12,658                   | \$12,658                                | \$ 7,453                      |
| Secured by multi-family residential properties . . . . .        | 7,252                      | 7,252                                   | 1,865                         |
| Secured by non-farm, non-residential properties . . . . .       | 5,840                      | 5,840                                   | 1,500                         |
| Commercial and industrial . . . . .                             | 430                        | 430                                     | 406                           |
| Total loans with an allowance recorded . . . . .                | <u>\$26,180</u>            | <u>\$26,180</u>                         | <u>\$11,224</u>               |
| <b><u>Total impaired loans</u></b>                              |                            |   |                               |
| Loans secured by real estate                                    |                            |   |                               |
| Construction, land development and other land loans . . . . .   | \$15,303                   | \$15,303                                | \$ 7,453                      |
| Secured by 1-4 family residential properties . . . . .          | 325                        | 325                                     | —                             |
| Secured by multi-family residential properties . . . . .        | 10,279                     | 10,279                                  | 1,865                         |
| Secured by non-farm, non-residential properties . . . . .       | 27,311                     | 27,311                                  | 1,500                         |
| Commercial and industrial . . . . .                             | 1,085                      | 1,085                                   | 406                           |
| Total impaired loans . . . . .                                  | <u>\$54,303</u>            | <u>\$54,303</u>                         | <u>\$11,224</u>               |

The average net investment in impaired loans and interest income recognized and received on impaired loans as of December 31, 2013 and 2012 were as follows:

|   | <b>December 31, 2013</b>                   |   |   |
|---|--|---|---|
|   | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Interest<br/>Income<br/>Received</b> |
| <b>(Dollars in Thousands)</b>                                 |  |   |   |
| Loans secured by real estate                                  |  |   |   |
| Construction, land development and other land loans . . . . . | \$10,249                                   | \$ 177                                    | \$ 179                                  |
| Secured by 1-4 family residential properties . . . . .        | 303  | 7   | 7                                       |
| Secured by multi-family residential properties . . . . .      | 8,690                                      | 438                                       | 446                                     |
| Secured by non-farm, non-residential properties . . . . .     | 22,272                                     | 918                                       | 935                                     |
| Commercial and industrial . . . . .                           | 987  | 33  | 34                                      |
| Total . . . . .   | <u>\$42,501</u>                            | <u>\$1,573</u>                            | <u>\$1,601</u>                          |



**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
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|   | December 31, 2012                 |                                  |                                |
|---|-----------------------------------|----------------------------------|--------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Received |
|   | (Dollars in Thousands)            |                                  |                                |
| Loans secured by real estate                                  |                                   |                                  |                                |
| Construction, land development and other land loans . . . . . | \$18,283                          | \$ 546                           | \$ 598                         |
| Secured by 1–4 family residential properties . . . . .        | 146                               | 10                               | 9                              |
| Secured by multi-family residential properties . . . . .      | 4,942                             | 483                              | 455                            |
| Secured by non-farm, non-residential properties . . . . .     | 29,627                            | 1,452                            | 1,478                          |
| Commercial and industrial . . . . .                           | 1,222                             | 38                               | 42                             |
| Total . . . . .   | \$54,220                          | \$2,529                          | \$2,582                        |

Loans on which the accrual of interest has been discontinued amounted to \$10.6 million and \$23.6 million as of December 31, 2013 and 2012, respectively. If interest on those loans had been accrued, such income would have approximated \$0.6 million and \$1.1 million for 2013 and 2012, respectively. Interest income actually recorded on those loans amounted to \$0.1 million and \$0.2 million for 2013 and 2012, respectively. Accruing loans past due 90 days or more amounted to \$1.7 million and \$1.6 million for 2013 and 2012, respectively.

**Troubled Debt Restructurings:**

Loans are considered restructured loans if concessions have been granted to borrowers that are experiencing financial difficulty. The concessions granted generally involve the modification of terms of the loan, such as changes in payment schedule or interest rate, which generally would not otherwise be considered. Restructured loans can involve loans remaining on non-accrual, moving to non-accrual or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Non-accrual restructured loans are included and treated with all other non-accrual loans. In addition, all accruing restructured loans are being reported as troubled debt restructurings. Generally, restructured loans remain on non-accrual until the customer has attained a sustained period of repayment performance under the modified loan terms (generally a minimum of six months). However, performance prior to the restructuring, or significant events that coincide with the restructuring, are considered in assessing whether the borrower can meet the new terms and whether the loan should be returned to or maintained on non-accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan remains on non-accrual. Based on the above, the Company had \$5.7 million and \$12.4 million of non-accruing loans that were restructured and remained on non-accrual status as of December 31, 2013 and 2012, respectively. In addition, the Company had \$2.0 million of restructured loans that were restored to accrual status based on a sustained period of repayment performance as of December 31, 2013, compared to \$0.1 million as of December 31, 2012.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
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The following table provides the number of loans modified in a troubled debt restructuring by loan portfolio as of December 31, 2013 and 2012, as well as the pre- and post-modification principal balance as of December 31, 2013 and 2012.

|   | December 31, 2013      |  |                                     | December 31, 2012 |  |                                     |
|---|------------------------|--|-------------------------------------|-------------------|--|-------------------------------------|
|   | Number of Loans        | Pre-Modification Outstanding Principal Balance | Post-Modification Principal Balance | Number of Loans   | Pre-Modification Outstanding Principal Balance | Post-Modification Principal Balance |
|   | (Dollars in Thousands) |  |                                     |                   |  |                                     |
| Loans secured by real estate:                                 |                        |  |                                     |                   |  |                                     |
| Construction, land development and other land loans . . . . . | 10                     | \$ 7,551                                       | \$3,837                             | 10                | \$11,267                                       | \$ 9,988                            |
| Secured by 1-4 family residential properties . . .            | 17                     | 1,375  | 1,067                               | 4                 | 596  | 586                                 |
| Secured by non-farm, non-residential properties . . .         | 9                      | 2,683  | 2,418                               | 6                 | 1,811  | 1,586                               |
| Commercial loans . . . . .                                    | <u>4</u>               | <u>416</u>                                     | <u>344</u>                          | <u>4</u>          | <u>380</u>                                     | <u>356</u>                          |
| Total . . . . .   | <u>40</u>              | <u>\$12,025</u>                                | <u>\$7,666</u>                      | <u>24</u>         | <u>\$14,054</u>                                | <u>\$12,516</u>                     |

The following table provides the number of loans modified in a troubled debt restructuring that have subsequently defaulted, by loan portfolio, as of December 31, 2013 and 2012.

|   | December 31, 2013      |                     | December 31, 2012 |                     |
|---|------------------------|---------------------|-------------------|---------------------|
|   | Number of Loans        | Recorded Investment | Number of Loans   | Recorded Investment |
|   | (Dollars in Thousands) |                     |                   |                     |
| Construction, land development and other land loans . . . . . | 2                      | \$ 566              | 6                 | \$7,062             |
| Secured by non-farm, non-residential properties . . . . .     | 4                      | 1,073               | 2                 | 433                 |
| Commercial . . . . .  | <u>—</u>               | <u>—</u>            | <u>2</u>          | <u>68</u>           |
| Total . . . . .   | <u>6</u>               | <u>\$1,639</u>      | <u>10</u>         | <u>\$7,563</u>      |

Restructured loan modifications may include payment schedule modifications, interest rate concessions, maturity date extensions, modification of note structure, principal reduction or some combination of these concessions.

During the years ended December 31, 2013 and 2012, restructured loan modifications of loans secured by real estate, commercial and industrial loans primarily included maturity date extensions and payment schedule modifications.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

Troubled debt restructurings as of December 31, 2013 and December 31, 2012 were as follows:

|   | <u>December 31,</u><br><u>2013</u> | <u>December 31,</u><br><u>2012</u> | <u>Change</u>    |
|---|------------------------------------|------------------------------------|------------------|
|   | (Dollars in Thousands)             |                                    |                  |
| Loans secured by real estate:                                 |                                    |                                    |                  |
| Construction, land development and other land loans . . . . . | \$3,837                            | \$ 9,988                           | \$(6,151)        |
| Secured by 1-4 family residential properties . . . . .        | 1,067                              | 586                                | 481              |
| Secured by non-farm, non-residential properties . . . . .     | 2,418                              | 1,586                              | 832              |
| Commercial and industrial loans . . . . .                     | <u>344</u>                         | <u>356</u>                         | <u>(12)</u>      |
| Total . . . . .   | <u>\$7,666</u>                     | <u>\$12,516</u>                    | <u>\$(4,850)</u> |

All loans \$500,000 and over, modified in a troubled debt restructuring and rated substandard or lower, are evaluated for impairment. The nature and extent of impairment of restructured loans, including those which have experienced a subsequent payment default, are considered in the determination of an appropriate level of allowance for loan losses. This evaluation resulted in an allowance for loan losses on these restructured loans of \$0.8 million and \$6.3 million for 2013 and 2012, respectively.

**5. OTHER REAL ESTATE OWNED**

Other real estate and certain other assets acquired in foreclosure are reported at the lower of the recorded investment or fair value of the property less estimated costs to sell. The following table summarizes foreclosed property activity as of December 31, 2013 and 2012.

|                                     | <u>December 31, 2013</u> |               |                 |
|-------------------------------------|--------------------------|---------------|-----------------|
|                                     | <u>FUSB</u>              | <u>ALC</u>    | <u>TOTAL</u>    |
|                                     | (Dollars in Thousands)   |               |                 |
| Balance December 31, 2012 . . . . . | \$11,089                 | \$2,197       | \$13,286        |
| Transfers from loans . . . . .      | 1,859                    | 537           | 2,396           |
| Sales proceeds . . . . .            | <u>(3,051)</u>           | <u>(969)</u>  | <u>(4,020)</u>  |
| Gross gains . . . . .               | 69                       | 27            | 96              |
| Gross losses . . . . .              | <u>(215)</u>             | <u>(729)</u>  | <u>(944)</u>    |
| Net losses . . . . .                | (146)                    | (702)         | (848)           |
| Impairment . . . . .                | <u>(1,288)</u>           | <u>(216)</u>  | <u>(1,504)</u>  |
| Balance December 31, 2013 . . . . . | <u>\$ 8,463</u>          | <u>\$ 847</u> | <u>\$ 9,310</u> |

|                                     | <u>December 31, 2012</u> |                 |                 |
|-------------------------------------|--------------------------|-----------------|-----------------|
|                                     | <u>FUSB</u>              | <u>ALC</u>      | <u>TOTAL</u>    |
|                                     | (Dollars in Thousands)   |                 |                 |
| Balance December 31, 2011 . . . . . | \$12,606                 | \$ 4,168        | \$16,774        |
| Transfers from loans . . . . .      | 6,611                    | 757             | 7,368           |
| Sales proceeds . . . . .            | <u>(4,514)</u>           | <u>(1,477)</u>  | <u>(5,991)</u>  |
| Gross gains . . . . .               | 42                       | 63              | 105             |
| Gross losses . . . . .              | <u>(663)</u>             | <u>(725)</u>    | <u>(1,388)</u>  |
| Net losses . . . . .                | (621)                    | (662)           | (1,283)         |
| Impairment . . . . .                | <u>(2,993)</u>           | <u>(589)</u>    | <u>(3,582)</u>  |
| Balance December 31, 2012 . . . . . | <u>\$11,089</u>          | <u>\$ 2,197</u> | <u>\$13,286</u> |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
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Valuation adjustments are primarily recorded in other non-interest expense; adjustments are also recorded as a charge to the allowance for loan losses if incurred within 60 days after the date of transfer from loans. Valuation adjustments are primarily post-foreclosure write-downs that are a result of continued declining property values based on updated appraisals or other indications of value, such as offers to purchase.

**6. PREMISES AND EQUIPMENT**

Premises and equipment and their depreciable lives are summarized as follows:

|  | <b>2013</b>                   | <b>2012</b>     |
|--|-------------------------------|-----------------|
|  | <b>(Dollars in Thousands)</b> |                 |
| Land .....   | \$ 2,003                      | \$ 2,003        |
| Premises (40 years) .....                            | 12,408                        | 12,176          |
| Furniture, fixtures, and equipment (3-7 years) ..... | 12,695                        | 12,484          |
| Total .....  | 27,106                        | 26,663          |
| Less accumulated depreciation .....                  | (18,178)                      | (17,760)        |
| Total .....  | <b>\$ 8,928</b>               | <b>\$ 8,903</b> |

Depreciation expense of \$0.7 million was recorded in both 2013 and 2012 on premises and equipment.

**7. INVESTMENT IN LIMITED PARTNERSHIPS**

The Company has limited partnership investments in affordable housing projects for which it provides funding as a limited partner and receives tax credits related to its investments in the projects based on its partnership share. The Company has invested in limited partnerships of affordable housing projects, both as direct investments and investments in funds that invest solely in affordable housing projects. The Company has determined that these structures require evaluation as a VIE under ASC Topic 810, *Consolidation*. The Company consolidates one of the funds in which it has a 99.9% limited partnership interest. Assets recorded by the Company as a result of the consolidation totaled approximately \$53,000 and \$70,000 as of December 31, 2013 and 2012, respectively. In addition, net loss associated with the consolidation reported as a reduction to the Company's net income totaled approximately \$26,000 and \$70,000 in 2013 and 2012, respectively. In both years, a small portion of the loss (less than \$1,000) was attributable to noncontrolling interests, with the remainder of the loss attributable to the Company. The remaining limited partnership investments are unconsolidated and are accounted for under the cost method as allowed under ASC Topic 325, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects*. The Company amortizes the excess of carrying value of the investment over its estimated residual value during the period in which tax credits are allocated to the investors. The Company's maximum exposure to future loss related to these limited partnerships was limited to the \$0.8 million recorded investment as of December 31, 2013 and 2012.

The assets and liabilities of these partnerships consist primarily of apartment complexes and related mortgages. The Company's carrying value approximates cost or its underlying equity in the net assets of the partnerships. Market quotations are not available for any of the aforementioned partnerships. Management has no knowledge of intervening events since the date of the partnerships' financial statements that would have had a material effect on the Company's consolidated financial position or results of operations.

The Bank had no remaining cash commitments to these partnerships as of December 31, 2013.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**8. DEPOSITS**

As of December 31, 2013, the scheduled maturities of the Bank's time deposits were as follows:

|                           | <u>December 31, 2013</u>  |
|---------------------------|---------------------------|
|                           | (Dollars in<br>Thousands) |
| 2014 .....                | \$137,052                 |
| 2015 .....                | 37,974                    |
| 2016 .....                | 18,709                    |
| 2017 .....                | 12,818                    |
| 2018 and Thereafter ..... | 5,171                     |
| Total .....               | <u>\$211,724</u>          |

At December 31, 2013 and 2012, the Company had brokered certificates of deposit totaling \$15.2 million and \$21.9 million, respectively. Deposits from related parties held by the Company amounted to \$3.9 million and \$4.1 million at December 31, 2013 and 2012, respectively.

**9. SHORT-TERM BORROWINGS**

Short-term borrowings consist of federal funds purchased and securities sold under repurchase agreements. Federal funds purchased generally mature within one to four days. There were no federal funds purchased outstanding as of December 31, 2013 or 2012.

Securities sold under repurchase agreements, which are secured borrowings, generally are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. The Company monitors the fair value of the underlying securities on a daily basis. Securities sold under repurchase agreements as of December 31, 2013 and 2012 were \$1.2 million and \$0.6 million, respectively.

As of December 31, 2013, the Bank had \$18.8 million in available federal fund lines from correspondent banks.

**10. LONG-TERM DEBT**

The Company uses FHLB advances as an alternative to funding sources with similar maturities such as certificates of deposit or other deposit programs. These advances generally offer more attractive rates when compared to other mid-term financing options. They are also flexible, allowing the Company to quickly obtain the necessary maturities and rates that best suit its overall asset/liability strategy. As of December 31, 2013, the Company had advances outstanding of \$5.0 million and assets pledged of \$5.1 million. As of December 31, 2012, no advances were outstanding, and no assets were pledged.

The following summarizes information concerning FHLB advances and other borrowings:

|   | <u>2013</u>                                   | <u>2012</u> |
|---|---|-------------|
|   | (Dollars in Thousands,<br>Except Percentages) |             |
| Balance at year-end .....                       | \$ 5,000                                      | \$ —        |
| Average balance during the year .....           | 1,890   | 4,918       |
| Maximum month-end balance during the year ..... | 5,000   | 20,000      |
| Average rate paid during the year .....         | 0.58%   | 2.30%       |
| Weighted average remaining maturity .....       | 1.67 years                                    | —           |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
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As of December 31, 2013 the Company had one FHLB advance with a rate of 0.57% maturing August 2015. There were no FHLB advances as of December 31, 2012.

December 31, 2013, the Bank had \$165.9 million in available credit from the FHLB.

**11. INCOME TAXES**

The Company files a consolidated income tax return with the federal government and the State of Alabama. ALC files a Mississippi state income tax return related to operations from its Mississippi branches. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and the states in which it files for the years ended December 31, 2010 through 2013.

As of December 31, 2013, the Company had no unrecognized tax benefits related to federal or state income tax matters and does not anticipate any material increase or decrease in unrecognized tax benefits relative to any tax positions taken prior to December 31, 2013. As of December 31, 2013, the Company had accrued no interest and no penalties related to uncertain tax positions.

The consolidated provisions for (benefits from) income taxes for the years ended December 31, 2013 and 2012 were as follows:

|                | <u>2013</u>               | <u>2012</u>   |
|----------------|---------------------------|---------------|
|                | (Dollars in<br>Thousands) |               |
| Federal        |                           |               |
| Current .....  | \$ 971                    | \$(381)       |
| Deferred ..... | 245                       | 830           |
|                | <u>1,216</u>              | <u>449</u>    |
| State          |                           |               |
| Current .....  | 230                       | 126           |
| Deferred ..... | 63                        | 170           |
|                | <u>293</u>                | <u>296</u>    |
| Total .....    | <u>\$1,509</u>            | <u>\$ 745</u> |

The consolidated tax expense (benefit) differed from the amount computed by applying the federal statutory income tax rate of 34.0% as described in the following table:

|   | <u>2013</u>               | <u>2012</u>   |
|---|---------------------------|---------------|
|   | (Dollars in<br>Thousands) |               |
| Income tax expense at federal statutory rate .....          | \$1,848                   | \$1,000       |
| Increase (decrease) resulting from:                         |                           |               |
| Tax-exempt interest .....                                   | (394)                     | (375)         |
| State income tax expense, net of federal income taxes ..... | 190                       | 102           |
| Other .....   | (135)                     | 18            |
| Total .....   | <u>\$1,509</u>            | <u>\$ 745</u> |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
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The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 2013 and 2012 are presented below:

|  | <u>2013</u>            | <u>2012</u>     |
|--|------------------------|-----------------|
|  | (Dollars in Thousands) |                 |
| Deferred tax assets:                                       |                        |                 |
| Allowance for loan losses . . . . .                        | \$ 3,556               | \$ 7,321        |
| Accrued vacation . . . . .                                 | 66                     | 69              |
| Deferred compensation . . . . .                            | 1,608                  | 1,543           |
| Deferred commissions and fees . . . . .                    | 269                    | 420             |
| Goodwill amortization . . . . .                            | 104                    | 147             |
| Impairment OREO . . . . .                                  | 3,103                  | 2,254           |
| Federal NOL carryover . . . . .                            | 2,135                  | —               |
| State NOL carryover . . . . .                              | 568                    | 205             |
| Federal AMT & general business credits carryover . . . . . | 216                    | 155             |
| Other . . . . .  | 42                     | 44              |
|  | <u>11,667</u>          | <u>12,158</u>   |
| Deferred tax liabilities:                                  |                        |                 |
| Premises and equipment . . . . .                           | 236                    | 308             |
| Limited Partnerships . . . . .                             | 154                    | —               |
| Unrealized gain on securities available-for-sale . . . . . | 317                    | 1,883           |
| Other . . . . .  | 173                    | 438             |
|  | <u>880</u>             | <u>2,629</u>    |
| Net deferred tax asset, included in other assets . . . . . | <u>\$10,787</u>        | <u>\$ 9,529</u> |

As of December 31, 2013, of the \$10.8 million net deferred tax asset, \$3.6 million related to the provision for loan losses, \$3.1 million related to impairment of OREO, \$1.6 million resulted from deferred compensation, and \$2.7 million related to carryover of federal and state net operating losses (“NOLs”). As of December 31, 2012, of the \$9.5 million net deferred tax asset, \$7.3 million related to the provision for loan losses, \$2.3 million related to impairment of OREO and \$1.5 million resulted from deferred compensation.

The calculation of the income tax provision requires the use of estimates and judgments by management. As part of the Company’s overall business strategy, management must take into account tax laws and regulations that apply to specific tax issues faced by the Company each year. Management’s determination of the realization of the net deferred tax asset is based upon an evaluation of the four possible sources of taxable income: 1) the future reversals of taxable temporary differences; 2) future taxable income, exclusive of reversing temporary differences and carryforwards; 3) taxable income in prior carryback years; and 4) tax-planning strategies. In making a conclusion, management has evaluated the available positive and negative evidence impacting these sources of taxable income. The primary sources of positive and negative evidence impacting taxable income are summarized below:

*Positive Evidence*

- History of earnings – The Company has a strong history of generating earnings and has demonstrated positive earnings in 18 of the last 20 years. The Company has a full 20-year carryforward period for federal tax purposes and eight years for the State of Alabama to absorb and use any operating losses triggered as a result of reversing deductible differences, such as loan charge-offs or sales of other real estate.



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- Creation of future taxable income – The Company has projected future taxable income that will be sufficient to absorb the remaining deferred tax assets after the reversal of future taxable temporary differences. The taxable income forecasting process utilizes the forecasted pre-tax earnings and adjusts for book-tax differences that will be exempt from taxation, primarily tax-exempt interest income and bank-owned life insurance, as well as temporary book-tax differences, including the allowance for loan losses. The projections relied upon for this process are consistent with those used for the Company’s financial forecasting process. Management believes that the projections resulting from the taxable income forecasting process are sound, however; there can be no assurance that such taxable income will be realized due to unanticipated changes in economic and competitive factors.
- Strong capital position – As of December 31, 2013, the Company had a Tier 1 leverage ratio of 10.88%, calculated as a percentage of 2013 average assets, which is substantially above the 5.00% minimum standard to be considered well capitalized under regulatory guidelines. Also, the total risk-based capital ratio of 19.20% substantially exceeds the 10.00% minimum standard to be considered well capitalized.
- Ability to implement tax-planning strategies – The Company has the ability to implement tax planning strategies to maximize the realization of deferred tax assets, such as the sale of assets. As an example, during the year ended December 31, 2013, the Company’s portfolio of securities available for sale had \$2.4 million of gross unrealized pre-tax gains that could accelerate the recognition of the associated taxable temporary differences, which management would consider to be a tax planning strategy to maximize the realization of the deferred tax assets that may expire unutilized.
- The largest losses experienced were in one type of loan, real estate development. Except in unusual circumstances, the Company no longer invests in these types of loans and is focused on managing this segment of the loan portfolio aggressively. Of the loan loss provision expensed in 2012, 25.0%, or \$1.1 million, was in the loan category of real estate development loans, raw land or residential lots. In 2013, recoveries of previously charged-off amounts in this category, coupled with an improvement in the credit quality and other inherent risks of the loan portfolio at December 31, 2012, resulted in a credit to the loan loss provision.

*Negative Evidence*

- Cumulative loss position – As of December 31, 2013, the Company was in a three-year cumulative loss position. Excluding goodwill impairment in 2011, as this item is nondeductible for income tax purposes, the cumulative continuing operations pre-tax loss position for 2011 through 2013 was \$2.6 million. The cumulative loss primarily resulted from the unprecedented provision for loan losses and net recoveries of \$22.5 million during these periods. Based on our current evaluation of the loan portfolio under current economic conditions, management believes that the provision for loan losses will continue to return to more normalized levels in future periods. During 2013, the Company experienced a reduction in the reserve of \$0.6 million, as compared with a provision for loan losses of \$4.3 million and \$18.8 million in 2012 and 2011, respectively.

The Company believes that the positive evidence, when considered in its entirety, outweighs the negative evidence of recent pre-tax losses. Accordingly, a valuation allowance was not established as of December 31, 2013 or 2012.

**12. EMPLOYEE BENEFIT PLANS**

The Company sponsors a combined 401(k) and employee stock ownership plan, the United Security Bancshares, Inc. Employee Stock Ownership Plan (With 401(k) Provisions) (the “401(k) Plan”). The 401(k)

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Plan allows participants to defer up to 15% of their compensation on a pre-tax basis, subject to the statutory annual contribution limit. For 2013 and 2012, the Company made “safe harbor” contributions on behalf of participants in the form of a match that was equal to 100% of each participant’s elective deferrals, up to a maximum of 4% of the participant’s eligible compensation. The 401(k) Plan also allows the Company to make discretionary matching contributions on behalf of participants equal to 2% of each participant’s elective deferrals. No discretionary match was made in 2013 or 2012. The Company’s matching contributions to the 401(k) Plan totaled \$0.3 million in both 2013 and 2012.

Participants can elect to invest all or a portion of their assets in the 401(k) Plan in the form of Company stock. The 401(k) Plan held 321,814 and 335,349 shares of Company stock as of December 31, 2013 and 2012, respectively. These shares are allocated to participants in the 401(k) Plan and, accordingly, are included in the earnings per share calculations.

**13. DEFERRED COMPENSATION PLAN**

The Bank has entered into supplemental compensation benefits agreements with the directors and certain executive officers. The measurement of the liability under these agreements includes estimates involving life expectancy, length of time before retirement and the expected returns on the Bank-owned life insurance policies used to fund those agreements. Should these estimates prove materially wrong, the cost of these agreements could change accordingly. The related deferred compensation obligation to these directors and executive officers included in other liabilities was \$3.5 and \$3.4 million as of December 31, 2013 and 2012, respectively.

Non-employee directors may elect to defer payment of all or any portion of their FUSB director fees under the United Security Bancshares, Inc. Non-Employee Directors’ Deferred Compensation Plan (the “Deferral Plan”), and, beginning on January 1, 2012, all USBI director fees are deferred under the Deferral Plan. The Deferral Plan, which was ratified by shareholders at the annual meeting held on May 11, 2004, permits non-employee directors to invest their directors’ fees and to receive the adjusted value of the deferred amounts in cash and/or shares of USBI’s common stock.

Neither USBI nor the Bank makes any contribution to participants’ accounts under the Deferral Plan.

While not required by the Deferral Plan, the Company established a grantor trust (Rabbi Trust) as an instrument to fund the stock portion of the Deferral Plan. As of December 31, 2013 and 2012, the grantor trust held 13,701 and 18,170 shares, respectively, of USBI’s common stock. These shares have been classified in equity as treasury stock. The related deferred compensation obligation, included in other liabilities, was \$0.6 million for both December 31, 2013 and 2012.

**14. SHAREHOLDERS’ EQUITY**

Dividends are paid at the discretion of the Company’s Board of Directors, based on the Company’s operating performance and financial position, including earnings, capital and liquidity. Dividends from the Bank are the Company’s primary source of funds for the payment of dividends to shareholders, and there are various legal and regulatory limits regarding the extent to which the Bank may pay dividends or otherwise supply funds to the Company. In addition, federal and state regulatory agencies have the authority to prevent the Company from paying a dividend to shareholders. The Company has not paid a dividend to its shareholders since the first quarter of 2011 due to substantial net losses at the Bank, and the Company can make no assurances that it will be able or permitted to pay dividends in the future.

The Company is subject to various regulatory capital requirements that prescribe quantitative measures of the Company’s assets, liabilities and certain off-balance sheet items. The Company’s regulators also have

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imposed qualitative guidelines for capital amounts and classifications such as risk weightings, capital components and other details. The quantitative measures to ensure capital adequacy require that the Company maintain amounts and ratios, as set forth in the schedule below, of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations) and of Tier I capital to average total assets (as defined in the regulations). Failure to meet minimum capital requirements can initiate certain actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Management believes that, as of December 31, 2013 and 2012, the Company met all capital adequacy requirements imposed by its regulators.

As of December 31, 2013, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios, as set forth in the table. There have been no conditions or events since that notification that management believes have changed the Bank's categorization. The Bank was categorized as "well-capitalized" as of December 31, 2012, as well.

Actual capital amounts, as well as required and well capitalized total risk-based, Tier I risk-based, and Tier I leverage ratios as of December 31, 2013 and 2012, for the Company and the Bank were as follows:

|   | 2013                   |        |                      |       |  |        |
|---|------------------------|--------|----------------------|-------|--|--------|
|   | Actual                 |        | Adequacy<br>Purposes |       | To Be Well<br>Capitalized Under<br>Prompt<br>Corrective<br>Action Provisions |        |
|   | Amount                 | Ratio  | Amount               | Ratio | Amount   | Ratio  |
|   | (Dollars in Thousands) |        |                      |       |  |        |
| Total Capital (to Risk Weighted Assets):  |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | \$64,842               | 19.20% | \$27,012             | 8.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 65,304                 | 19.34% | 27,012               | 8.00% | \$33,765   | 10.00% |
| Tier I Capital (to Risk Weighted Assets): |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | 60,557                 | 17.93% | 13,506               | 4.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 61,019                 | 18.07% | 13,506               | 4.00% | 20,259   | 6.00%  |
| Tier I Leverage (to Average Assets):      |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | 60,557                 | 10.88% | 16,698               | 3.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 61,019                 | 10.97% | 16,691               | 3.00% | 27,819   | 5.00%  |
|   | 2012                   |        |                      |       |  |        |
|   | Actual                 |        | Adequacy<br>Purposes |       | To Be Well<br>Capitalized Under<br>Prompt<br>Corrective<br>Action Provisions |        |
|   | Amount                 | Ratio  | Amount               | Ratio | Amount   | Ratio  |
|   | (Dollars in Thousands) |        |                      |       |  |        |
| Total Capital (to Risk Weighted Assets):  |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | \$63,957               | 17.05% | \$30,008             | 8.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 64,422                 | 17.17% | 30,008               | 8.00% | \$37,510   | 10.00% |
| Tier I Capital (to Risk Weighted Assets): |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | 59,088                 | 15.75% | 15,004               | 4.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 59,553                 | 15.88% | 15,004               | 4.00% | 22,506   | 6.00%  |
| Tier I Leverage (to Average Assets):      |                        |        |                      |       |  |        |
| United Security Bancshares, Inc. . . . .  | 59,088                 | 10.51% | 16,873               | 3.00% | N/A  | N/A    |
| First United Security Bank . . . . .      | 59,553                 | 10.60% | 16,862               | 3.00% | 28,104   | 5.00%  |

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**15. SEGMENT REPORTING**

Under ASC Topic 280, *Segment Reporting*, certain information is disclosed for the two reportable operating segments of the Company: FUSB, ALC and all other (primarily FUSB Reinsurance). The reportable segments were determined using the internal management reporting system. These segments are composed of the Company's and the Bank's significant subsidiaries. The accounting policies for each segment are the same as those described in Note 2, "Summary of Significant Accounting Policies." The segment results include certain overhead allocations and intercompany transactions that were recorded at current market prices. All intercompany transactions have been eliminated to determine the consolidated balances. The results for the two reportable segments of the Company are included in the following table:

|   | 2013                   |                 |              |              | Consolidated |
|---|------------------------|-----------------|--------------|--------------|--------------|
|   | FUSB                   | ALC             | All<br>Other | Eliminations |              |
|   | (Dollars in Thousands) |                 |              |              |              |
| Total interest income . . . . .   | \$ 19,833              | \$17,026        | \$ 10        | \$ (3,233)   | \$ 33,636    |
| Total interest expense . . . . .  | 2,915                  | 3,223           | —            | (3,233)      | 2,905        |
| Net interest income . . . . .   | 16,918                 | 13,803          | 10           | —            | 30,731       |
| Provision (reduction in reserve) for<br>loan losses . . . . .           | (2,862)                | 2,220           | —            | —            | (642)        |
| Net interest income after provision<br>(reduction in reserve) . . . . . | 19,780                 | 11,583          | 10           | —            | 31,373       |
| Total non-interest income . . . . .                                     | 3,553                  | 1,387           | 812          | (887)        | 4,865        |
| Total non-interest expense . . . . .                                    | 20,464                 | 10,303          | 922          | (887)        | 30,802       |
| Income (loss) before income<br>taxes . . . . .                          | 2,869                  | 2,667           | (100)        | —            | 5,436        |
| Provision for income taxes . . . . .                                    | 493                    | 1,012           | 4            | —            | 1,509        |
| Net income (loss) . . . . .   | <u>\$ 2,376</u>        | <u>\$ 1,655</u> | <u>(104)</u> | <u>—</u>     | <u>3,927</u> |
| Other significant items:  |                        |                 |              |              |              |
| Total assets . . . . .  | \$559,159              | \$71,572        | \$76,236     | \$(137,166)  | \$569,801    |
| Total investment securities . . . . .                                   | 170,724                | —               | 80           | —            | 170,804      |
| Total loans, net . . . . .  | 293,069                | 67,474          | —            | (59,616)     | 300,927      |
| Investment in subsidiaries . . . . .                                    | 784                    | —               | 71,096       | (71,875)     | 5            |
| Fixed asset additions . . . . .   | 323                    | 58              | —            | —            | 381          |
| Depreciation and amortization<br>expense . . . . .                      | 539                    | 178             | —            | —            | 717          |
| Total interest income from<br>external customers . . . . .              | 16,610                 | 17,026          | —            | —            | 33,636       |
| Total interest income from<br>affiliates . . . . .                      | 3,223                  | —               | 10           | (3,233)      | —            |

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|  | 2012                   |                 |                 |              |                 |
|--|------------------------|-----------------|-----------------|--------------|-----------------|
|  | FUSB                   | ALC             | All<br>Other    | Eliminations | Consolidated    |
|  | (Dollars in Thousands) |                 |                 |              |                 |
| Total interest income . . . . .                            | \$ 24,109              | \$18,503        | \$ 19           | \$ (3,878)   | \$ 38,753       |
| Total interest expense . . . . .                           | 4,575                  | 3,859           | —               | (3,878)      | 4,556           |
| Net interest income . . . . .                              | 19,534                 | 14,644          | 19              | —            | 34,197          |
| Provision for loan losses . . . . .                        | 1,294                  | 3,044           | —               | —            | 4,338           |
| Net interest income after<br>provision . . . . .           | 18,240                 | 11,600          | 19              | —            | 29,859          |
| Total non-interest income . . . . .                        | 3,967                  | 1,414           | 956             | (772)        | 5,565           |
| Total non-interest expense . . . . .                       | 21,368                 | 10,734          | 1,154           | (772)        | 32,484          |
| Income (loss) before income<br>taxes . . . . .             | 839                    | 2,280           | (179)           | —            | 2,940           |
| (Benefit from) provision for income<br>taxes . . . . .     | (145)                  | 884             | 6               | —            | 745             |
| Net income (loss) . . . . .                                | <u>\$ 984</u>          | <u>\$ 1,396</u> | <u>\$ (185)</u> | <u>—</u>     | <u>\$ 2,195</u> |
| Other significant items:                                   |                        |                 |                 |              |                 |
| Total assets . . . . .                                     | \$557,374              | \$79,090        | \$74,958        | \$(144,289)  | \$567,133       |
| Total investment securities . . . . .                      | 113,670                | —               | 80              | —            | 113,750         |
| Total loans, net . . . . .                                 | 329,425                | 71,609          | —               | (63,634)     | 337,400         |
| Investment in subsidiaries . . . . .                       | 784                    | —               | 69,757          | (70,536)     | 5               |
| Fixed asset additions . . . . .                            | 314                    | 258             | —               | —            | 572             |
| Depreciation and amortization<br>expense . . . . .         | 562                    | 153             | —               | —            | 715             |
| Total interest income from<br>external customers . . . . . | 20,250                 | 18,503          | —               | —            | 38,753          |
| Total interest income from<br>affiliates . . . . .         | 3,858                  | —               | 19              | (3,877)      | —               |

**16. OTHER OPERATING EXPENSES**

Other operating expenses for the years 2013 and 2012 consisted of the following:

|   | 2013                   | 2012           |
|---|------------------------|----------------|
|   | (Dollars in Thousands) |                |
| Legal, accounting and other professional fees . . . . . | \$1,355                | \$1,361        |
| Postage, stationery and supplies . . . . .              | 851                    | 859            |
| Telephone/data communication . . . . .                  | 622                    | 631            |
| FDIC insurance assessments . . . . .                    | 722                    | 787            |
| Other . . . . .   | 5,493                  | 6,198          |
| Total . . . . .   | <u>\$9,043</u>         | <u>\$9,836</u> |

**17. OPERATING LEASES**

The Company leases equipment and office space under noncancellable operating leases and also month-to-month rental agreements.

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The following is a schedule, by years, of future minimum rental payments required under operating leases having initial or remaining noncancellable terms in excess of one year as of December 31, 2013 (dollars in thousands):

|                          |       |
|--------------------------|-------|
| Year ending December 31, |       |
| 2014 .....               | \$401 |
| 2015 .....               | 303   |
| 2016 .....               | 226   |
| 2017 .....               | 151   |
| 2018 .....               | 126   |
| 2019 .....               | 73    |

Total rental expense under all operating leases was \$0.3 million and \$0.7 million in 2013 and 2012, respectively.

**18. GUARANTEES, COMMITMENTS AND CONTINGENCIES**

The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to make loans and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making these commitments as it does for on-balance sheet instruments. For interest rate swap transactions and commitments to purchase or sell securities for forward delivery, the contract or notional amounts do not represent exposure to credit loss. The Bank controls the credit risk of these derivative instruments through credit approvals, limits and monitoring procedures. Certain derivative contracts have credit risk for the carrying value plus the amount to replace such contracts in the event of counterparty default. All of the Bank's financial instruments are held for risk management and not for trading purposes. During the years ended December 31, 2013 and 2012, there were no credit losses associated with derivative contracts.

In the normal course of business, there are outstanding commitments and contingent liabilities, such as commitments to extend credit, letters of credit, and others that are not included in the consolidated financial statements. The financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of amounts recognized in the financial statements. A summary of these commitments and contingent liabilities is presented below:

|                                    |                        |             |
|------------------------------------|------------------------|-------------|
|                                    | <u>December 31,</u>    |             |
|                                    | <u>2013</u>            | <u>2012</u> |
|                                    | (Dollars in Thousands) |             |
| Standby Letters of Credit .....    | \$ 931                 | \$ 1,092    |
| Commitments to Extend Credit ..... | \$28,875               | \$32,123    |

Standby letters of credit are contingent commitments issued by the Bank generally to guarantee the performance of a customer to a third party. The Bank has recourse against the customer for any amount that it is required to pay to a third party under a standby letter of credit. Revenues are recognized over the lives of the standby letters of credit. The potential amount of future payments that the Bank could be required to make under its standby letters of credit, which represent the Bank's total credit risk, are listed in the table above.

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



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requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties.

Commitments to purchase securities for delayed delivery require the Bank to purchase a specified security at a specified price for delivery on a specified date. Similarly, commitments to sell securities for delayed delivery require the Bank to sell a specified security at a specified price for delivery on a specified date. Market risk arises from potential movements in security values and interest rates between the commitment and delivery dates. As of December 31, 2013, there was \$3.0 million in outstanding commitments to purchase securities for delayed delivery and no outstanding commitments to sell securities for delayed delivery. As of December 31, 2012, there were no outstanding commitments to purchase and sell securities for delayed delivery.

*Litigation*

On September 27, 2007, Malcomb Graves Automotive, LLC ("Graves Automotive"), Malcomb Graves and Tina Graves filed a lawsuit in the Circuit Court of Shelby County, Alabama against USBI, the Bank, ALC and their respective directors and officers seeking an unspecified amount of compensatory and punitive damages. A former employee of ALC, Corey Mitchell, was named as a co-defendant, and ALC and the Bank filed a crossclaim against him seeking, among other relief, defense and indemnification for any damages suffered in the underlying lawsuit. The underlying complaint alleged that the defendants committed fraud in misrepresenting to Graves Automotive the amounts that Graves Automotive owed on certain loans and failing to credit Graves Automotive properly for certain loans. The defendants moved to compel arbitration, and the trial court denied the defendants' motion. The defendants appealed this decision, and, on September 29, 2010, the Alabama Supreme Court affirmed the trial court's denial of defendants' motion. Following the return of the case to the active docket, on November 30, 2010, ALC and the Bank moved to dismiss the lawsuit. In response to this motion to dismiss, on June 15, 2011, the Circuit Court dismissed all claims against USBI, the Bank and their respective directors and officers and all claims that were brought by Malcomb Graves and Tina Graves in their individual capacities. The Circuit Court also dismissed Graves Automotive's claims for conversion and negligent supervision against ALC and ordered Graves Automotive to re-plead its fraud allegations against ALC with more particularity. On September 15, 2011, Graves Automotive filed a third amended complaint in response to the Circuit Court's June 15, 2011 order. In its third amended complaint, Graves Automotive asserted claims against ALC for breach of contract, fraud, unjust enrichment and conversion. ALC moved to dismiss the third amended complaint on many of the same grounds as set forth in its previous motion to dismiss. On October 13, 2011, the Circuit Court dismissed Graves Automotive's conversion claim and again ordered Graves Automotive to re-plead its fraud claims with more particularity, this time within 60 days. On December 12, 2011, Graves Automotive filed its fourth amended complaint, this time asserting only two counts, breach of contract and unjust enrichment. Despite removing the fraud claims, the fourth amended complaint still requests punitive damages. On January 11, 2012, ALC filed a motion to dismiss the fourth amended complaint and to strike Graves Automotive's request for punitive damages. This motion was heard on November 27, 2012, and the Circuit Court struck the punitive damages claim but allowed the breach of contract and unjust enrichment claims to go forward. Because Graves Automotive had been unable to produce any documents supporting these remaining claims, on September 30, 2013, the court entered an order requiring Graves Automotive to produce a number of categories of specific documents evidencing the unreimbursed work it had allegedly performed for ALC. After the deadline to produce the documents had passed, ALC filed a Motion to Dismiss for failure to comply with the discovery order or, in the alternative, Motion for Summary Judgment based upon Graves Automotive's inability to produce evidence supporting its claims. In response, Graves recently submitted an affidavit and produced a number of documents purportedly supporting its claims and



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damages. ALC is currently in the process of supplementing its Motion to Dismiss, or in the Alternative, Motion for Summary Judgment to address Graves Automotive's recent production. This motion is set for hearing on May 20, 2014. ALC also has made a nominal settlement offer to avoid the costs associated with additional litigation. ALC has yet to receive a response to this offer. ALC continues to deny the allegations against it in the lawsuit with respect to the remaining claims and intends to vigorously defend itself in this matter. Given the lack of discovery conducted, it is too early to assess the likelihood of a resolution of the remaining claims in this matter or the possibility of an unfavorable outcome.

On December 2, 2013, Wayne Allen Russell filed a lawsuit against the Bank in the Circuit Court of Tuscaloosa County, alleging that the Bank wrongfully foreclosed on a parcel of property owned by Russell that was subject to a mortgage in favor of the Bank. Mr. Russell alleges that the loan secured by the mortgage had been satisfied in full from the proceeds of a prior foreclosure of additional properties subject to the same mortgage. Mr. Russell seeks an unspecified amount of damages. The Bank denies Mr. Russell's allegations and will vigorously defend the lawsuit. However, given the lack of discovery conducted, it is too early to assess the likelihood of a resolution of this matter or the possibility of an unfavorable outcome.

The Company is also party to other litigation, and the Company intends to vigorously defend itself in all such litigation. In the opinion of the Company, based on review and consultation with legal counsel, the outcome of such other litigation should not have a material adverse effect on the Company's consolidated financial statements or results of operations.

#### **19. FAIR VALUE MEASUREMENTS**

The Company follows the provisions of ASC Topic 820, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements.

##### Fair Value Hierarchy

The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather represent a good-faith estimate of the increase or decrease in value of financial instruments held by the Company since purchase, origination or issuance.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between willing market participants at the measurement date. In determining fair value, the Company uses various methods, including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated or generally unobservable inputs. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in the valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

- **Level 1** — Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes equity securities in banks that are publicly traded. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

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- **Level 2** — Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third-party pricing services for identical or similar assets or liabilities.
- **Level 3** — Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The Company rarely transfers assets and liabilities measured at fair value between Level 1 and Level 2 measurements. Trading account assets and securities available-for-sale may be periodically transferred to or from Level 3 valuation based on management’s conclusion regarding the best method of pricing for an individual security. Such transfers are accounted for as if they occurred at the beginning of a reporting period. There were no such transfers during the years ended December 31, 2013 or 2012.

Fair Value Measurements on a Recurring Basis

*Available-for-Sale Securities*

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include exchange-traded equities. Level 2 securities include U.S. treasury and agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset-backed and other securities. Level 2 fair values are obtained from quoted prices of securities with similar characteristics. In certain cases, where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

The following table presents the balances of available-for-sale securities measured at fair value on a recurring basis as of December 31, 2013 and 2012.

|  | <u>Fair Value Measurements as of December 31, 2013 Using</u> |   |  |  |
|--|--|---|--|--|
|  | <u>Totals<br/>At<br/>December 31,<br/>2013</u>               | <u>Quoted<br/>Prices in<br/>Active<br/>Markets For<br/>Identical<br/>Assets<br/>(Level 1)</u> | <u>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</u> |
|  |  | (Dollars in Thousands)  |  |  |
| Mortgage-backed securities:                                |  |   |  |  |
| Residential .....  | \$83,434   | \$—   | \$83,434   | \$—  |
| Commercial .....   | 30,465   | —   | 30,465   | —  |
| Obligations of states and political<br>subdivisions .....  | 17,027   | —   | 17,027   | —  |
| U.S. treasury securities .....                             | 3,827  | —   | 3,827  | —  |
| Obligations of U.S. government sponsored<br>agencies ..... | 1,001  | —   | 1,001  | —  |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

| Fair Value Measurements as of December 31, 2012 Using     |                                      |  |   |  |
|---|--------------------------------------|--|---|--|
|   | Totals<br>At<br>December 31,<br>2012 | Quoted<br>Prices in<br>Active<br>Markets For<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (Dollars in Thousands)                                    |                                      |  |   |  |
| Mortgage-backed securities:                               |                                      |  |   |  |
| Residential .....   | \$49,264                             | \$—  | \$49,264  | \$—  |
| Commercial .....  | 28,289                               | —  | 28,289  | —  |
| Obligations of states and political<br>subdivisions ..... | 14,981                               | —  | 14,981  | —  |
| U.S. treasury securities .....                            | 80                                   | —  | 80  | —  |

Fair Value Measurements on a Non-recurring Basis

*Impaired Loans*

Estimates of fair value are determined based on a variety of information, including the use of available appraisals, estimates of market value by licensed appraisers or local real estate brokers and the knowledge and experience of the Company's management related to values of properties in the Company's market areas. Management takes into consideration the type, location and occupancy of the property, as well as current economic conditions in the area in which the property is located, in assessing estimates of fair value. Accordingly, fair value estimates for impaired loans are classified as Level 3.

Loan impairment is reported when full payment under the loan terms is not expected. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. When an impaired loan is determined to be collateral-dependent, the fair value is determined through the utilization of a third-party appraisal. It is the policy of the Company to update appraisals every 18-24 months. The types of collateral influence the frequency of obtaining updated appraisals. Management knows the market trends of collateral values well and monitors trends in sales and valuations in all of the various categories of collateral. These trends influence how often new appraisals are obtained within the 18-24 month timeframe. An example would be loans collateralized by residential subdivision lots. The values of this type of collateral have been volatile in recent years, and, therefore, appraisals are generally updated at the lower end of the timeframe (i.e., closer to 18 months), while timberland appraisals, which have been less volatile in recent years, would be updated closer to the upper end of the timeframe (i.e., closer to 24 months). Any observed trend indicating significant changes in valuations would require updated appraisals. Based on experience, current appraisals are discounted 9% for estimated costs associated with foreclosures and costs to sell. If a loan is evaluated for impairment under ASC Topic 310-10-35, *Accounting by Creditors for Impairment of a Loan*, and the appraisal is outdated, a new appraisal is ordered. If the new appraisal is not received in sufficient time to assess any required impairment to meet financial reporting obligations, the old appraisal may be adjusted to reflect values observed in similar properties. After a new appraisal is obtained, the analysis is updated to reflect the new valuation. Loan losses are charged against the allowance when management believes that the uncollectability of a loan is confirmed. Loans, net of specific allowances, subject to this evaluation amounted to \$11.4 million and \$15.0 million as of December 31, 2013 and 2012, respectively. This valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

*Foreclosed Assets*

Estimates of fair values are determined based on a variety of information, including the use of available appraisals, estimates of market value by licensed appraisers or local real estate brokers and the knowledge and experience of the Company's management related to values of properties in the Company's market areas. Management takes into consideration the type, location and occupancy of the property, as well as current economic conditions in the area in which the property is located, in assessing estimates of fair value. Accordingly, the fair value estimates for foreclosed real estate are classified as Level 3.

The fair value of a foreclosed asset, upon initial recognition, is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. Foreclosed assets measured at fair value upon initial recognition totaled \$0.5 million and \$2.1 million (utilizing Level 3 valuation inputs) as of December 31, 2013 and 2012, respectively. In connection with the measurement and initial recognition of the foregoing foreclosed assets, the Company recognized charge-offs of the allowance for loan losses totaling approximately \$0.5 million and \$0.4 million as of December 31, 2013 and 2012, respectively. Foreclosed assets totaling \$5.3 million and \$9.3 million (utilizing Level 3 valuation inputs) were remeasured at fair value as of December 31, 2013 and 2012, respectively, resulting in impairment loss of \$1.3 million and \$3.6 million on other real estate owned as of December 31, 2013 and 2012, respectively.

The following table presents the balances of impaired loans and foreclosed assets measured at fair value on a non-recurring basis as of December 31, 2013 and 2012.

| <u>Fair Value Measurements as of December 31, 2013 Using</u> |  |   |  |  |
|--|--|---|--|--|
|  | <u>Totals<br/>At<br/>December 31,<br/>2013</u> | <u>Quoted<br/>Prices in<br/>Active<br/>Markets For<br/>Identical<br/>Assets<br/>(Level 1)</u> | <u>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</u> |
| (Dollars in Thousands)                                       |  |   |  |  |
| Impaired loans . . . . .                                     | \$11,358                                       | \$—   | \$—  | \$11,358   |
| Foreclosed property and other real estate . . . . .          | 5,832  | —   | —  | 5,832  |

| <u>Fair Value Measurements as of December 31, 2012 Using</u> |  |   |  |  |
|--|--|---|--|--|
|  | <u>Totals<br/>At<br/>December 31,<br/>2012</u> | <u>Quoted<br/>Prices in<br/>Active<br/>Markets For<br/>Identical<br/>Assets<br/>(Level 1)</u> | <u>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</u> |
| (Dollars in Thousands)                                       |  |   |  |  |
| Impaired loans . . . . .                                     | \$14,956                                       | \$—   | \$—  | \$14,956   |
| Foreclosed property and other real estate . . . . .          | 11,368   | —   | —  | 11,368   |

Non-Recurring Fair Value Measurements Using Significant Unobservable Inputs:

The following table presents information regarding assets and liabilities measured at fair value using significant unobservable inputs (Level 3) as of December 31, 2013. The table includes the valuation techniques and the significant unobservable inputs utilized. The range of each unobservable input, as well as the weighted average within the range utilized as of December 31, 2013, are both included. Following the table is a description of the valuation technique and the sensitivity of the technique to changes in the significant unobservable input.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

| Level 3 Significant Unobservable Input Assumptions         |                                    |   |   |   |
|--|------------------------------------|---|---|---|
|  | Fair Value<br>December 31,<br>2013 | Valuation Technique   | Unobservable Input                            | Quantitative<br>Range<br>of Unobservable<br>Inputs (Weighted-<br>Average) |
|  |                                    | (Dollars in Thousands)  |   |   |
| <b>Non-recurring fair value measurements:</b>              |                                    |   |   |   |
| <b>Impaired loans . . . . .</b>                            | \$11,358                           | Multiple data points, including discount to appraised value of collateral based on recent market activity | Appraisal compatibility adjustment (discount) | 9%—30%<br>(11.6%)   |
| <b>Foreclosed property and other real estate . . . . .</b> | \$5,832                            | Discount to appraised value of property based on recent market activity for sales of similar properties   | Appraisal compatibility adjustment (discount) | 9%—10%<br>(9.3%)  |

*Impaired loans*

Impaired loans are valued based on multiple data points indicating the fair value for each loan. The primary data point for non-performing loans is the appraisal value of the underlying collateral to which a discount is applied. Management establishes this discount or comparability adjustment based on recent sales of similar property types. As liquidity in the market increases or decreases, the comparability adjustment and the resulting asset valuation are impacted.

*Foreclosed property and other real estate*

Foreclosed property and other real estate under a binding contract for sale are valued based on contract price. If no sales contract is pending for a specific property, management establishes a comparability adjustment to the appraised value based on historical activity considering proceeds for properties sold versus the corresponding appraised value. Increases or decreases in realization for properties sold impact the comparability adjustment for similar assets remaining on the balance sheet.

Fair Value of Financial Instruments

ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

**Cash, due from banks and federal funds sold:** The carrying amount of cash, due from banks and federal funds sold approximates fair value.

**Federal Home Loan Bank (“FHLB”):** Based on the redemption provision of the FHLB, the stock has no quoted market value and is carried at cost.

**Securities:** Fair values of securities are based on quoted market prices where available. If quoted market prices are not available, estimated fair values are based on market prices of comparable instruments.

**Accrued interest receivable and payable:** The carrying amount of accrued interest approximates fair value.

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**Loans, net:** For variable-rate loans, fair values are based on carrying values. Fixed-rate commercial loans, other installment loans and certain real estate mortgage loans are valued using discounted cash flows. The discount rate used to determine the present value of these loans is based on interest rates currently being charged by the Company on comparable loans as to credit risk and term.

**Demand and savings deposits:** The fair values of demand deposits are equal to the carrying value of such deposits. Demand deposits include non-interest bearing demand deposits, savings accounts, NOW accounts and money market demand accounts.

**Time deposits:** The fair values of relatively short-term time deposits are equal to their carrying values. Discounted cash flows are used to value long-term time deposits. The discount rate used is based on interest rates currently being offered by the Company on comparable deposits as to amount and term.

**Short-term borrowings:** These borrowings may consist of federal funds purchased, securities sold under agreements to repurchase and the floating rate borrowings from the FHLB account. Due to the short-term nature of these borrowings, fair values approximate carrying values.

**Long-term debt:** The fair value of this debt is estimated using discounted cash flows based on the Company's current incremental borrowing rate for similar types of borrowing arrangements as of December 31, 2013 and 2012.

**Off-balance sheet instruments:** The carrying amount of commitments to extend credit and standby letters of credit approximates fair value. The carrying amount of the off-balance sheet financial instruments is based on fees currently charged to enter into such agreements.

The estimated fair value and related carrying or notional amounts, as well as the level within the fair value hierarchy, of the Company's financial instruments as of December 31, 2013 and 2012, are as follows:

|  | December 31, 2013      |                         |          |         |         |
|--|------------------------|-------------------------|----------|---------|---------|
|  | Carrying<br>Amount     | Estimated<br>Fair Value | Level 1  | Level 2 | Level 3 |
|  | (Dollars in Thousands) |                         |          |         |         |
| Assets:  |                        |                         |          |         |         |
| Cash and cash equivalents . . . . .                    | \$ 47,720              | \$ 47,720               | \$47,720 | \$ —    | \$ —    |
| Investment securities available-<br>for-sale . . . . . | 135,754                | 135,754                 | —        | 135,754 | —       |
| Investment securities held-to-<br>maturity . . . . .   | 35,050                 | 33,365                  | —        | 33,365  | —       |
| Federal Home Loan Bank<br>stock . . . . .              | 906                    | 906                     | —        | 906     | —       |
| Loans, net of allowance for loan<br>losses . . . . .   | 300,927                | 303,291                 | —        | —       | 303,291 |
| Liabilities:   |                        |                         |          |         |         |
| Deposits . . . . .                                     | 484,279                | 484,957                 | —        | 484,957 | —       |
| Short-term borrowings . . . . .                        | 1,231                  | 1,231                   | —        | 1,231   | —       |
| Long-term debt . . . . .                               | 5,000                  | 5,011                   | —        | 5,011   | —       |

**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

|  | December 31, 2012      |                         |          |         |         |
|--|------------------------|-------------------------|----------|---------|---------|
|  | Carrying<br>Amount     | Estimated<br>Fair Value | Level 1  | Level 2 | Level 3 |
|  | (Dollars in Thousands) |                         |          |         |         |
| Assets:  |                        |                         |          |         |         |
| Cash and cash equivalents . . . . .                | \$ 54,126              | \$ 54,126               | \$54,126 | \$ —    | \$ —    |
| Investment securities available-for-sale . . . . . | 92,614                 | 92,614                  | —        | 92,614  | —       |
| Investment securities held-to-maturity . . . . .   | 21,136                 | 21,185                  | —        | 21,185  | —       |
| Federal funds sold . . . . .                       | 5,000                  | 5,000                   | 5,000    | —       | —       |
| Federal Home Loan Bank stock . . . . .             | 936                    | 936                     | —        | 936     | —       |
| Loans, net of allowance for loan losses . . . . .  | 337,400                | 339,230                 | —        | —       | 339,230 |
| Liabilities:                                       |                        |                         |          |         |         |
| Deposits . . . . .                                 | 489,034                | 490,596                 | —        | 490,596 | —       |
| Short-term borrowings . . . . .                    | 638                    | 638                     | —        | 638     | —       |

**20. UNITED SECURITY BANCSHARES, INC. (PARENT COMPANY ONLY) FINANCIAL INFORMATION**

**Statements of Condition**

|   | Year-Ended December 31, |                 |
|---|-------------------------|-----------------|
|   | 2013                    | 2012            |
|   | (Dollars in Thousands)  |                 |
| ASSETS:   |                         |                 |
| Cash on deposit . . . . .                                   | \$ 73                   | \$ 83           |
| Investment in subsidiaries . . . . .                        | 70,557                  | 69,113          |
| <b>TOTAL ASSETS</b> . . . . .                               | <b>\$70,630</b>         | <b>\$69,196</b> |
| LIABILITIES:  |                         |                 |
| Other liabilities . . . . .                                 | \$ 535                  | \$ 549          |
| <b>SHAREHOLDERS' EQUITY</b> . . . . .                       | <b>70,095</b>           | <b>68,647</b>   |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> . . . . . | <b>\$70,630</b>         | <b>\$69,196</b> |

**Statements of Income**

|  | Year-Ended December 31, |                |
|--|-------------------------|----------------|
|  | 2013                    | 2012           |
|  | (Dollars in Thousands)  |                |
| INCOME:  |                         |                |
| Dividend income, First United Security Bank . . . . .                | \$ 200                  | \$ —           |
| Other Income . . . . .   | 6                       | —              |
| Total income . . . . .   | \$ 206                  | \$ —           |
| EXPENSE: . . . . .   | 334                     | 383            |
| LOSS BEFORE EQUITY IN UNDISTRIBUTED INCOME OF SUBSIDIARIES . . . . . | (128)                   | (383)          |
| EQUITY IN UNDISTRIBUTED INCOME OF SUBSIDIARIES . . . . .             | 4,055                   | 2,578          |
| <b>NET INCOME</b> . . . . .  | <b>\$3,927</b>          | <b>\$2,195</b> |



**UNITED SECURITY BANCSHARES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(CONTINUED)**

**Statements of Cash Flows**

|   | Year-Ended December 31, |          |
|---|-------------------------|----------|
|   | 2013                    | 2012     |
|   | (Dollars in Thousands)  |          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                         |          |
| Net income .....  | \$ 3,927                | \$ 2,195 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |          |
| Distributions in excess of undistributed income (loss) of subsidiaries .....      | (4,055)                 | (2,578)  |
| Decrease in other assets .....  | 131                     | 110      |
| (Increase) decrease in other liabilities .....                                    | (13)                    | 65       |
| DECREASE IN CASH .....  | (10)                    | (208)    |
| CASH AT BEGINNING OF YEAR .....   | 83                      | 291      |
| CASH AT END OF YEAR .....   | \$ 73                   | \$ 83    |

**21. QUARTERLY DATA (UNAUDITED)**

|  | Year-Ended December 31, |               |                |               |                |               |                |               |
|--|-------------------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|
|  | 2013                    |               |                |               | 2012           |               |                |               |
|  | Fourth Quarter          | Third Quarter | Second Quarter | First Quarter | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|  | (Dollars in Thousands)  |               |                |               |                |               |                |               |
| Interest income .....                                      | \$ 8,340                | \$8,270       | \$8,432        | \$8,594       | \$9,667        | \$9,328       | \$9,748        | \$10,010      |
| Interest expense .....                                     | 677                     | 702           | 737            | 789           | 888            | 1,031         | 1,177          | 1,460         |
| Net interest income .....                                  | 7,663                   | 7,568         | 7,695          | 7,805         | 8,779          | 8,297         | 8,571          | 8,550         |
| Provision for loan losses .....                            | (1,441)                 | 240           | 53             | 506           | 1,163          | 492           | 468            | 2,215         |
| Net interest income, after provision for loan losses ..... | 9,104                   | 7,328         | 7,642          | 7,299         | 7,616          | 7,805         | 8,103          | 6,335         |
| Non-interest:  |                         |               |                |               |                |               |                |               |
| Income .....   | 723                     | 1,291         | 1,228          | 1,623         | 1,507          | 1,453         | 1,331          | 1,274         |
| Expense .....  | 8,569                   | 7,365         | 7,176          | 7,692         | 7,652          | 7,562         | 7,442          | 9,828         |
| Income (loss) before income taxes ....                     | 1,258                   | 1,254         | 1,694          | 1,230         | 1,471          | 1,696         | 1,992          | (2,219)       |
| (Benefits from) provision for income taxes .....           | 303                     | 350           | 512            | 344           | 588            | 517           | 622            | (982)         |
| Net income (loss) after taxes .....                        | \$ 955                  | \$ 904        | \$1,182        | \$ 886        | \$ 883         | \$1,179       | \$1,370        | \$ (1,237)    |
| Earnings (losses) per common share:                        |                         |               |                |               |                |               |                |               |
| Basic and diluted earnings (losses) ....                   | \$ 0.16                 | \$ 0.15       | \$ 0.20        | \$ 0.15       | \$ 0.15        | \$ 0.20       | \$ 0.23        | \$ (0.21)     |

**Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures and Changes in Internal Control over Financial Reporting**

USBI maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in USBI's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to USBI's management, including its Chief Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

USBI's management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and the Principal Financial Officer, of the effectiveness of the design and operation of USBI's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act) as of December 31, 2013, pursuant to the evaluation of these controls and procedures required by Rule 13a-15 of the Exchange Act. Based upon that evaluation, USBI's management concluded, as of December 31, 2013, that USBI's disclosure controls and procedures are effective to ensure that the information required to be disclosed in USBI's periodic filings with the Securities and Exchange Commission is recorded, processed, summarized and reported within the time periods specified.

There were no changes in USBI's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, USBI's internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

This report is included in Item 8 on page 52 and is incorporated herein by reference.

**Item 9B. Other Information.**

None.

### PART III

#### Item 10. Directors, Executive Officers and Corporate Governance.

USBI has adopted a Code of Business Conduct and Ethics for directors, officers (including its Chief Executive Officer and Principal Financial Officer) and employees. The Code of Business Conduct and Ethics is incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2003. USBI will provide any interested person a copy of the Code of Business Conduct and Ethics free of charge, upon written request to United Security Bancshares, Inc., Attention: Beverly J. Dozier, Corporate Secretary, 131 West Front Street, Post Office Box 249, Thomasville, Alabama 36784, (334) 636-5424.

Other information required by this Item is incorporated by reference pursuant to General Instruction G(3) of Form 10-K from USBI's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A.

#### Item 11. Executive Compensation.

The information required by this Item is incorporated by reference pursuant to General Instruction G(3) of Form 10-K from USBI's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A.

#### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

##### Securities Authorized for Issuance Under Equity Compensation Plans

The following table summarizes, as of December 31, 2013, the securities that have been authorized for issuance under USBI's equity compensation plans, the United Security Bancshares, Inc. 2013 Incentive Plan (the "Omnibus Incentive Plan") and the United Security Bancshares, Inc. Non-Employee Directors' Deferred Compensation Plan (the "Deferral Plan"). The Omnibus Incentive Plan provides for grants of incentive stock options, nonqualified stock options, stock appreciation rights, restricted awards and performance compensation awards to employees, consultants and directors of the Company and was approved by USBI's shareholders in 2013. The Deferral Plan permits non-employee directors to defer their directors' fees and receive the adjusted value of the deferred amounts in cash and/or in USBI's common stock and was approved by USBI's shareholders in 2004.

| <u>Plan Category</u>   | <u>Equity Compensation Plan Information</u>  |  |  |
|--|--|--|--|
|  | <u>Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)</u> | <u>Weighted-average exercise price of outstanding options, warrants and rights (b)</u> | <u>Number of securities remaining available for future issuance (c) (excluding securities reflected in column (a))<sup>(1)</sup></u> |
| Equity compensation plans approved by shareholders .....     | 81,862   | \$0.00 <sup>(2)</sup>  | 600,000  |
| Equity compensation plans not approved by shareholders ..... | <u>0</u>   | <u>\$0.00</u>  | <u>0</u>   |
| Total .....  | 81,862   | \$0.00 <sup>(2)</sup>  | 600,000  |

(1) Does not include shares reserved for future issuance under the Deferral Plan. Includes shares available for issuance under the Omnibus Incentive Plan.

(2) Does not include amounts deferred pursuant to the Deferral Plan, as there is no exercise price associated with these deferred amounts.

Other information required by this Item is incorporated by reference pursuant to General Instruction G(3) of Form 10-K from USBI's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by this Item is incorporated by reference pursuant to General Instruction G(3) of Form 10-K from USBI's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A.

**Item 14. Principal Accounting Fees and Services.**

The information required by this Item is incorporated by reference pursuant to General Instruction G(3) of Form 10-K from USBI's definitive proxy statement for the 2014 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A.

## **PART IV**

### **Item 15. Exhibits and Financial Statement Schedules.**

#### **(a)(1) Financial Statements.**

The consolidated financial statements of USBI and its subsidiaries, included herein in Item 8, are as follows:

- Management's Report on Internal Control over Financial Reporting;
- Report of Independent Registered Public Accounting Firm – Carr, Riggs & Ingram, LLC;
- Consolidated Statements of Financial Condition – December 31, 2013 and 2012;
- Consolidated Statements of Operations – Years Ended December 31, 2013 and 2012;
- Consolidated Statements of Shareholders' Equity – Years Ended December 31, 2013 and 2012;
- Consolidated Statements of Comprehensive Income – Years Ended December 31, 2013 and 2012;
- Consolidated Statements of Cash Flows – Years Ended December 31, 2013 and 2012; and
- Notes to Consolidated Financial Statements – Years Ended December 31, 2013 and 2012.

#### **(a)(2) Financial Statement Schedules.**

The financial statement schedules required to be included pursuant to this Item are not included herein because they are not applicable, or the required information is shown in the financial statements or notes thereto, which are incorporated by reference at subsection (a)(1) of this Item above.

#### **(a)(3)&(b) Exhibits.**

The exhibits listed on the Exhibit Index beginning on page 108 of this Form 10-K are filed herewith or are incorporated herein by reference.

## 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, on this 21<sup>st</sup> day of March, 2014.

UNITED SECURITY BANCSHARES, INC.

By: /s/ James F. House

James F. House  
President and Chief Executive Officer

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 dates indicated.

| <u>Signature</u>  | <u>Title</u>   | <u>Date</u>    |
|---|--|----------------|
| <u>/s/ James F. House</u><br>James F. House                 | President, Chief Executive Officer<br>and Director (Principal Executive<br>Officer)  | March 21, 2014 |
| <u>/s/ Thomas S. Elley</u><br>Thomas S. Elley               | Vice President, Treasurer, Assistant<br>Secretary, Principal Financial Officer<br>and Principal Accounting Officer<br>(Principal Financial Officer,<br>Principal Accounting Officer) | March 21, 2014 |
| <u>/s/ Andrew C. Bearden, Jr.</u><br>Andrew C. Bearden, Jr. | Director   | March 21, 2014 |
| <u>/s/ Linda H. Breedlove</u><br>Linda H. Breedlove         | Director   | March 21, 2014 |
| <u>/s/ Gerald P. Corgill</u><br>Gerald P. Corgill           | Director   | March 21, 2014 |
| <u>/s/ John C. Gordon</u><br>John C. Gordon                 | Director   | March 21, 2014 |
| <u>/s/ William G. Harrison</u><br>William G. Harrison       | Director   | March 21, 2014 |
| <u>/s/ J. Lee McPhearson</u><br>J. Lee McPhearson           | Director   | March 21, 2014 |
| <u>/s/ Jack W. Meigs</u><br>Jack W. Meigs                   | Director   | March 21, 2014 |

| <u>Signature</u>  | <u>Title</u> | <u>Date</u>    |
|---|--------------|----------------|
| <u>/s/ A.J. Strickland, III</u><br>A.J. Strickland, III | Director     | March 21, 2014 |
| <u>/s/ Howard M. Whitted</u><br>Howard M. Whitted       | Director     | March 21, 2014 |
| <u>/s/ Bruce N. Wilson</u><br>Bruce N. Wilson           | Director     | March 21, 2014 |



**EXHIBIT INDEX**  
**ITEM 15(a)(3)**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 3.1                | Certificate of Incorporation of USBI, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 1999.  |
| 3.2                | Amended and Restated Bylaws of United Security Bancshares, Inc., incorporated herein by reference to Exhibit 3(ii) to the Current Report on Form 8-K filed on August 29, 2007.   |
| 10.1               | Amended and Restated Executive Employment Agreement, dated December 19, 2013 (effective as of January 1, 2014), between USBI, the Bank and James F. House, incorporated herein by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on December 19, 2013.* |
| 10.2               | Change in Control Agreement, dated November 19, 2013, between USBI, the Bank and Thomas S. Elley, incorporated herein by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on November 19, 2013.*  |
| 10.3               | Form of Director Indemnification Agreement between USBI and its directors, incorporated herein by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on October 30, 2009.*  |
| 10.4               | United Security Bancshares, Inc. 2013 Incentive Plan, effective March 22, 2013, incorporated herein by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on May 22, 2013.*   |
| 10.5               | First United Security Bank Salary Continuation Agreement dated September 20, 2002, with Robert Steen, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*   |
| 10.5A              | First Amendment to the First United Security Bank Salary Continuation Agreement dated September 20, 2002 for Robert Steen dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                    |
| 10.6               | First United Security Bank Director Retirement Agreement dated October 17, 2002, with Linda H. Breedlove, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*   |
| 10.6A              | First Amendment to the First United Security Bank Director Retirement Agreement dated October 17, 2002 for Linda H. Breedlove dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                |
| 10.7               | First United Security Bank Director Retirement Agreement dated October 21, 2002, with Gerald P. Corgill, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*  |
| 10.7A              | First Amendment to the First United Security Bank Director Retirement Agreement dated October 21, 2002 for Gerald P. Corgill dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                 |
| 10.8               | First United Security Bank Director Retirement Agreement dated October 17, 2002, with John C. Gordon, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*   |
| 10.8A              | First Amendment to the First United Security Bank Director Retirement Agreement dated October 17, 2002 for John C. Gordon dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                    |
| 10.9               | First United Security Bank Director Retirement Agreement dated October 16, 2002, with William G. Harrison, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2002.*  |

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.9A              | First Amendment to the First United Security Bank Director Retirement Agreement dated October 16, 2002 for William G. Harrison dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                   |
| 10.10              | First United Security Bank Director Retirement Agreement dated October 17, 2002, with Jack Meigs, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*   |
| 10.10A             | First Amendment to the First United Security Bank Director Retirement Agreement dated October 17, 2002 for Jack Meigs dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                            |
| 10.11              | First United Security Bank Director Retirement Agreement dated October 17, 2002, with Howard M. Whitted, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*  |
| 10.11A             | First Amendment to the First United Security Bank Director Retirement Agreement dated October 17, 2002 for Howard M. Whitted dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                     |
| 10.12              | First United Security Bank Director Retirement Agreement dated October 17, 2002, with Bruce N. Wilson, incorporated herein by reference to the Exhibits to Form 10-Q for the quarter ended September 30, 2002.*  |
| 10.12A             | First Amendment to the First United Security Bank Director Retirement Agreement dated October 17, 2002 for Bruce N. Wilson dated November 20, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*                       |
| 10.13              | First United Security Bank Director Retirement Agreement dated November 17, 2011, with Andrew C. Bearden, Jr., incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2011.*  |
| 10.14              | First United Security Bank Director Retirement Agreement dated November 30, 2011, with J. Lee McPhearson, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2011.*   |
| 10.15              | United Security Bancshares, Inc. Non-Employee Directors' Deferred Compensation Plan, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2003.*  |
| 10.15A             | Amendment One to the United Security Bancshares, Inc. Non-Employee Directors' Deferred Compensation Plan dated December 18, 2008, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2008.*   |
| 10.15B             | Amendment Two to the United Security Bancshares, Inc. Non-Employee Directors' Deferred Compensation Plan dated December 30, 2010, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2010 (as originally filed on March 15, 2011).* |
| 10.16              | United Security Bancshares, Inc. Summary of Directors' Fees.   |
| 14                 | United Security Bancshares, Inc. Code of Business Conduct and Ethics, incorporated herein by reference to the Exhibits to Form 10-K for the year ended December 31, 2003.  |
| 21                 | Subsidiaries of United Security Bancshares, Inc.   |
| 23                 | Consent of Carr, Riggs & Ingram, LLC.  |
| 31.1               | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.   |
| 31.2               | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.   |
| 32                 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 101                | Interactive Data Files   |

\* Indicates a management contract or compensatory plan or arrangement.

**United Security Bancshares, Inc.**  
**Summary of Directors' Fees**

USBI's Board of Directors approved the following retainers and attendance fees for board and committee meetings subject to the United Security Bancshares, Inc. Non-Employee Directors' Deferred Compensation Plan (the "Deferral Plan") described below:

United Security Bancshares, Inc.

Retainers:

|               |               |
|---------------|---------------|
| Chairperson   | \$1,350/month |
| Board Members | \$600/month   |

Board Meeting Fees:

|               |                              |
|---------------|------------------------------|
| Board Members | \$500/board meeting attended |
|---------------|------------------------------|

Committee Chairperson Fees:

|   |                                  |
|---|----------------------------------|
| Chairperson of the Audit Committee, the Compensation Committee and the Nominating, Executive and Corporate Governance Committee | \$400/committee meeting attended |
|---|----------------------------------|

First United Security Bank

Board Meeting Fees:

|               |             |
|---------------|-------------|
| Board Members | \$400/month |
|---------------|-------------|

Each non-employee member of the committees of United Security Bancshares, Inc. ("USBI") and First United Security Bank receives \$250/committee meeting attended. Additionally, any director who attends regularly scheduled or special board meetings or committee meetings held outside of the director's county of residence is reimbursed for mileage for meetings attended.

Non-employee directors may elect to defer payment of all or any portion of their First United Security Bank director fees under the Deferral Plan, and, beginning on January 1, 2012, all United Security Bancshares, Inc. director fees are deferred under the Deferral Plan. The Deferral Plan, which was ratified by shareholders at the annual meeting held on May 11, 2004, permits non-employee directors to invest their directors' fees and to receive the adjusted value of the deferred amounts in cash and/or shares of USBI's common stock.

**Subsidiaries of United Security Bancshares, Inc.**

| <u>Name of Subsidiary</u>   | <u>State of Organization</u> |
|---|------------------------------|
| First United Security Bank  | Alabama                      |
| Acceptance Loan Company, Inc.<br>(subsidiary of First United Security Bank) | Alabama                      |
| FUSB Reinsurance, Inc.<br>(subsidiary of First United Security Bank)        | Arizona                      |

**CONSENT OF CARR, RIGGS & INGRAM, LLC**

**Consent of Independent Registered Public Accounting Firm**

We consent to the incorporation by reference in the following Registration Statements of United Security Bancshares, Inc. and subsidiaries (the “Company”):

- Registration Statement No. 333 – 111071 on Form S-3
- Registration Statement No. 333 – 37995 on Form S-8
- Registration Statement No. 333 – 110013 on Form S-8
- Registration Statement No. 333 – 112127 on Form S-8
- Registration Statement No. 333 – 189113 on Form S-8; and
- Registration Statement No. 333 – 189767 on Form S-8

of our report dated March 21, 2014 with respect to the Company’s consolidated financial statements, which appear in this Annual Report on Form 10-K of the Company as of and for the year ended December 31, 2013.

/s/ Carr, Riggs & Ingram, LLC

Dothan, Alabama  
March 21, 2014

## CERTIFICATION

I, James F. House, certify that:

1. I have reviewed this annual report on Form 10-K of United Security Bancshares, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2014

By: /s/ James F. House

James F. House  
President and Chief Executive Officer

## CERTIFICATION

I, Thomas S. Elley, certify that:

1. I have reviewed this annual report on Form 10-K of United Security Bancshares, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2014

By: /s/ Thomas S. Elley

Thomas S. Elley  
Vice President, Treasurer, Assistant Secretary, Principal  
Financial Officer and Principal Accounting Officer



**CERTIFICATION  
PURSUANT TO 18 U.S.C. 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, James F. House, President and Chief Executive Officer of United Security Bancshares, Inc., and Thomas S. Elley, Vice President, Treasurer, Assistant Secretary, Principal Financial Officer and Principal Accounting Officer of United Security Bancshares, Inc., certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report on Form 10-K of United Security Bancshares, Inc. for the fiscal year ended December 31, 2013, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such Annual Report on Form 10-K fairly presents, in all material respects, the financial condition and results of operations of United Security Bancshares, Inc.

/s/ James F. House

James F. House  
President and Chief Executive Officer  
March 21, 2014

/s/ Thomas S. Elley

Thomas S. Elley  
Vice President, Treasurer, Assistant Secretary,  
Principal Financial Officer and Principal Accounting  
Officer  
March 21, 2014