

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2005

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 1-5735

UNION FINANCIAL BANCSHARES, INC.
(Exact name of registrant as specified in its Charter)

Delaware 57-1001177
(State or other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

203 West Main Street, Union, South Carolina 29379
(Address of Principal Executive Offices)

(864) 429-1864
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.) Yes No

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

The Corporation had 1,916,482 shares, \$0.01 par value, of common stock issued and outstanding as of October 25, 2005.

UNION FINANCIAL BANCSHARES, INC.

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UNION FINANCIAL BANCSHARES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Presentation of Consolidated Financial Statements

The accompanying unaudited consolidated financial statements of Union Financial Bancshares, Inc. (the "Corporation" or "Union Financial") were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of consolidated financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments which are, in the opinion of management, necessary for the fair presentation of the interim consolidated financial statements have been included. All such adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2005 are not necessarily indicative of the results which may be expected for the entire calendar year. Certain amounts in the prior year's financial statements have been reclassified to conform with current year classifications.

Recently Issued Accounting Standards

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by the Corporation:

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123[®]"). SFAS No. 123[®] will require companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123[®] requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123[®] is effective beginning as of the first interim or annual reporting period beginning after December 15, 2006. The Corporation is currently evaluating the impact that the adoption of SFAS No. 123[®] will have on its financial position, results of operations and cash flows. The cumulative effect of adoption, if any, will be measured and recognized in the statement of income on the date of adoption.

In April 2005, the Securities and Exchange Commission's Office of the Chief Accountant and its Division of Corporation Finance has released Staff Accounting Bulletin ("SAB") No. 107 to provide guidance regarding the application of SFAS No. 123 (revised 2004), "Share-Based Payment". SFAS No. 123[®] covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. SAB No. 107 provides interpretive guidance related to the interaction between SFAS No. 123[®] and certain SEC rules and regulations, as well as the staff's views regarding the valuation of share-based payment arrangements for public companies. SAB No. 107 also reminds public companies of the importance of including disclosures within filings made with the SEC relating to the accounting for share-based payment

transactions, particularly during the transition to SFAS No.123[®]). In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS No. 154"). SFAS No. 154 establishes retrospective application as the required method for reporting a change in accounting principle, unless it is impracticable, in which case the changes should be applied to the latest practicable date presented. SFAS No. 154 also requires that a correction of an error be reported as a prior period adjustment by restating prior period financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

Additional accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

2. Income Per Share

Basic income per share amounts for the three and nine months ended September 30, 2005 and 2004 were computed based on the weighted average number of common shares outstanding during the period. Diluted income per share adjusts for the dilutive effect of outstanding common stock options during the periods utilizing the treasury stock method. Common stock equivalents included in the diluted earnings per share calculation for the three months ended September 30, 2005 and 2004 were 46,285 and 67,842, respectively and for the nine months ended September 30, 2005 and 2004 were 57,323 and 92,018, respectively.

3. Assets Pledged

Approximately \$77,675,000 and \$62,396,000 of debt securities at September 30, 2005 and December 31, 2004, respectively, were pledged by Provident Community Bank, N.A. (the "Bank") as collateral to secure deposits of the State of South Carolina, and Union, Laurens and York counties along with additional borrowings and repurchase agreements. The Bank pledges as collateral for Federal Home Loan Bank advances the Bank's Federal Home Loan Bank stock and has entered into a blanket collateral agreement with the Federal Home Loan Bank whereby the Bank maintains, free of other encumbrances, qualifying mortgages (as defined) with unpaid principal balances equal to, when discounted at 75% of the unpaid principal balances, 100% of total advances. As part of the total assets pledged, the Bank will also pledge securities to cover additional advances from the Federal Home Loan Bank that exceed the qualifying mortgages balance along with security repurchase lines with various brokerage houses.

4. Contingencies and Loan Commitments

In the ordinary course of business, the Bank enters into financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These instruments expose the Bank to credit risk in excess of the amount recognized on the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Total credit exposure at September 30, 2005 related to these items is summarized below:

<u>Loan Commitments:</u>	<u>Contract Amount</u>
Approved loan commitments	\$ 1,086,000
Unadvanced portions of loans and credit lines	<u>39,787,000</u>
Total loan commitments	<u>\$ 40,873,000</u>

Loan 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. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained upon extension of credit is based on management's credit evaluation of the counter party. Collateral held is primarily residential and commercial property.

Commitments outstanding at September 30, 2005 consisted of fixed and adjustable rate loans at rates ranging from 5.0% to 6.5%. Commitments to originate loans generally expire within 30 to 60 days.

Commitments to fund loans, including credit lines (principally variable rate, consumer lines secured by real estate and overdraft protection) totaled approximately \$87,345,000 at September 30, 2005. Of these lines, the outstanding loan balances totaled approximately \$47,558,000.

5. Floating Rate Junior Subordinated Deferrable Interest Debentures

On December 18, 2001, Union Financial Statutory Trust I, (the "Trust") issued \$8,000,000 of floating rate capital securities through a pooled trust preferred securities offering. The proceeds from this issuance, along with the Corporation's \$247,000 capital contribution for the Trust's common securities, were used to acquire \$8,247,000 aggregate principal amount of the Corporation's floating rate junior subordinated deferrable interest debentures due December 18, 2031 (the "Debentures"), which constitute the sole asset of the Trust. The interest rate on the Debentures and the capital securities is variable and adjustable quarterly at 3.60% over

the three-month LIBOR. A rate cap of 12.50% is effective through December 18, 2006. The Corporation has, through the Trust Agreement establishing the Trust, the Guarantee Agreement, the notes and the related Debentures, taken together, fully irrevocably and unconditionally guaranteed all of the Trust's obligations under the capital securities.

A summary of the Trust securities issued and outstanding follows:

<u>Name</u>	<u>Amount Outstanding at September 30,</u>			<u>Prepayment Option Date</u>	<u>Maturity</u>	<u>Distribution Payment Frequency</u>
	<u>2005</u>	<u>2004</u>	<u>Rate</u>			
Union Financial Statutory Trust I	\$8,000,000	\$8,000,000	7.48%	December 18, 2006	December 18, 2031	Quarterly

The stated maturity of the Debentures is December 18, 2031. In addition, the Debentures are subject to redemption at par at the option of the Corporation, subject to prior regulatory approval, in whole or in part on any interest payment date after December 18, 2006. The Debentures are also subject to redemption prior to December 18, 2006 at 107.5% of par after the occurrence of certain events that would either have a negative tax effect on the Trust or the Corporation or would result in the Trust being treated as an investment company that is required to be registered under the Investment Company Act of 1940.

The Corporation has the right, at one or more times, to defer interest payments on the Debentures for up to twenty consecutive quarterly periods. During any deferral period, each installment of interest that would otherwise have been due and payable will bear additional interest (to the extent payment of such interest would be legally enforceable) at the applicable distribution rate, compounded quarterly. Additionally, during any deferral period, the Corporation will be prohibited from declaring or paying cash dividends on its common stock.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward Looking Statements

Management's discussion and analysis of financial condition and results of operations and other portions of this Form 10-Q may contain certain "forward-looking statements" concerning the future operations of the Corporation and the Bank. These forward-looking statements are generally identified by the use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar expressions. Management intends to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing the Corporation of the protections of such safe harbor with respect to all forward-looking statements contained in this report to describe future plans and strategies. Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could effect actual results include interest rate trends, the general economic climate in the Corporation's and the Bank's market area and the country as a whole, the ability of the Corporation and the Bank to control costs and expenses, competitive products and pricing, loan delinquency rates, the quality and composition of the loan and investment portfolios, changes in accounting principles and guidelines and changes in federal and state regulation. These factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements.

Except as required by applicable law or regulation, the Corporation does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward looking statements to reflect events or circumstances after the date of these statements or to reflect the occurrence of anticipated or unanticipated events.

Financial Condition

Assets

Total assets of the Corporation increased \$7,655,000, or 2.18%, to \$359,253,000 at September 30, 2005 from \$351,598,000 at December 31, 2004.

Loans increased \$10,347,000, or 6.05%, to \$181,441,000 at September 30, 2005. The Corporation continues to focus on consumer and commercial lending with specialized loan officers and products. Short term interest earning deposits decreased \$8,250,000, or 71.05%, to \$3,361,000, from December 31, 2004 to September 30, 2005, as these deposits were used to fund growth in loans. Other assets increased \$440,000, or 16.72%, to \$3,071,000, from December 31, 2004 to September 30, 2005, due to an increase in a net deferred tax receivable that was related to the mark to market adjustment for investments available for sale.

Liabilities

Total liabilities increased \$8,138,000, or 2.50%, to \$333,717,000 at September 30, 2005 from \$325,579,000 at December 31, 2004. Deposits increased \$11,727,000, or 5.15%, to \$239,316,000 at September 30, 2005 from \$227,589,000 at December 31, 2004. The increase was due primarily to growth in lower cost demand accounts partially offset by a reduction in higher cost certificates of deposit accounts. The Corporation continues to target lower cost demand deposit accounts through media advertising versus traditional higher cost certificates of deposits.

Borrowings from the Federal Home Loan Bank (the "FHLB") decreased \$1,000,000, or 1.57%, to \$62,500,000 at September 30, 2005 from \$63,500,000 at December 31, 2004. Securities sold under agreement to repurchase decreased \$4,000,000 to \$20,000,000 at September 30, 2005 from \$24,000,000 at December 31, 2004. Borrowings were reduced with deposit growth and reductions in short term interest earning deposits. Other liabilities increased \$1,041,000 to \$2,911,000 at September 30, 2005 from \$1,870,000 at December 31, 2004, due primarily to an increase in outstanding loan fundings.

Shareholders' Equity

Shareholders' equity decreased \$483,000, or 1.86%, to \$25,536,000 at September 30, 2005 from \$26,019,000 at December 31, 2004 due to the repurchase of 81,108 shares at a cost of \$1,349,000, dividend payments of \$0.30 per share at a cost of \$577,000 and a \$445,000 increase in unrealized losses on securities available for sale, offset by net income of \$1,726,000.

Liquidity

Liquidity is the ability to meet demand for loan disbursements, deposit withdrawals, repayment of debt, payment of interest on deposits and other operating expenses. The primary sources of liquidity are deposits, loan repayments, borrowings, maturity of securities and interest payments.

While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit outflows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. The primary investing activities of the Corporation are the origination of commercial and consumer loans, and the purchase of investment, and mortgage-backed securities. These activities are funded primarily by principal and interest payments on loans and investment securities, deposit growth, securities sold under agreements to repurchase and the utilization of FHLB advances.

During the nine months ended September 30, 2005, the Corporation's loan originations totaled \$55,589,000. At September 30, 2005, the Corporation's investment in agency and mortgage-backed securities totaled \$143,460,000, nearly all

of which is available for sale. Approximately \$77,675,000 and \$62,396,000 of debt securities at September 30, 2005 and December 31, 2004, respectively, were pledged by Provident Community Bank, N.A. (the "Bank") as collateral to secure deposits of the State of South Carolina, and Union, Laurens and York counties along with additional borrowings and repurchase agreements.

Additionally, outstanding loan commitments (including commitments to fund credit lines) totaled \$40,873,000 at September 30, 2005. Management of the Corporation anticipates that it will have sufficient funds available to meet its current loan commitments.

During the nine months ended September 30, 2005, total deposits increased \$11,727,000. The Corporation closely monitors its liquidity position on a daily basis. Certificates of deposit, which are scheduled to mature in one year or less from September 30, 2005, totaled \$93,985,000. The Corporation relies primarily on competitive rates, customer service, and long-standing relationships with customers to retain deposits. From time to time, the Corporation will also offer special products to its customers to increase retention and to attract new deposits. Based upon the Corporation's experience with deposit retention and current retention strategies, management believes that, although it is not possible to predict future terms and conditions upon renewal, a significant portion of such deposits will remain with the Corporation. If the Corporation requires funds beyond its ability to generate them internally, additional sources of funds are available through FHLB advances and lines of credit. At September 30, 2005, the Corporation had outstanding \$62,500,000 of FHLB borrowings and \$20,000,000 of securities sold under agreements to repurchase. At September 30, 2005, the Corporation had unused short-term lines of credit to purchase federal funds from unrelated banks totaling \$17,000,000 and the ability to borrow an additional \$22,000,000 from secured borrowing lines. Lines of credit are available on a one-to-ten day basis for general purposes of the Corporation. All of the lenders have reserved the right to withdraw these lines at their option.

Capital Management

The Bank and the Corporation are subject to various regulatory capital requirements administered by banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weights and other factors.

Quantitative measures established by regulations to ensure capital adequacy require the Bank and the Corporation to maintain minimum amounts and ratios of total and

Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of September 30, 2005, that the Bank and the Corporation meet the capital adequacy requirements to which they are subject.

As of September 30, 2005, the Bank was "well capitalized" under the regulatory framework for prompt corrective action based on its capital ratio calculations. In order to be "well capitalized", the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table.

Under present regulations of the Office of the Comptroller of the Currency, the Bank must have core capital (leverage requirement) equal to 4.0% of assets, of which 1.5% must be tangible capital, excluding intangible assets. The Bank must also maintain risk-based regulatory capital as a percent of risk weighted assets at least equal to 8.0%. In measuring compliance with capital standards, certain adjustments must be made to capital and total assets.

The following tables present the total risk-based, Tier 1 risk-based and Tier 1 leverage requirements for the Corporation and the Bank (dollars in thousands).

	<u>September 30, 2005</u>					
	<u>Actual</u>		<u>Regulatory Minimum</u>		<u>"Well Capitalized"</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	\$	%	\$	%	\$	%
Leverage ratio						
Corporation	30,054	8.31%	14,469	4.00%	n/a	n/a
Bank	29,294	8.10%	14,469	4.00%	18,086	5.00%
Tier 1 capital ratio						
Corporation	30,054	13.71%	8,770	4.00%	n/a	n/a
Bank	29,294	13.35%	8,776	4.00%	13,164	6.00%
Total risk-based capital ratio						
Corporation	32,652	14.89%	17,541	8.00%	n/a	n/a
Bank	31,891	14.54%	17,552	8.00%	21,940	10.00%

During fiscal 2003, the Corporation implemented a share repurchase program under which the Board of Directors of the Corporation authorized the repurchase of up to 5% of the outstanding shares or 98,000 shares. The program was expanded by an additional 5%, or 98,000 shares, in fiscal 2004 and by an additional 5%, or 95,000 shares in fiscal 2005. The shares are to be repurchased either through open market purchases or privately negotiated transactions and will be made from time to time depending on market conditions and other factors. Repurchased shares will be held in treasury and will be available for the Corporation's benefit plans. The repurchase program is expected to improve the Corporation's operating performance on a per share basis and enhance, in the long term, the market price per share of the Corporation's common stock. During the three and nine months ended September 30, 2005, the Corporation repurchased 17,140 and 81,108 shares, respectively. As of September 30, 2005, the Corporation had repurchased a total of 164,093 shares under these authorizations. Of the three authorizations, 32,000 shares remain to be purchased under the second authorization.

Off-Balance Sheet Risk

In the normal course of operations, the Corporation engages in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in its financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customer's requests for funding and take the form of legally binding agreements to lend money to customers at predetermined interest rates for a specified period of time. Outstanding loan commitments (including commitments to fund credit lines) totaled \$47,558,000 at September 30, 2005. Each customer's credit worthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on the credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, commercial and residential real estate. The credit risk on these commitments is managed by subjecting each customer to normal underwriting and risk management processes.

For the period ended September 30, 2005, the Corporation did not engage in any off-balance sheet transactions reasonably likely to have a material effect on its financial condition, results of operation and cash flows.

Results of operations for the three months ended September 30, 2005 and 2004

General

Net income increased \$130,000, or 25.59%, to \$638,000 for the three months ended September 30, 2005 as compared to \$508,000 for the same period in 2004 as increases in net interest income and non-interest income and reductions in the provision for loan losses were partially offset by an increase in non-interest expense.

Interest Income

Interest income increased \$621,000, or 14.50%, to \$4,904,000 for the three months ended September 30, 2005 as compared to the same period in 2004. Interest income on loans increased by 22.70%, or \$600,000, to \$3,243,000 for the three months ended September 30, 2005 from \$2,643,000 for the three months ended September 30, 2004, due primarily to increasing market interest rates along with a higher average balance of loans with a higher average rate due to our increased emphasis on commercial and consumer loan originations. Interest on deposits and federal funds sold, combined with interest and dividends on investment and mortgage-backed securities increased \$21,000, or 1.28%, for the three months ended September 30, 2005 to \$1,661,000 from \$1,640,000 during the same period in 2004 due to higher yields, due to higher market interest rates, offset by lower average balances.

Interest Expense

Interest expense increased \$512,000, or 28.22%, to \$2,326,000 for the three months ended September 30, 2005 as compared to the three months ended September 30, 2004. Interest expense on deposit accounts increased \$389,000, or 40.52%, to \$1,349,000 for the three months ended September 30, 2005 from \$960,000 during the same period in 2004 due to higher cost of deposits as a result of higher market rates offset by growth in lower costing transaction accounts. The Corporation continues to target lower cost demand deposit accounts versus traditional higher cost certificates of deposits. Interest expense on borrowings increased \$82,000, or 11.01%, for the three months ended September 30, 2005 as compared to the same period in the previous year due to lower borrowing levels offset by higher market interest rates. Interest expense on floating rate junior subordinated deferrable interest debentures increased \$41,000, or 37.61%, to \$150,000 for the three months ended September 30, 2005 from \$109,000 during the same period in 2004 due to higher market interest rates.

Provision for Loan Losses

During the three months ended September 30, 2005, the provision for loan losses was \$220,000 as compared to \$390,000 for the same period in the previous year, due to lower charge-offs and non-accrual loans, offset by the growth in the loan portfolio and the increase in commercial and consumer loans with greater risk. Commercial and consumer loans accounted for 67.18% of the loan portfolio at September 30, 2005 compared to 63.00% for the same period in 2004. During the three months ended September 30, 2005, bad debt charge-offs, net of recoveries, were \$89,000 as compared to \$178,000 in net bad debt charge-offs for the same period in the previous year. During the three months ended September 30, 2005, non-accrual loans decreased \$2,516,000 from \$4,001,000 at June 30, 2005 to \$1,485,000 at September 30, 2005. This compares to non-accrual loans at September 30, 2004 of \$1,286,000. The decrease in non-accrual loans for the quarter ending September 30, 2005 included one commercial loan for \$2.4 million that was paid off. Management believes the Corporation's loan loss allowance is adequate to absorb possible loan losses inherent in the portfolio.

The allowance for loan loss calculation includes a segmentation of loan categories subdivided by residential mortgage, commercial and consumer loans. Each category is rated for all loans including performing groups. The weight assigned to each performing group is developed from previous loan loss experience and as the loss experience changes, the category weight is adjusted accordingly. In addition to loan loss experience, management's evaluation of the loan portfolio includes the market value of the underlying collateral, growth and composition of the loan portfolio, delinquency trends and economic conditions. Management evaluates the carrying value of loans periodically and the allowance for loan loss calculation will adjust accordingly.

Non-Interest Income

Total non-interest income increased \$53,000, or 8.29%, to \$692,000 for the three months ended September 30, 2005 from \$639,000 for the same period in the previous year. Fees from financial services increased \$66,000, or 10.98%, to \$667,000 for the three months ended September 30, 2005 from \$601,000 for the same period in the previous year. The increase was from an increase in transaction accounts that was offset by lower fees generated from third party investment brokerage and financing receivables programs due to a reduction in product volumes. Gain on sale of loans for the three months ended September 30, 2005 was \$11,000 compared to \$30,000 for the same period in the previous year due to lower residential loan originations as a result of the rising interest rate environment along with the Corporation's shift in focus to consumer/commercial loans. The sales represent loans funded and sold through a third party on a servicing released basis.

Non-Interest Expense

For the three months ended September 30, 2005, total non-interest expense increased \$119,000, or 5.80%, to \$2,170,000 from \$2,051,000 for the same period in 2004. Compensation and employee benefits increased \$105,000, or 11.58%, to \$1,012,000 for

the three months ended September 30, 2005 from \$907,000 for the same period in 2004 due primarily to higher amortization expense for deferred compensation contracts. Occupancy and equipment expense decreased \$48,000, or 8.89%, to \$492,000 for the three months ended September 30, 2005 from \$540,000 for the same period in 2004 due to primarily to lower depreciation expense. Professional services expense increased \$19,000, or 28.36%, to \$86,000 for the three months ended September 30, 2005 from \$67,000 for the same period in 2004 due to higher consultant expense utilized to implement improved loan documentation policies and procedures. Loan operations expense increased \$53,000, or 110.42%, to \$101,000 for the three months ended September 30, 2005 from \$48,000 for the same period in 2004, due to higher costs associated with foreclosures. Items processing expense decreased \$18,000, or 26.87%, to \$49,000 for the three months ended September 30, 2005 from \$67,000 for the same period in 2004. The Corporation entered into a new items processing contract that was effective January 1, 2005 that reduced the long term expense for demand accounts. Telephone expense increased \$16,000, or 47.06%, to \$50,000 for the three months ended September 30, 2005 from \$34,000 for the same period in 2004 due to prior year expense credits received with the purchase of a new system.

Results of operations for the nine months ended September 30, 2005 and 2004

General

Net income increased \$161,000, or 10.29%, to \$1,726,000 for the nine months ended September 30, 2005 as compared to the same period in 2004 as an increase in net interest income was partially offset by an increase in non-interest expense.

Interest Income

Interest income increased \$1,498,000, or 11.96%, to \$14,023,000 for the nine months ended September 30, 2005 as compared to the same period in 2004. Interest income on loans increased by 19.86%, or \$1,509,000, to \$9,108,000 for the nine months ended September 30, 2005 from \$7,599,000 for the nine months ended September 30, 2004, due primarily to increasing market interest rates along with a higher average balance of loans with a higher average rate due to our increased emphasis on commercial and consumer loan originations. Interest on deposits and federal funds sold, combined with interest and dividends on investment and mortgage-backed securities decreased \$11,000, or 0.22%, for the nine months ended September 30, 2005 to \$4,915,000 from \$4,926,000 during the same period in 2004 due to lower average balances, offset by higher yields. Proceeds from the maturity and sale of investment securities were utilized to fund growth in higher yielding loans.

Interest Expense

Interest expense increased \$1,115,000, or 20.72%, to \$6,495,000 for the nine months ended September 30, 2005 as compared to the nine months ended September 30,

2004. Interest expense on deposit accounts increased \$889,000, or 30.86%, to \$3,770,000 for the nine months ended September 30, 2005 from \$2,881,000 during the same period in 2004 due to higher cost of deposits as a result of higher market rates offset by growth in lower costing transaction accounts. The Corporation continues to target lower cost demand deposit accounts versus traditional higher cost certificates of deposits. Interest expense on borrowings increased \$117,000, or 5.34%, for the nine months ended September 30, 2005 as compared to the same period in the previous year due to lower borrowing levels offset by higher market interest rates. Interest expense on floating rate junior subordinated deferrable interest debentures increased \$109,000, or 35.39%, to \$417,000 for the nine months ended September 30, 2005 from \$308,000 during the same period in 2004 due to higher market interest rates.

Provision for Loan Losses

During the nine months ended September 30, 2005, the provision for loan losses was \$768,000 as compared to \$775,000 for the same period in the previous year, which reflected loan growth along with an increase in non-accrual loans, offset by a decrease in net charge-offs. The provision also reflects the Corporation's continued movement from longer term, fixed rate residential mortgage loans to shorter term, floating rate consumer and commercial loans. Consumer and commercial loans carry higher risk weighted rates in the reserve calculation as compared to residential mortgage loans. Non-performing loans increased \$735,000 from \$750,000 at December 31, 2004 to \$1,485,000 at September 30, 2005. The increase in non-accrual loans for the nine months ending September 30, 2005 includes one commercial loan for \$380,000 that was downgraded as a result of an analysis of the underlying collateral. Loans 30-89 days past due and still accruing was \$3,442,000 at September 30, 2005 compared to \$7,214,000 at December 31, 2004. The reduction in delinquent loans is a result of increased emphasis and focus from the Credit Administration area of the Bank that was developed with the utilization of outside loan consultants. During the nine months ended September 30, 2005, bad debt charge-offs, net of recoveries, was \$197,000 as compared to \$1,058,000 for the same period in the previous year. The previous year bad debt charge-offs included approximately \$737,000 from two commercial loans that were written down due to a reduction in the market value of the supporting loan collateral. The Corporation's loan loss allowance at September 30, 2005 was approximately 1.44% of the Corporation's outstanding loan portfolio and 174.88% of non-performing loans compared to 1.18% of the Corporation's outstanding loan portfolio and 270.13% of non-performing loans at December 31, 2004.

The changes in the allowance for loan losses consisted of the following (in thousands):

Balance at beginning of year	\$2,026
Provision for loan losses	768

Charge-offs, net	<u>(197)</u>
Balance at end of quarter	<u>\$2,597</u>

The following table sets forth information with respect to the Bank's non-performing assets at the dates indicated (dollars in thousands):

	<u>September 30, 2005</u>	<u>December 31, 2004</u>
Non-accruing loans which are contractually past due 90 days or more:		
Real estate	\$ 406	\$ 217
Commercial	802	142
Consumer	<u>277</u>	<u>391</u>
Total	<u>\$1,485</u>	<u>\$ 750</u>
Percentage of loans receivable, net	<u>0.81%</u>	<u>0.44%</u>
Percentage of allowance for loan losses to total loans outstanding	<u>1.44%</u>	<u>1.18%</u>
Allowance for loan losses	<u>\$2,597</u>	<u>\$2,026</u>
Real estate acquired through foreclosure and repossessed assets	<u>\$ 223</u>	<u>\$ 373</u>

Non-Interest Income

Total non-interest income increased \$18,000, or 0.94%, to \$1,942,000 for the nine months ended September 30, 2005 from \$1,924,000 for the same period in the previous year. Fees from financial services increased \$45,000, or 2.48%, to \$1,856,000 for the nine months ended September 30, 2005 from \$1,811,000 for the same period in the previous year. The increase was due primarily to higher fees for financial services as a result of an increase in demand deposit accounts offset by lower fees generated from third party investment brokerage and financing receivables programs due to a reduction in product volumes. Gain on sale of loans for the nine months ended September 30, 2005 was \$37,000 compared to \$72,000 for the same period in the previous year due to lower sales of fixed-rate mortgage loans because of lower residential loan originations as a result of the rising interest rate environment along with the Corporation's shift in focus to consumer/commercial loans. The sales represent loans funded and sold through a third party on a servicing released basis.

Non-Interest Expense

For the nine months ended September 30, 2005, total non-interest expense increased \$144,000, or 2.32%, to \$6,363,000 from \$6,219,000 for the same period in 2004. Compensation and employee benefits increased \$128,000, or 4.44% to \$3,010,000 for the nine month period ended September 30, 2005 from \$2,882,000 for the same period in 2004, due to normal merit salary increases along with higher amortization expense for deferred compensation contracts. Occupancy and equipment expense decreased \$39,000, or 2.50%, to \$1,523,000 for the nine months ended September 30, 2005 from \$1,562,000 for the same period in 2004 due primarily to lower depreciation expense. Professional services expense increased \$50,000, or 22.12%, to \$276,000 for the nine months ended September 30, 2005 from \$226,000 for the same period in 2004 due to higher consultant expense utilized to implement improved loan documentation procedures and higher audit fees. Advertising expense decreased \$15,000, or 12.40%, to \$106,000 for the nine months ended September 30, 2005 from \$121,000 for the same period in 2004, due to reductions in media advertising in slower growth markets. Loan operations costs increased \$68,000, or 61.26%, to \$179,000 for the nine months ended September 30, 2005 from \$111,000 for the same period in 2004, due to higher costs associated with foreclosures. Items processing expense decreased \$80,000, or 42.11%, to \$110,000 for the nine months ended September 30, 2005 from \$190,000 for the same period in 2004. The Corporation entered into a new items processing contract that was effective January 1, 2005 that reduced the long term expense for demand accounts. Telephone expense increased \$24,000, or 21.62%, to \$135,000 for the nine months ended September 30, 2005 from \$111,000 for the same period in 2004, due to installation charges incurred for two new banking center systems and prior year expense credits received on the purchase of new equipment.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Corporation is committed to following a program of asset and liability management in an effort to manage the fluctuations in earnings caused by movements in interest rates. A significant portion of the Corporation's income results from the spread between the yield realized on its interest-earning assets and the rate of interest paid on its deposits and other borrowings. Differences in the timing and volume of repricing assets versus the timing and volume of repricing liabilities expose the Corporation to interest rate risk. Management's policies are directed at minimizing the impact on earnings of movements in interest rates.

The Corporation's Asset/Liability Committee makes pricing and marketing decisions on deposit and loan products in conjunction with managing the Corporation's interest rate risk. In addition, the Asset/Liability Committee reviews the Corporation's securities portfolio, FHLB advances and other borrowings as well as the Corporation's asset and liability policies.

The primary objective of Asset/Liability management at the Corporation is to manage interest rate risk and achieve reasonable stability in net interest income throughout interest rate cycles in order to maintain adequate liquidity. This is achieved by

maintaining the proper balance of rate-sensitive earning assets and rate-sensitive costing liabilities. The relationship of rate-sensitive earning assets to rate-sensitive costing liabilities is the principal factor in projecting the effect that fluctuating interest rates will have on future net interest income. Rate-sensitive assets and interest-bearing liabilities are those that can be repriced to current market rates within a relatively short time period. Management monitors the rate sensitivity of earning assets and interest-bearing liabilities over the entire life of these instruments.

The Corporation has established policies and monitors results to control interest rate sensitivity. Although the Corporation utilizes measures such as static gap, which is simply the measurement of the difference between interest-sensitive assets and interest-sensitive liabilities repricing for a particular time period, just as important a process is the evaluation of how particular assets and liabilities are impacted by changes in interest rates or selected indices as they reprice. Asset/liability modeling techniques are utilized by the Corporation to assess varying interest rate and balance sheet mix assumptions.

Net Interest Income Simulation Analysis. We analyze our interest rate sensitivity position to manage the risk associated with interest rate movements through the use of interest income simulation. The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are “interest sensitive.” An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period.

Our goal is to manage asset and liability positions to moderate the effects of interest rate fluctuations on net interest income. Interest income simulations utilizing interest rate shocks are completed quarterly and presented to the Asset/Liability Committee. The simulations provide an estimate of the impact of changes in interest rates on net interest income under a range of assumptions. The interest rate shocks are compared to board approved policy limits and are reviewed by the Asset/Liability Committee on a quarterly basis. The simulation incorporates assumptions regarding the potential timing in the repricing of certain assets and liabilities when market rates change and the changes in spreads between different market rates. The simulation analysis incorporates management’s current assessment of the risk that pricing margins will change adversely over time due to competition or other factors.

Simulation analysis is only an estimate of our interest rate risk exposure at a particular point in time. We continually review the potential effect changes in interest rates could have on the repayment of rate sensitive assets and funding requirements of rate sensitive liabilities.

The table below sets forth an approximation of our exposure as a percentage of estimated net interest income for the next twelve month period using interest income simulation. The simulation uses projected repricing of assets and liabilities on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rates can have a significant impact on interest income

simulation. When interest rates rise, prepayments tend to slow. When interest rates fall, prepayments tend to rise.

The following table reflects changes in estimated net interest income from rate shocks of (+) or (-) 1% and 2% in a rising and falling interest rate environment for the Corporation. Management did not include a 200 basis points decrease in the simulation model at December 31, 2004 as such a change in interest rates at that time was a highly remote scenario.

	At September 30, <u>2005</u>	At December 31, <u>2004</u>
00 basis point increase in rates	+6.26%	+5.75%
100 basis point increase in rates	+3.41%	+3.12%
100 basis point decrease in rates	4.50%	- 3.22%
200 basis point decrease in rates	-11.79%	N/A

The 200 and 100 basis point change in rates in the above table is assumed to occur evenly over the following twelve months. Based on the scenario above, net interest income would be positively affected in the twelve-month periods if rates rose by 100 and 200 basis points, but would be adversely affected if rates declined by 100 and 200 basis points.

Item 4. Controls and Procedures

The Corporation's management, including the Corporation's principal executive officer and principal financial officer, have evaluated the effectiveness of the Corporation's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Corporation's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Corporation files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Corporation's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

There has been no change in the Corporation's internal control over financial reporting identified in connection with the evaluation required by Rule 13(a)-15(e) that occurred

during the Corporation's last fiscal quarter that has materially affected or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation is involved in various claims and legal actions arising in the normal course of business. Management believes that these proceedings are immaterial to the Corporation's financial condition and results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides certain information with regard to shares repurchased by the Corporation during the second quarter of 2005.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per share	©) Total Number of Shares Purchased as part of Publicly Announced Programs	(d) Maximum Number of Shares that may be purchased under Program
July 1, 2005 through July 31, 2005	3,000	\$18.01	3,000	141,422
August 1, 2005 through August 31, 2005	4,140	\$18.02	4,140	137,282
September 1, 2005 through September 30, 2005	10,000	\$18.04	10,000	127,282
Total	17,140	\$18.03	17,140	N/A

In November 2004, the Corporation implemented a share repurchase program under which the Corporation may repurchase up to 5% of the outstanding shares or 98,000 shares. In May 2005, the program was expanded by an additional 5% or 95,000 shares. The repurchase program will continue until it is completed or terminated by the Board of Directors.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

31(a) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31(b) Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32(a) Chief Executive Officer Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32(b) Chief Financial Officer Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

UNION FINANCIAL BANCSHARES, INC.
(Registrant)

Date: November 7, 2005

By: /s/ Dwight V. Neese
Dwight V. Neese, CEO

Date: November 7, 2005

By: /s/ Richard H. Flake
Richard H. Flake, CFO

EXHIBIT 31 (a)
CERTIFICATION

I, Dwight V. Neese, certify that:

1. I have reviewed this Form 10-Q of Union Financial Bancshares, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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)) 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) 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
 - (c) 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: November 7, 2005

/s/ Dwight V. Neese

Dwight V. Neese

President and Chief Executive Officer

EXHIBIT 31 (b)
CERTIFICATION

I, Richard H. Flake, certify that:

1. I have reviewed this Form 10-Q of Union Financial Bancshares, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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)) 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) 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
 - (c) 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: November 7, 2005

/s/ Richard H. Flake

Richard H. Flake

Executive Vice President and Chief Financial
Officer

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

In connection with the Quarterly Report of Union Financial Bancshares, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission (the "Report"), I, Dwight V. Neese, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

/s/ Dwight V. Neese
Dwight V. Neese
President and Chief Executive Officer

Date: November 7, 2005

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

In connection with the Quarterly Report of Union Financial Bancshares, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission (the "Report"), I, Richard H. Flake, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as added by Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

/s/ Richard H. Flake

Richard H. Flake

Executive Vice President and Chief Financial
Officer

Date: November 7, 2005