

# 2015 ANNUAL REPORT



FOCUS ON THE FUTURE



# FOCUS ON THE FUTURE



## DEAR FELLOW SHAREHOLDERS

Nobody could have predicted the global economy crisis which began seven years ago and the impact it had on the world and will continue to have for many more years. It literally reshaped the way we do business and how we are growing our bank as we move forward.

It was a difficult journey, one that required strong risk management, credit discipline, efficiency, and expense management while also expanding our ability to generate profits through the expansion of our mortgage business line and auto lending as competitive advantages.

We continue to operate in an extended and unusually low-rate environment and there remains a consistent challenge in the ever-evolving regulatory requirements confronting our industry with related increasing expenses. The equilibrium of the banking industry has shifted since the 1980's affecting small to mid-size community banks. The rapidly changing environment includes new players into the world of finance, technological changes such as mobile banking, and the challenge of balancing compliance expense versus investing in technology in order to remain competitive with larger banks who can more easily afford both.

As our markets have slowly recovered, we have returned to profitability and are once again seeing growth in our core deposit base and loan portfolio. We also continue to focus on delivering profits that are consistent and sustainable as we know this is what you, our shareholder, look for. Our culture is the catalyst propelling our company to higher levels as

we move forward and it's what has kept us successful over the past few years. This is the foundation that creates franchise value, that intangible value that can't be measured.

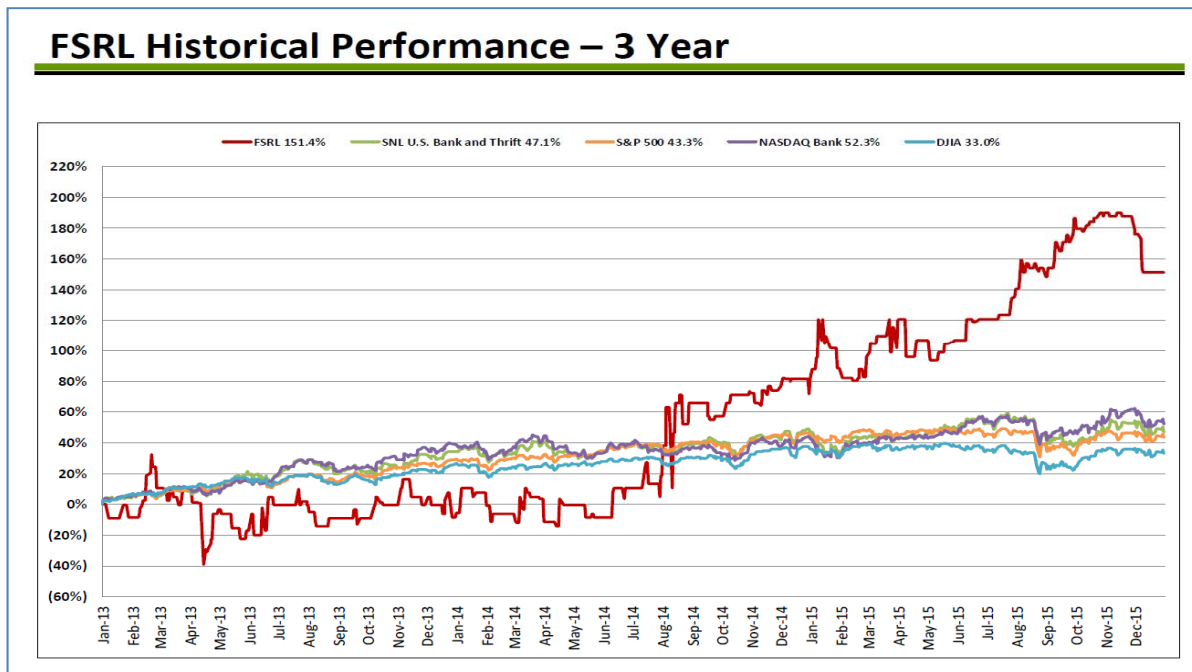
We have made significant progress since our last report and I'd like to highlight a few strategic areas critical to our growth, profitability and value that we continue to make great strides in.

### Solid Asset and Capital Ratios

We have always taken a very conservative approach when it comes to the level of capital we retain. This has allowed us to weather the financial crisis and it gives us the strength and resources necessary to pursue opportunities and safeguard us against the next event that could disrupt our industry. Our capital ratios remain well above what is required by regulators. Asset quality has continued to improve as non performing assets have declined adding further to the health of our franchise.

We plan to pay back a portion of TARP through retained earnings in the second quarter of 2016. Then we will address the remaining portion of TARP at a later date, but will not enter any repayment strategy that would be more dilutive to capital than the current cost of TARP.

Our share price, though rarely traded, continues to be valued below our tangible book



value. Although we continue trade below our core value, our share price has begun to see improvement, outperforming the banking sector significantly over the past year. As we

continue to see stable earnings and address our expensive capital, we should continue to see improvement in our share price.

Creating a strong balance sheet, ensuring strong asset quality, generating core sustainable profitability, and building long-term shareholder value have always topped our desire to grow the franchise.

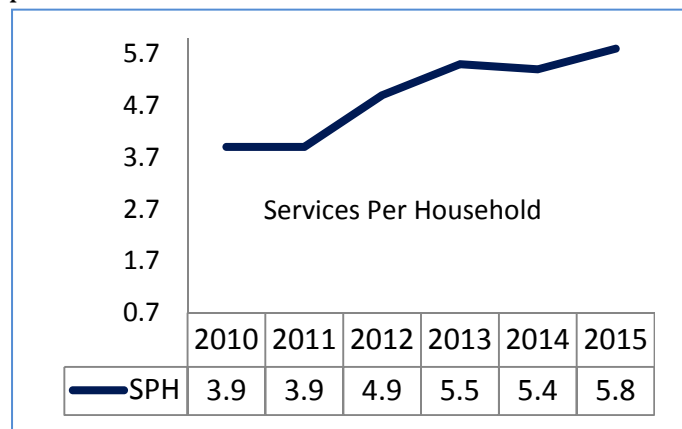
### **Profitability and Creating Long Term Value**

Despite all the pressures on community banking, we continue to focus on our long-held customer satisfaction advantage over large banks and attribute it to developing deeper relationships with our customers and having a clear purpose ‘to make the lives of our customers better.’ Customers consistently give us a 95% or above customer satisfaction rating and they demonstrate they are willing to refer friends or family, as a large percent of new customers open an account because of word of mouth advertising.

We have a clearly defined business model that outlines our customer value proposition and keeps us focused on differentiating ourselves in our markets.

We continue to increase our services per household from the time we onboard a new customer to over the life of their relationship with the bank. We know that as a customer stays with us longer they buy more products and services from us.

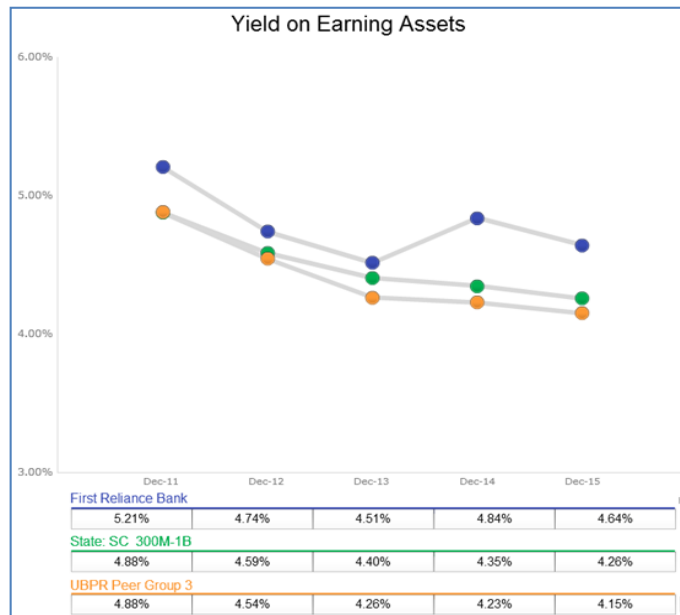
Customers stay with us longer because they are happy with us and like the brand of banking they experience. We believe our customer satisfaction rating stays high for multiple reasons which include error rate reduction, quick resolutions when there are errors, better products and services, responsiveness to our customers, exceptional friendly service, events in the branch and online, and enhancements to our online and mobile banking.



We continue to enhance our products and services and optimize how we deliver a better experience to our customers. Small business lending has long been the staple of banks. We continue to grow loans to small businesses and support community development that they contribute to.

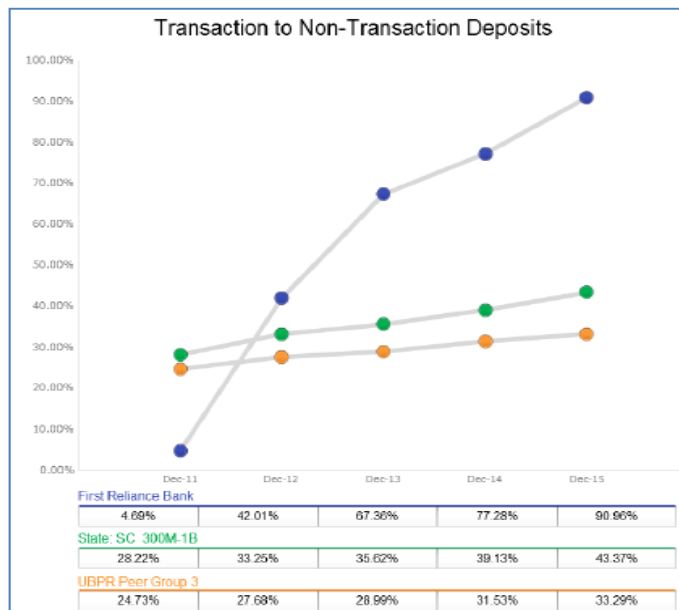
We made a strategic decision to diversify our revenue sources and in early 2015 expanded our mortgage business line. We have no desire to become a mortgage bank and will be disciplined as we grow the business line, not allowing it to contribute more than 20% of our total revenue.

The indirect auto finance business line, now into its second year, is contributing to profitability as well and is positioned for continued slow-to-moderate growth. We are partnering with dealers who possess financial strength, exceptional reputations and operate only in the markets we currently serve.



As our legacy assets have paid off we have repositioned our loan portfolio, focusing growth in residential mortgages and consumer loans. This has resulted in better asset yields and also improved margins, along with a better diversified loan portfolio which reduces risk. As you can see in the yield on earning assets graph, our asset yields are proving this strategy is working.

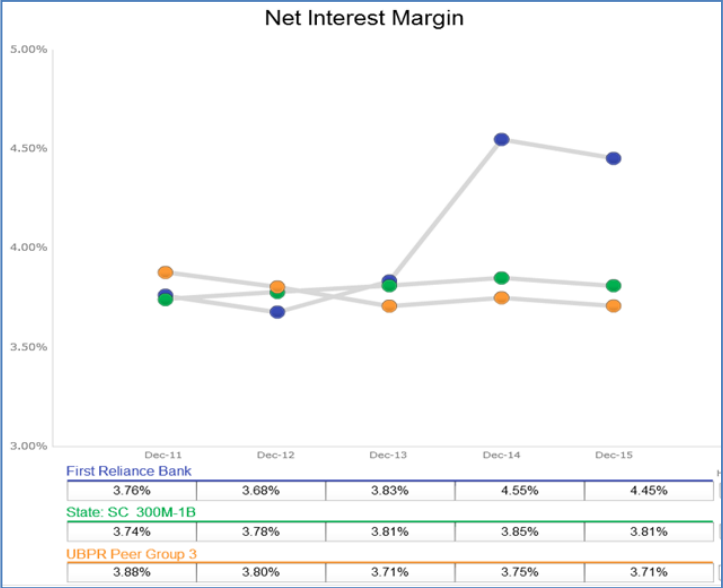
We had an extraordinary year of growth in our deposit base and our attention remained squarely on generating checking accounts and low-cost/no cost deposits which grew 15.52% or \$32.8 million by year end. This deposit composition improves the stability of our deposits and allows us to better manage and predict our funding cost (our largest expense). In 2011, our funding cost performed in the bottom 10% and by year end 2015, we were in the top 10 percentile performance for all banks nationally. Our lending and funding strategies have been successful and show in the performance of our net interest margin improvement.



Our unique customer programs such as Hometown Heroes, Moms First, iMatter young adult and Better Life programs help us generate more customers, retain more of those we have and deepen relationships with our customers.

The results of our business strategy are beginning to become evident. Total revenues increased 13.04% to \$20.6 million from \$18.2 million in 2014 and net income in 2015 was \$8.8 million compared to \$4.4 million for 2014

Although we are closely managing our expenses, we have seen a slight increase in our operating expense. The increase is primarily attributed to the expansion of the mortgage division and the related increase in compensation. As we increase our mortgage lending, we expect revenues to grow further enhancing our operating efficiencies.



**Growth and Expansion**

Strategically, we will continue to be focused on growing our market presence in the Coastal and Midlands regions of South Carolina, diversifying our revenue sources, targeting non-interest income revenue ranges from 30-40% of total revenue and efficiency goal targets below 70% within the next few years. The expansion of the mortgage business line and indirect auto lending has and will continue to help us reach those targets

Unchanged over the next few years is our clearly defined business model that outlines our customer value proposition and keeps us focused on actions that are value creators for our shareholders. These actions include:

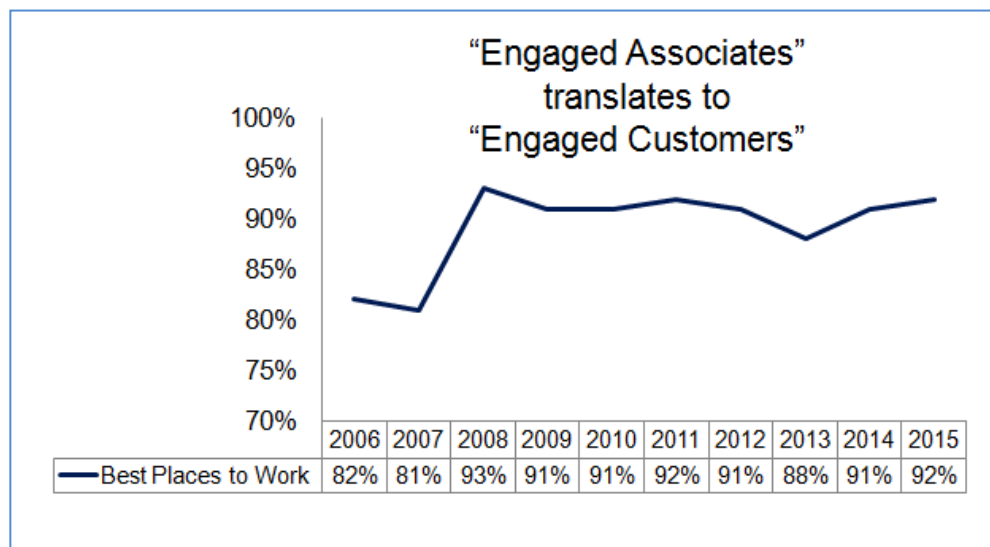
- Continue to increase core deposits
- Recruit and retain talented people
- Increase market share in Columbia and Charleston markets through our two new business lines, indirect auto finance and expanded mortgage line
- Increase customer wallet share, starting with on-boarding customers
- Increase customer retention through loyalty and tenure

## Our Culture

Last year marked our sixteenth anniversary since the bank began. We thought it appropriate to distribute our culture book to every associate in the bank especially since we have new associates in our expanded mortgage business line and indirect auto finance areas. The culture book includes thoughts on why we started the bank, what our purpose is, our service promise and our seven values. There are stories in it from our customers and associates which are examples of our culture. These core principles and stories describe how we conduct business and will continue to guide us as we move forward.

Staff engagement score is 92% and is a testament to our model and strong culture.

Our associates are extremely committed to the company's vision and are driven to provide exceptional



service. They are the reason our customer satisfaction rating is the highest in the industry at 95%. We believe that highly engaged associates are the reason we are able to deliver a First Reliance Bank branded customer experience.

The Bank makes significant economic contributions to the communities we serve. We contribute approximately \$30 million into our local markets from salaries, interest paid on deposits, and the goods and services we purchase. The Bank has always focused on serving its communities and does so through sponsorships and volunteer involvement, donating over 800 volunteer hours of service annually

One of the things, I'm most proud of is our people and how we managed our way through the challenge. I am confident that we have the right people in place to get us through any storm and lead us into the future. Our leaders have managed the last few years, with fortitude, making tough decisions, driving results and working together as a team. They are

the reason why both our performance and culture have remained strong in this environment. We are a safer and stronger community bank as a result of the past and remain committed to supporting our communities and providing our customers with an exceptional customer experience.

Thank you and best regards,

A handwritten signature in black ink, appearing to read "Rick Saunders". The signature is fluid and cursive, with a long horizontal stroke at the end.

Rick Saunders  
President and CEO

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## Independent Auditor's Report

The Board of Directors  
First Reliance Bancshares, Inc. and Subsidiary  
Florence, South Carolina

### **Report on the Consolidated Financial Statements**

We have audited the accompanying consolidated financial statements of First Reliance Bancshares, Inc. and its Subsidiary which comprise the consolidated balance sheets as of December 31, 2015 and 2014, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

### **Management's Responsibility for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Reliance Bancshares, Inc. and Subsidiary as of December 31, 2015 and 2014, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Columbia, South Carolina  
March 31, 2016

*Elliott Davis Decosimo, LLC*

# First Reliance Bancshares, Inc. and Subsidiary

## Consolidated Balance Sheets

As of December 31, 2015 and 2014

	<u>2015</u>	<u>2014</u>
<b>Assets</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 3,703,357	\$ 4,955,110
Interest-bearing deposits with other banks	<u>16,357,619</u>	<u>17,891,077</u>
Total cash and cash equivalents	<u>20,060,976</u>	<u>22,846,187</u>
Time deposits in other banks	101,612	101,409
Securities available-for-sale	11,255,855	13,045,588
Securities held-to-maturity (Estimated fair value of \$26,270,623 and \$32,242,017 at December 31, 2015 and 2014, respectively)	25,470,171	31,384,418
Nonmarketable equity securities	<u>813,400</u>	<u>1,502,400</u>
Total investment securities	<u>37,539,426</u>	<u>45,932,406</u>
Mortgage loans held for sale	8,070,283	1,970,068
Loans receivable	259,806,101	255,381,014
Less allowance for loan losses	<u>(2,693,985)</u>	<u>(3,002,922)</u>
Loans, net	<u>257,112,116</u>	<u>252,378,092</u>
Premises, furniture and equipment, net	22,856,744	23,395,306
Accrued interest receivable	979,347	1,034,316
Other real estate owned	2,506,733	2,444,253
Cash surrender value life insurance	13,615,610	13,282,565
Net deferred tax assets	9,950,018	3,198,771
Mortgage servicing rights	1,015,403	-
Other assets	<u>1,502,230</u>	<u>1,172,948</u>
Total assets	<u>\$ 375,310,498</u>	<u>\$ 367,756,321</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing transaction accounts	\$ 68,147,262	\$ 65,445,513
Interest-bearing transaction accounts	76,304,111	57,229,738
Savings	99,870,631	88,822,371
Time deposits \$250,000 and over	14,990,007	27,814,120
Other time deposits	<u>44,612,452</u>	<u>46,006,876</u>
Total deposits	303,924,463	285,318,618
Securities sold under agreement to repurchase	8,201,396	7,573,403
Advances from Federal Home Loan Bank	10,000,000	25,000,000
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	54,002	806,079
Other liabilities	<u>2,586,907</u>	<u>2,380,554</u>
Total liabilities	<u>335,076,768</u>	<u>331,388,654</u>
<b>Commitments and contingencies - Notes 4 and 17</b>		
<b>Shareholders' Equity</b>		
Preferred stock		
Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding	15,179,709	15,179,709
Series B cumulative perpetual preferred stock - 767 shares issued and outstanding	767,000	767,000
Series D non-cumulative preferred stock - 612 shares issued and outstanding	612	-
Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,680,481 and 4,739,823 shares issued and outstanding at December 31, 2015 and 2014, respectively	46,804	47,398
Capital surplus	26,007,698	30,914,242
Treasury stock, at cost, 38,249 and 35,176 shares at December 31, 2015 and 2014, respectively	(217,230)	(205,512)
Nonvested restricted stock	(326,481)	(385,330)
Retained earnings (deficit)	(1,259,166)	(10,071,514)
Accumulated other comprehensive income	<u>34,784</u>	<u>121,674</u>
Total shareholders' equity	<u>40,233,730</u>	<u>36,367,667</u>
Total liabilities and shareholders' equity	<u>\$ 375,310,498</u>	<u>\$ 367,756,321</u>

See Notes to Consolidated Financial Statements

# First Reliance Bancshares, Inc. and Subsidiary

## Consolidated Statements of Operations

For the years ended December 31, 2015 and 2014

	<u>2015</u>	<u>2014</u>
<b>Interest income:</b>		
Loans, including fees	\$ 13,866,514	\$ 13,758,531
Investment securities:		
Taxable	925,411	1,120,902
Tax exempt	113,599	114,081
Other interest income	<u>129,247</u>	<u>80,517</u>
Total	<u>15,034,771</u>	<u>15,074,031</u>
<b>Interest expense:</b>		
Time deposits	327,768	706,565
Other deposits	209,324	129,677
Other interest expense	<u>303,036</u>	<u>323,314</u>
Total	<u>840,128</u>	<u>1,159,556</u>
<b>Net interest income</b>	14,194,643	13,914,475
Provision for loan losses	<u>777,678</u>	<u>706,891</u>
<b>Net interest income after provision for loan losses</b>	<u>13,416,965</u>	<u>13,207,584</u>
<b>Noninterest income:</b>		
Service charges on deposit accounts	1,430,808	1,624,575
Income from mortgage operations	3,110,229	953,743
Income from bank owned life insurance	333,046	336,872
Other service charges, commissions, and fees	1,161,788	1,076,560
Gain on sale of available-for-sale securities	9,562	5,321
Other	<u>328,365</u>	<u>284,518</u>
Total	<u>6,373,798</u>	<u>4,281,589</u>
<b>Noninterest expenses:</b>		
Salaries and benefits	9,747,542	7,317,950
Occupancy	1,628,527	1,529,855
Furniture and equipment related expenses	1,583,048	1,690,837
Other	<u>4,345,959</u>	<u>5,624,164</u>
Total	<u>17,305,076</u>	<u>16,162,806</u>
<b>Income before income taxes</b>	2,485,687	1,326,367
Income tax benefit	<u>(6,326,661)</u>	<u>(3,081,244)</u>
<b>Net income</b>	8,812,348	4,407,611
Preferred stock dividends accrued	1,450,440	1,220,205
Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium	<u>-</u>	<u>31,218</u>
<b>Net income available to common shareholders</b>	<u>\$ 7,361,908</u>	<u>\$ 3,156,188</u>
Average common shares outstanding, basic	4,491,053	4,612,758
Average common shares outstanding, diluted	4,595,204	4,688,981
<b>Income per common share:</b>		
Basic income per common share	\$ 1.64	\$ 0.68
Diluted income per common share	1.60	0.67

See Notes to Consolidated Financial Statements

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**First Reliance Bancshares, Inc. and Subsidiary****Consolidated Statements of Comprehensive Income****For the years ended December 31, 2015 and 2014**

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	<u>2015</u>	<u>2014</u>
<b>Net income</b>	<u>\$ 8,812,348</u>	<u>\$ 4,407,611</u>
<b>Other comprehensive loss, net of tax:</b>		
<b>Securities available-for-sale</b>		
Unrealized holding losses arising during the period	(54,140)	(46,077)
Income tax benefit	<u>18,408</u>	<u>15,665</u>
Net of income taxes	<u>(35,732)</u>	<u>(30,412)</u>
Reclassification adjustment for gains realized in net income	(9,562)	(5,321)
Income tax expense	<u>3,251</u>	<u>1,809</u>
Net of income taxes	<u>(6,311)</u>	<u>(3,512)</u>
<b>Other comprehensive loss attributable to securities available-for-sale</b>	<u>(42,043)</u>	<u>(33,924)</u>
<b>Securities held-to-maturity</b>		
Amortization of net unrealized gains capitalized on securities transferred from available-for-sale	(67,950)	(73,361)
Income tax benefit	<u>23,103</u>	<u>24,943</u>
Net of income taxes	<u>(44,847)</u>	<u>(48,418)</u>
<b>Other comprehensive loss</b>	<u>(86,890)</u>	<u>(82,342)</u>
<b>Comprehensive income</b>	<u>\$ 8,725,458</u>	<u>\$ 4,325,269</u>

*See Notes to Consolidated Financial Statements*

**First Reliance Bancshares, Inc. and Subsidiary**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**For the years ended December 31, 2015 and 2014**

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Treasury Stock</u>	<u>Nonvested Restricted Stock</u>	<u>Retained Earnings (Deficit)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
<b>Balance, December 31, 2013</b>	\$ 15,915,491	\$ 45,687	\$ 30,609,281	\$ (201,686)	\$ (32,138)	\$(14,447,907)	\$ 204,016	\$ 32,092,744
Net income						4,407,611		4,407,611
Other comprehensive income, net of tax							(82,342)	(82,342)
Accretion of Series A Preferred Stock discount	34,112					(34,112)		-
Amortization of Series B Preferred Stock premium	(2,894)					2,894		-
Issuance of Common Stock		26	6,618					6,644
Net Change in Restricted Stock		1,685	298,343		(353,192)			(53,164)
Purchase of Treasury Stock				(3,826)				(3,826)
<b>Balance, December 31, 2014</b>	15,946,709	47,398	30,914,242	(205,512)	(385,330)	(10,071,514)	121,674	36,367,667
Net income						8,812,348		8,812,348
Other comprehensive loss, net of tax							(86,890)	(86,890)
Dividend payment on preferred stock			(4,914,514)					(4,914,514)
Conversion of Common Stock to Preferred Stock - Series D	612	(612)						-
Issuance of Common Stock		18	7,970					7,988
Net Change in Restricted Stock					58,849			58,849
Purchase of Treasury Stock				(11,718)				(11,718)
<b>Balance, December 31, 2015</b>	<u>\$ 15,947,321</u>	<u>\$ 46,804</u>	<u>\$ 26,007,698</u>	<u>\$ (217,230)</u>	<u>\$ (326,481)</u>	<u>\$ (1,259,166)</u>	<u>\$ 34,784</u>	<u>\$ 40,233,730</u>

See Notes to Consolidated Financial Statements

**First Reliance Bancshares, Inc. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31, 2015 and 2014**

	<u>2015</u>	<u>2014</u>
<b>Cash flows from operating activities:</b>		
Net income	\$ 8,812,348	\$ 4,407,611
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan losses	777,678	706,891
Depreciation and amortization expense	930,789	968,159
Gain on sales of securities available-for-sale	(9,562)	(5,321)
Impairment loss on premises	-	399,812
Discount accretion and premium amortization	188,173	136,834
Gain on sale of other real estate owned	(436,028)	(141,868)
Write down of other real estate owned	33,580	65,873
Disbursements for mortgages held for sale	(141,957,066)	(26,647,034)
Proceeds from sales of mortgages held for sale	135,856,851	26,925,218
Deferred income tax benefit	(6,751,247)	(3,489,761)
Decrease in interest receivable	54,969	95,565
(Decrease) increase in interest payable	(752,077)	218,430
Increase in cash surrender value of life insurance	(333,045)	(336,872)
Increase (decrease) in deferred compensation on restricted stock	58,849	(53,164)
(Increase) decrease in other assets	(486,919)	155,343
Increase in mortgage servicing rights	(1,015,403)	-
Increase in other liabilities	<u>206,354</u>	<u>296,376</u>
Net cash (used) provided by operating activities	<u>(4,821,756)</u>	<u>3,702,092</u>
<b>Cash flows from investing activities:</b>		
Purchases of securities available-for-sale	(5,000,000)	(8,315,697)
Maturities of securities available-for-sale	1,546,426	2,035,251
Maturities of securities held-to-maturity	5,749,484	5,395,415
Proceeds from sale of securities available-for-sale	5,179,670	5,295,529
Net decrease in nonmarketable equity securities	689,000	92,500
Net increase in time deposits in other banks	(203)	(202)
Net increase in loans receivable	(9,649,939)	(18,674,448)
Purchases of premises, furniture and equipment	(279,351)	(297,595)
Proceeds from sale of other real estate owned	<u>4,485,864</u>	<u>7,761,819</u>
Net cash provided (used) by investing activities	<u>2,720,951</u>	<u>(6,707,428)</u>
<b>Cash flows from financing activities:</b>		
Net increase in demand deposits, interest-bearing transaction accounts and savings accounts	32,824,382	13,627,645
Net decrease in certificates of deposit and other time deposits	(14,218,537)	(10,724,050)
Net (decrease) increase in advances from Federal Home Loan Bank	(15,000,000)	2,000,000
Net increase in securities sold under agreements to repurchase	627,993	2,697,285
Net proceeds from issuance of common stock	7,988	6,644
Purchase of treasury stock	(11,718)	(3,826)
Payment of dividends on preferred stock	<u>(4,914,514)</u>	<u>-</u>
Net cash (used) provided by financing activities	<u>(684,406)</u>	<u>7,603,698</u>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(2,785,211)</b>	<b>4,598,362</b>
<b>Cash and cash equivalents, beginning of year</b>	<b><u>22,846,187</u></b>	<b><u>18,247,825</u></b>
<b>Cash and cash equivalents, end of year</b>	<b><u>\$ 20,060,976</u></b>	<b><u>\$ 22,846,187</u></b>
<b>Cash paid during the year for:</b>		
Income taxes	\$ 597,270	\$ 56,000
Interest	1,592,205	941,126
<b>Supplemental noncash investing and financing activities:</b>		
Foreclosures on loans	\$ 4,145,896	\$ 1,197,443
Net change in unrealized losses on investment securities	(86,890)	(82,342)

**See Notes to Consolidated Financial Statements**

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## First Reliance Bancshares, Inc. and Subsidiary

### *Notes to Consolidated Financial Statements*

*December 31, 2015 and 2014*

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#### **Note 1. Summary of Significant Accounting Policies**

##### Organization:

First Reliance Bancshares, Inc. (the "Company") was incorporated to serve as a bank holding company for its subsidiary, First Reliance Bank (the "Bank"). First Reliance Bank was incorporated on August 9, 1999 and commenced business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence, Lexington, and Charleston Counties in South Carolina. The Bank is a South Carolina chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The consolidated financial statements include the accounts of the parent company and its wholly-owned subsidiary after elimination of all significant intercompany balances and transactions. In 2005, the Company formed First Reliance Capital Trust I (the "Trust") for the purpose of issuing trust preferred securities. In accordance with current accounting guidance, the Trust is not consolidated in these financial statements.

##### Management's Estimates:

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, including valuation allowances for impaired loans, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for losses on loans and valuation of foreclosed real estate, management obtains independent appraisals in accordance with regulatory policy. Management must also make estimates in determining the estimated useful lives and methods for depreciating premises and equipment.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary, based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowances for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for losses on loans and foreclosed real estate may change materially in the near term.

##### Concentrations of Credit Risk:

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of loans receivable, investment securities, federal funds sold and amounts due from banks.

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily in Florence, Lexington, Charleston and Mount Pleasant, South Carolina. At December 31, 2015 and 2014, the majority of the total loan portfolio was to borrowers from within these areas.



## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 1. Summary of Significant Accounting Policies, Continued

##### Concentrations of Credit Risk, continued:

The Company's loan portfolio is not concentrated in loans to any single borrower or a relatively small number of borrowers. Additionally, management is not aware of any concentrations of loans to groups of borrowers or industries that would also be affected by sector-specific economic conditions.

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risk from concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g., principal deferral periods, loans with initial interest-only periods, etc.), and loans with high loan-to-value ratios. Management has determined that there is minimal concentration of credit risk associated with its lending policies or practices.

There are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. For example, the Company makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e., balloon payment loans). These loans are underwritten and monitored to manage the associated risks and management believes that these particular practices do not subject the Company to unusual credit risk. The Company's investment portfolio consists principally of obligations of the United States and its agencies or its corporations and obligations of state and local governments. In the opinion of management, there is no concentration of credit risk in its investment portfolio. The Company places its deposits and correspondent accounts with and sells its federal funds to high quality institutions. Management believes credit risk associated with correspondent accounts is not significant.

##### Securities Available-for-Sale:

Investment securities available-for-sale are carried at amortized cost and adjusted to estimated market value by recognizing the aggregate unrealized gains or losses in a valuation account. Aggregate market valuation adjustments are recorded as part of accumulated other comprehensive income in shareholders' equity net of deferred income taxes. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security. The adjusted cost basis of investments available-for-sale is determined by specific identification and is used in computing the gain or loss upon sale.

##### Securities Held-to-Maturity:

Investment securities held-to-maturity are stated at cost, adjusted for amortization of premium and accretion of discount computed by the straight-line method. The Company has the ability and management has the intent to hold designated investment securities to maturity. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security.

##### Nonmarketable Equity Securities:

At December 31, 2015 and 2014, non-marketable equity securities consist of the following:

	<u>2015</u>	<u>2014</u>
Federal Home Loan Bank stock	\$ 755,300	\$ 1,444,300
Community Bankers Bank stock	58,100	58,100
Total	<u>\$ 813,400</u>	<u>\$ 1,502,400</u>

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Nonmarketable Equity Securities, continued:

Nonmarketable equity securities are carried at cost since no quoted market value and no ready market exists. Investment in the Federal Home Loan Bank ("FHLB") is a condition to borrowing from that bank, and the stock is pledged to collateralize such borrowings. Dividends received on nonmarketable equity securities are included as a separate component of interest income.

##### Loans Receivable:

Loans receivable are stated at their unpaid principal balance, net of charge offs. Interest income is computed using the simple interest method and is recorded in the period earned.

When serious doubt exists as to the collectability of a loan or when a loan becomes contractually 90 days past due as to principal or interest, interest income is generally discontinued unless the estimated net realizable value of collateral exceeds the principal balance and accrued interest. When interest accruals are discontinued, income earned but not collected is reversed. Loans are removed from nonaccrual status when they become current as to both principal and interest, when concern no longer exists as to the collectability of the principal and interest, and after a sufficient history of satisfactory payment performance has been established.

Loan origination and commitment fees and certain direct loan origination costs (principally salaries and employee benefits) are deferred and amortized as an adjustment of the related loan yields. Generally, these amounts are amortized over the contractual life of the related loans or commitments.

The Company identifies impaired loans through its normal internal loan review process. Loans on the Company's problem loan watch list are considered potentially impaired loans. These loans are evaluated in determining whether all outstanding principal and interest are expected to be collected. Loans are not considered impaired if a minimal payment delay occurs and all amounts due, including accrued interest at the contractual interest rate for the period of delay, are expected to be collected.

##### Allowance for Loan Losses:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Allowance for Loan Losses, continued:

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. 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 loan agreement.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

In situations where, for economic or legal reasons related to a borrower's financial difficulties, a concession to the borrower is granted that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring. The restructuring of a loan may include the transfer from the borrower to the Company of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan, modification of the loan terms, or a combination of the above.

##### Premises, Furniture and Equipment:

Premises, furniture and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed by the straight-line method, based on the estimated useful lives for buildings of 40 years and for furniture and equipment of 5 to 10 years. Leasehold improvements are amortized over the term of the lease. The cost of assets sold or otherwise disposed of and the related allowance for depreciation is eliminated from the accounts and the resulting gains or losses are reflected in the income statement when incurred. Maintenance and repairs are charged to current expense. The costs of major renewals and improvements are capitalized based upon the Company's policy.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Other Real Estate Owned:

Other real estate owned includes real estate acquired through foreclosure. Other real estate owned is carried at the lower of cost or the fair market value minus estimated costs to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses to maintain such assets and subsequent changes in the valuation allowance are included in other noninterest expense along with gains and losses on disposal.

##### Cash Surrender Value of Life Insurance:

Cash surrender value of life insurance represents the cash value of policies on certain current and former officers of the Company.

##### Residential Mortgage Loans Held for Sale:

Loans held for sale represent loans originated or acquired by the Company with the intent to sell. The Company has elected the fair value option of accounting for certain residential mortgage loans. Electing to use the fair value option of accounting allows a better offset of the changes in the fair values of the loans and the derivative instruments used to economically hedge them without the burden of complying with the requirements for hedge accounting. These loans are initially recorded and carried at fair value, with changes in fair value recognized in income from mortgage operations. Loan origination fees are recorded when earned.

The Company issues rate lock commitments to borrowers on prices quoted by secondary market investors. Derivatives related to these commitments are recorded as either assets or liabilities in the balance sheet and are measured at fair value. Changes in the fair value of the derivatives are reported in current income or other comprehensive income depending on the purpose for which the derivative is held. The Company does not currently engage in any activities that qualify for hedge accounting. Accordingly, changes in fair value of these derivative instruments are included in noninterest income in the consolidated statements of operations.

##### Mortgage Servicing Rights:

Mortgage servicing rights ("MSRs") represent the present value of the future net servicing fees from servicing mortgage loans. Servicing assets and servicing liabilities must be initially measured at fair value, if practicable. For subsequent measurements, an entity can choose to measure servicing assets and liabilities either based on fair value or lower of cost or market. The Company uses the fair value measurement option for MSRs.

The methodology used to determine the fair value of MSRs is subjective and requires the development of a number of assumptions, including anticipated prepayments of loan principal. Fair value is determined by estimating the present value of the asset's future cash flows utilizing market-based prepayment rates, discount rates and other assumptions validated through comparison to trade information, industry surveys and with the use of independent third party appraisals. Risks inherent in the MSRs valuation include higher than expected prepayment rates and/or delayed receipt of cash flows. The value of MSRs is significantly affected by mortgage interest rates available in the marketplace, which influence mortgage loan prepayment speeds. In general, during periods of declining interest rates, the value of mortgage servicing rights declines due to increasing prepayments attributable to increased mortgage refinance activity. Conversely, during periods of rising interest rates, the value of servicing rights generally increases due to reduced refinance activity. MSRs are carried at fair value with changes in fair value and servicing fees (cost) recorded as a component of income from mortgage operations.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Liabilities for Representations and Warranties:

The Company is exposed to certain liabilities under representations and warranties made to purchasers of mortgage loans and servicing rights that require indemnification or repurchase of loans. At the time it issues a guarantee, the Company is required to recognize an initial liability for the fair value of obligations assumed under the guarantee.

The Company establishes a contingency reserve for its liabilities under representations and warranties provided to purchasers of its mortgage loans and servicing rights. This reserve is maintained at a level considered appropriate by management to provide adequately for known and inherent losses. The reserve is based upon a continuing review of past loss experience, estimates and assumptions of risk elements and future economic conditions. Additions to the reserve are recorded in other expenses.

Management's judgment about the adequacy of the reserve is based upon a number of assumptions about future events which it believes to be reasonable but which may or may not be accurate. There is no assurance that additional increases in the reserve will not be required. The Company may from time-to-time be required to repurchase loans previously sold to investors due to loan nonperformance. At December 31, 2015 and 2014, the Company had no general reserve recorded for potential indemnifications to other third-party purchasers based on management's analysis.

##### Income Taxes:

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. In addition, deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Interest and penalties related to income tax matters are recognized in income tax expense.

##### Advertising Expense:

Advertising and public relations costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent. Advertising and public relations costs of \$268,836 and \$119,463 were included in the Company's results of operations for 2015 and 2014, respectively.

##### Retirement Benefits:

A trusted retirement savings plan is sponsored by the Company and provides retirement benefits to substantially all officers and employees who meet certain age and service requirements. The plan includes a "salary reduction" feature pursuant to Section 401(k) of the Internal Revenue Code. In 2004, the Company converted the 401(k) plan to a 404(c) plan. The 404(c) plan changes investment alternatives to include the Company's stock. Under the plan and present policies, participants are permitted to make contributions up to 15% of their annual compensation. At its discretion, the Company can make matching contributions up to 6% of the participants' compensation. The Company charged \$147,119 and \$120,477 to earnings for the retirement savings plan in 2015 and 2014, respectively.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Retirement Benefits, continued:

During 2006, the Board of Directors approved a supplemental retirement plan for the directors and certain officers. These benefits are not qualified under the Internal Revenue Code and they are not funded. For 2015 and 2014 the supplemental retirement expense was \$192,057 and \$189,041, respectively. The current accrued but unfunded amount is \$1,642,646 and \$1,465,532 at December 31, 2015 and 2014, respectively. However, certain funding is provided informally and indirectly by bank owned life insurance policies. The cash surrender value of the life insurance policies is recorded as a separate line item in the accompanying consolidated balance sheets at \$13,615,610 and \$13,282,565 at December 31, 2015 and 2014, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2015 and 2014, the split-dollar liability relating to these arrangements totaled \$286,558 and \$269,701, respectively. For 2015 and 2014, the Company recognized net expenses of \$16,857 and \$16,285, respectively, related to these arrangements.

##### Equity Incentive Plan:

On January 19, 2006, the Company approved the 2006 Equity Incentive Plan. This plan provides for the granting of dividend equivalent rights, options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which shall be subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the plan. The plan allows granting up to 950,000 shares of stock to officers, employees, and directors, consultants and service providers of the Company or its affiliates. Awards may be granted for a term of up to ten years from the effective date of grant. Under this Plan, the Board of Directors has sole discretion as to the exercise date of any awards granted. The per-share exercise price of incentive stock options may not be less than the market value of a share of common stock on the date the option is granted. The related compensation cost for all stock-based awards is recognized over the service period for awards expected to vest. Any options that expire unexercised or are canceled become available for re-issuance. The Company's equity incentive plan is further described in Note 18.

##### Common Stock Owned by the Employee Stock Ownership Plan ("ESOP"):

All shares held by the ESOP are treated as outstanding for purposes of computing earnings per share. Purchases and redemptions of the Company's common stock by the ESOP are at estimated fair value as determined by independent valuations. Dividends on shares held by the ESOP are charged to retained earnings. At December 31, 2015 and 2014, the ESOP owned 419,106 and 385,585 shares of the Company's common stock with an estimated value of \$1,542,673 and \$1,069,239, respectively. All of these shares were allocated to participants.

##### Income Per Common Share:

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and similar share-based compensation instruments and are determined using the treasury stock method (see Note 19).

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## First Reliance Bancshares, Inc. and Subsidiary

### *Notes to Consolidated Financial Statements*

*December 31, 2015 and 2014*

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#### **Note 1. Summary of Significant Accounting Policies, Continued**

##### Statements of Cash Flows:

For purposes of reporting cash flows in the consolidated financial statements, the Company considers certain highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents include amounts due from banks and federal funds sold. Generally, federal funds are sold for one-day periods. Changes in the valuation account of securities available-for-sale, including the deferred tax effects, are considered noncash transactions for purposes of the statement of cash flows and are presented in detail in the notes to the consolidated financial statements.

##### Off-Balance Sheet Financial Instruments:

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. These financial instruments are recorded in the consolidated financial statements when they become payable by the customer.

##### Recently Issued Accounting Pronouncements:

The following is a summary of recent authoritative pronouncements:

In January 2014, the Financial Accounting Standards Board (“FASB”) amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (“OREO”). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments were effective for the Company for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company applied the amendments prospectively. These amendments did not have a material effect on the Company’s financial statements.

In May 2014 and August 2015, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for annual periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 1. Summary of Significant Accounting Policies, Continued

##### Recently Issued Accounting Pronouncements, continued:

In February 2015, the FASB issued guidance which amends the consolidation requirements and significantly changes the consolidation analysis required under U.S. GAAP. Although the amendments are expected to result in the deconsolidation of many entities, the Company will need to reevaluate all its previous consolidation conclusions. The amendments will be effective for fiscal years beginning after December 15, 2015, and interim periods beginning after December 15, 2017, with early adoption permitted (including during an interim period), provided that the guidance is applied as of the beginning of the annual period containing the adoption date. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB issued new guidance to change accounting for leases and that will generally require most leases to be recognized on the balance sheet. The new lease standard only contains targeted changes to accounting by lessors, however, lessees will be required to recognize most leases in their balance sheets as lease liabilities for lease payments and right-of-use assets representing the lessee's rights to use the underlying assets for the lease terms for lease arrangements longer than 12 months. Under this approach, a lessee will account for most existing capital/finance leases as Type A leases and most existing operating leases as Type B leases. Type A and Type B leases have unique accounting and disclosure requirements. Existing sale-leaseback guidance, including guidance for real estate, will be replaced with a new model applicable to both lessees and lessors. The new guidance will be effective for annual periods beginning after December 15, 2019. Early adoption is permitted for all companies and organizations. Management is currently analyzing the impact of the adoption of this guidance on the Company's consolidated financial statements, including assessing changes that might be necessary to information technology systems, processes and internal controls to capture new data and address changes in financial reporting.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operation or cash flow.

##### Risks and Uncertainties:

In the normal course of its business, the Company encounters two significant types of risks: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different basis, than its interest-earning assets. Credit risk is the risk of default on the Company's loan portfolio that results from borrower's inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of real estate held by the Company.



## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 1. Summary of Significant Accounting Policies, Continued

##### *Risks and Uncertainties (continued):*

The Company is subject to the regulations of various governmental agencies (regulatory risk). These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions from the regulators' judgments based on information available to them at the time of their examination.

##### *Reclassifications:*

Certain captions and amounts in the 2014 consolidated financial statements were reclassified to conform with the 2015 presentation. The reclassifications did not have an impact on net income or shareholders' equity.

#### Note 2. Cash and Due From Banks

The Company is required to maintain balances with the Federal Reserve computed as a percentage of deposits. At December 31, 2015 and 2014, this requirement was \$2,892,000 and \$3,464,000, respectively, net of vault cash and balances on deposit with the Federal Reserve.

#### Note 3. Investment Securities

The amortized cost and estimated fair values of securities available-for-sale were:

	<u>Amortized Cost</u>	<u>Gross Unrealized</u>		<u>Estimated Fair Value</u>
		<u>Gains</u>	<u>Losses</u>	
<b>December 31, 2015</b>				
U.S. Government sponsored agencies	\$ 5,000,000	\$ -	\$ 29,850	\$ 4,970,150
Mortgage-backed securities	3,458,548	31,825	-	3,490,373
Corporate bonds	2,811,091	-	45,759	2,765,332
Equity security	30,000	-	-	30,000
Total	<u>\$ 11,299,639</u>	<u>\$ 31,825</u>	<u>\$ 75,609</u>	<u>\$ 11,255,855</u>
<b>December 31, 2014</b>				
Mortgage-backed securities	\$ 10,207,150	\$ 49,894	\$ 56,356	\$ 10,200,688
Corporate bonds	2,788,520	26,380	-	2,814,900
Equity security	30,000	-	-	30,000
Total	<u>\$ 13,025,670</u>	<u>\$ 76,274</u>	<u>\$ 56,356</u>	<u>\$ 13,045,588</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 3. Investment Securities, Continued

The amortized cost and estimated fair values of securities held-to-maturity were:

	Amortized Cost	Gross Unrealized		Estimated Fair Value
		Gains	Losses	
<b>December 31, 2015</b>				
U.S. Government sponsored agencies	\$ 5,729,310	\$ 205,658	\$ -	\$ 5,934,968
Mortgage-backed securities	16,508,390	493,975	57,815	16,944,550
Municipals	3,135,985	255,120	-	3,391,105
	<u>25,373,685</u>	<u>\$ 954,753</u>	<u>\$ 57,815</u>	<u>\$ 26,270,623</u>
Capitalization of net unrealized gains on securities transferred from available-for-sale in 2013	96,486			
Total	<u>\$ 25,470,171</u>			
<b>December 31, 2014</b>				
U.S. Government sponsored agencies	\$ 6,404,933	\$ 183,346	\$ -	\$ 6,588,279
Mortgage-backed securities	21,665,238	684,643	99,292	22,250,589
Municipals	3,149,811	253,338	-	3,403,149
	<u>31,219,982</u>	<u>\$ 1,121,327</u>	<u>\$ 99,292</u>	<u>\$ 32,242,017</u>
Capitalization of net unrealized gains on securities transferred from available-for-sale in 2013	164,436			
Total	<u>\$ 31,384,418</u>			

The following is a summary of maturities of securities available-for-sale and held-to-maturity as of December 31, 2015. The amortized cost and estimated fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalty. Mortgage-backed securities are presented as a separate line, maturities of which are based on expected maturities since paydowns are expected to occur before contractual maturity dates.

	Securities Available-for-Sale		Securities Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due after five years through ten years	\$ 5,000,000	\$ 4,970,150	\$ 504,877	\$ 522,860
Due after ten years	2,811,091	2,765,332	8,456,904	8,803,213
	7,811,091	7,735,482	8,961,781	9,326,073
Mortgage-backed securities	3,458,548	3,490,373	16,508,390	16,944,550
Equity security	30,000	30,000	-	-
Total	<u>\$ 11,299,639</u>	<u>\$ 11,255,855</u>	<u>\$ 25,470,171</u>	<u>\$ 26,270,623</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 3. Investment Securities, Continued

The following tables show gross unrealized losses and fair value of securities available-for-sale and securities held-to-maturity, aggregated by investment category, and length of time that individual securities have been in a continuous realized loss position at December 31, 2015 and 2014.

	December 31, 2015		December 31, 2014	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Securities Available-for-Sale</b>				
<b>Less Than 12 Months</b>				
U.S. Government sponsored agencies	\$ 4,970,150	\$ 29,850	\$ -	\$ -
Mortgage-backed securities	-	-	4,199,552	16,300
Corporate bonds	<u>2,765,331</u>	<u>45,759</u>	-	-
Total	<u>7,735,481</u>	<u>75,609</u>	<u>4,199,552</u>	<u>16,300</u>
<b>12 Months or More</b>				
Mortgage-backed securities	-	-	1,520,395	40,056
Total securities available-for-sale	<u>\$ 7,735,481</u>	<u>\$ 75,609</u>	<u>\$ 5,719,947</u>	<u>\$ 56,356</u>
<b>Securities Held-to-Maturity</b>				
<b>Less Than 12 Months,</b>				
U.S. Government sponsored agencies	\$ -	\$ -	\$ -	\$ -
Mortgage-backed securities	2,927,507	33,201	-	-
Municipals	-	-	-	-
Total	<u>2,927,507</u>	<u>33,201</u>	<u>-</u>	<u>-</u>
<b>12 Months or More</b>				
Mortgage-backed securities	<u>815,344</u>	<u>24,614</u>	<u>4,552,866</u>	<u>99,292</u>
Total securities held-to-maturity	<u>\$ 3,742,951</u>	<u>\$ 57,815</u>	<u>\$ 4,552,866</u>	<u>\$ 99,292</u>

At December 31, 2015, one security classified as available-for-sale and two securities classified as held-to-maturity were in a loss position as detailed in the preceding tables. The Company does not intend to sell these securities in the near future and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. The Company believes that, based on industry analyst reports and credit ratings, the deterioration in value is attributable to changes in market interest rates and, therefore, these losses are not considered other-than-temporary.

During 2015 and 2014, gross proceeds from the sale of available-for-sale securities were \$5,179,670 and \$5,295,529, respectively. During these periods, gross gains totaled \$13,546 and \$39,110, while gross losses totaled \$3,984 and \$33,789, respectively.

At December 31, 2015 and 2014, investment securities with a par value of \$13,233,612 and \$17,652,510 and a fair market value of \$13,295,031 and \$17,790,098, respectively, were pledged as collateral to secure public deposits and borrowings.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses

Major classifications of loans receivable are summarized as follows at December 31:

	<u>2015</u>	<u>2014</u>
Real estate loans:		
Construction	\$ 21,818,648	\$ 26,547,868
Residential	74,442,236	70,295,788
Nonresidential	<u>92,029,160</u>	<u>99,450,427</u>
Total real estate loans	188,290,044	196,294,083
Commercial and industrial	29,182,335	31,503,599
Consumer and other	<u>42,333,722</u>	<u>27,583,332</u>
Total loans	<u>\$ 259,806,101</u>	<u>\$ 255,381,014</u>

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$44,338,113 and \$87,493,033 at December 31, 2015 and 2014, respectively.

Loans sold with limited recourse are 1-4 family residential mortgages originated by the Company and sold to various other financial institutions. These loans are sold with the agreement that a loan may be returned to the Company within 90 days of purchase, at any time in the event the Company fails to provide necessary documents related to the mortgages to the buyers, or if the Company makes false representations or warranties to the buyers. Loans sold under these agreements in 2015 and 2014 totaled \$135,856,851 and \$26,925,218, respectively. The Company uses the same credit policies in making loans held for sale as it does for on-balance-sheet instruments. Sales commitments are to sell loans at an agreed upon price and are generally funded within 60 days.

The following is an analysis of the allowance for loan losses by class of loans for the years ended December 31, 2015 and 2014.

	<u>December 31, 2015</u>						
	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>
		<u>Construction</u>	<u>Residential</u>	<u>Non-Residential</u>			
Beginning balance	\$ 3,002,922	\$ 225,890	\$ 1,244,879	\$ 1,247,137	\$ 2,717,906	\$ 38,045	\$ 246,971
Provisions	777,678	429,677	(198,621)	(122,620)	108,436	4,239	665,003
Recoveries	474,520	171,861	14,371	234,605	420,837	26,444	27,239
Charge-offs	<u>(1,561,135)</u>	<u>(552,768)</u>	<u>(343,744)</u>	<u>(385,000)</u>	<u>(1,281,512)</u>	<u>(30,230)</u>	<u>(249,393)</u>
Ending balance	<u>\$ 2,693,985</u>	<u>\$ 274,660</u>	<u>\$ 716,885</u>	<u>\$ 974,122</u>	<u>\$ 1,965,669</u>	<u>\$ 38,498</u>	<u>\$ 689,820</u>
	<u>December 31, 2014</u>						
	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>
		<u>Construction</u>	<u>Residential</u>	<u>Non-Residential</u>			
Beginning balance	\$ 2,894,152	\$ 303,016	\$ 1,043,055	\$ 1,382,073	\$ 2,728,144	\$ 65,003	\$ 101,005
Provisions	706,891	263,959	520,920	(159,975)	624,904	(89,986)	171,973
Recoveries	519,228	165,073	27,012	248,108	440,193	68,030	11,005
Charge-offs	<u>(1,117,349)</u>	<u>(506,158)</u>	<u>(346,108)</u>	<u>(223,069)</u>	<u>(1,075,335)</u>	<u>(5,002)</u>	<u>(37,012)</u>
Ending balance	<u>\$ 3,002,922</u>	<u>\$ 225,890</u>	<u>\$ 1,244,879</u>	<u>\$ 1,247,137</u>	<u>\$ 2,717,906</u>	<u>\$ 38,045</u>	<u>\$ 246,971</u>

# First Reliance Bancshares, Inc. and Subsidiary

## Notes to Consolidated Financial Statements

December 31, 2015 and 2014

### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the years ended December 31, 2015 and 2014.

		December 31, 2015						
		Real Estate Loans			Total	Commercial	Consumer	
		Construction	Residential	Non-Residential	Real Estate Loans	and Industrial	and Other	
		Total						
<b>Allowance</b>								
Evaluated for impairment								
Individually	\$ 45,817	\$ -	\$ 21,541	\$ 23,572	\$ 45,113	\$ -	\$ 704	
Collectively	<u>2,648,168</u>	<u>274,660</u>	<u>695,344</u>	<u>950,550</u>	<u>1,920,556</u>	<u>38,498</u>	<u>689,116</u>	
Allowance for loan losses								
	<u>\$ 2,693,985</u>	<u>\$ 274,660</u>	<u>\$ 716,885</u>	<u>\$ 974,122</u>	<u>\$ 1,965,669</u>	<u>\$ 38,498</u>	<u>\$ 689,820</u>	
<b>Total Loans</b>								
Evaluated for impairment								
Individually	\$ 8,237,102	\$ 1,745,745	\$ 2,066,045	\$ 4,319,989	\$ 8,131,779	\$ 2,927	\$ 102,396	
Collectively	<u>251,568,999</u>	<u>20,072,903</u>	<u>72,376,191</u>	<u>87,709,171</u>	<u>180,158,265</u>	<u>29,179,408</u>	<u>42,231,326</u>	
Loans receivable								
	<u>\$ 259,806,101</u>	<u>\$ 21,818,648</u>	<u>\$ 74,442,236</u>	<u>\$ 92,029,160</u>	<u>\$ 188,290,044</u>	<u>\$ 29,182,335</u>	<u>\$ 42,333,722</u>	
		December 31, 2014						
		Real Estate Loans			Total	Commercial	Consumer	
		Construction	Residential	Non-Residential	Real Estate Loans	and Industrial	and Other	
		Total						
<b>Allowance</b>								
Evaluated for impairment								
Individually	\$ 259,109	\$ 18,966	\$ 240,143	\$ -	\$ 259,109	\$ -	\$ -	
Collectively	<u>2,743,813</u>	<u>206,924</u>	<u>1,004,736</u>	<u>1,247,137</u>	<u>2,458,797</u>	<u>38,045</u>	<u>246,971</u>	
Allowance for loan losses								
	<u>\$ 3,002,922</u>	<u>\$ 225,890</u>	<u>\$ 1,244,879</u>	<u>\$ 1,247,137</u>	<u>\$ 2,717,906</u>	<u>\$ 38,045</u>	<u>\$ 246,971</u>	
<b>Total Loans</b>								
Evaluated for impairment								
Individually	\$ 10,104,375	\$ 2,936,762	\$ 2,747,543	\$ 4,306,712	\$ 9,991,017	\$ 11,907	\$ 101,451	
Collectively	<u>245,276,639</u>	<u>23,611,106</u>	<u>67,548,245</u>	<u>95,143,715</u>	<u>186,303,066</u>	<u>31,491,692</u>	<u>27,481,881</u>	
Loans receivable								
	<u>\$ 255,381,014</u>	<u>\$ 26,547,868</u>	<u>\$ 70,295,788</u>	<u>\$ 99,450,427</u>	<u>\$ 196,294,083</u>	<u>\$ 31,503,599</u>	<u>\$ 27,583,332</u>	

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2015.

	<u>Recorded Investments</u>	<u>Unpaid Principal</u>	<u>Related Allowance</u>	<u>Average Balance</u>	<u>Interest Income Recognized</u>
<b>With no related allowance recorded:</b>					
Real estate					
Construction	\$ 1,745,745	\$ 1,745,745	\$ -	\$ 1,749,692	\$ 85,110
Residential mortgages	1,120,703	1,120,703	-	1,144,016	49,062
Nonresidential	<u>3,141,327</u>	<u>3,141,327</u>	-	<u>3,382,888</u>	<u>214,610</u>
Total real estate loans	6,007,775	6,007,775	-	6,276,596	348,782
Commercial and industrial	2,927	2,927	-	5,383	404
Consumer and other	<u>68,019</u>	<u>68,019</u>	-	<u>73,604</u>	<u>4,333</u>
	<u>\$ 6,078,721</u>	<u>\$ 6,078,721</u>	<u>\$ -</u>	<u>\$ 6,355,583</u>	<u>\$ 353,519</u>
<b>With an allowance recorded:</b>					
Real estate					
Construction	\$ -	\$ -	\$ -	\$ -	\$ -
Residential mortgages	945,342	945,342	21,541	972,290	65,811
Nonresidential	<u>1,178,662</u>	<u>1,178,662</u>	<u>23,572</u>	<u>1,220,726</u>	<u>65,872</u>
Total real estate loans	2,124,004	2,124,004	45,113	2,193,016	131,683
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>34,377</u>	<u>34,377</u>	<u>704</u>	<u>39,925</u>	<u>1,017</u>
	<u>\$ 2,158,381</u>	<u>\$ 2,158,381</u>	<u>\$ 45,817</u>	<u>\$ 2,232,941</u>	<u>\$ 132,700</u>
<b>Total</b>					
Real estate					
Construction	\$ 1,745,745	\$ 1,745,745	\$ -	\$ 1,749,692	\$ 85,110
Residential mortgages	2,066,045	2,066,045	21,541	2,116,306	114,873
Nonresidential	<u>4,319,989</u>	<u>4,319,989</u>	<u>23,572</u>	<u>4,603,614</u>	<u>280,482</u>
Total real estate loans	8,131,779	8,131,779	45,113	8,469,612	480,465
Commercial and industrial	2,927	2,927	-	5,383	404
Consumer and other	<u>102,396</u>	<u>102,396</u>	<u>704</u>	<u>113,529</u>	<u>5,350</u>
Total	<u>\$ 8,237,102</u>	<u>\$ 8,237,102</u>	<u>\$ 45,817</u>	<u>\$ 8,588,524</u>	<u>\$ 486,219</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2014.

	Recorded Investments	Unpaid Principal	Related Allowance	Average Balance	Interest Income Recognized
<b>With no related allowance recorded:</b>					
Real estate					
Construction	\$ 1,667,262	\$ 1,696,000	\$ -	\$ 1,094,000	\$ 28,738
Residential mortgages	1,594,279	1,737,091	-	2,093,000	104,936
Nonresidential	<u>4,306,712</u>	<u>4,306,712</u>	-	<u>5,866,000</u>	<u>39,200</u>
Total real estate loans	7,568,253	7,739,803	-	9,053,000	172,874
Commercial and industrial	11,907	11,907	-	29,000	1,918
Consumer and other	<u>101,451</u>	<u>101,451</u>	-	<u>82,000</u>	<u>5,740</u>
	<u>\$ 7,681,611</u>	<u>\$ 7,853,161</u>	<u>\$ -</u>	<u>\$ 9,164,000</u>	<u>\$ 180,532</u>
<b>With an allowance recorded:</b>					
Real estate					
Construction	\$ 1,269,500	\$ 1,800,000	\$ 18,966	\$ 1,313,000	\$ 30,500
Residential mortgages	1,153,264	1,171,149	240,143	1,018,000	57,218
Nonresidential	-	-	-	<u>1,657,000</u>	-
Total real estate loans	2,422,764	2,971,149	259,109	3,988,000	87,718
Commercial and industrial	-	-	-	852,000	-
Consumer and other	-	-	-	<u>9,000</u>	-
	<u>\$ 2,422,764</u>	<u>\$ 2,971,149</u>	<u>\$ 259,109</u>	<u>\$ 4,849,000</u>	<u>\$ 87,718</u>
<b>Total</b>					
Real estate					
Construction	\$ 2,936,762	\$ 3,496,000	\$ 18,966	\$ 2,407,000	\$ 59,238
Residential mortgages	2,747,543	2,908,240	240,143	3,111,000	162,154
Nonresidential	<u>4,306,712</u>	<u>4,306,712</u>	-	<u>7,523,000</u>	<u>39,200</u>
Total real estate loans	9,991,017	10,710,952	259,109	13,041,000	260,592
Commercial and industrial	11,907	11,907	-	881,000	1,918
Consumer and other	<u>101,451</u>	<u>101,451</u>	-	<u>91,000</u>	<u>5,740</u>
Total	<u>\$ 10,104,375</u>	<u>\$ 10,824,310</u>	<u>\$ 259,109</u>	<u>\$ 14,013,000</u>	<u>\$ 268,250</u>

The following is an aging analysis of the Company's loan portfolio at December 31, 2015:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment 90 Days and Accruing
Real estate							
Construction	\$ -	\$ -	\$ 84,969	\$ 84,969	\$ 21,733,679	\$ 21,818,648	\$ 84,969
Residential	-	115,520	498,169	613,689	73,828,547	74,442,236	-
Nonresidential	<u>16,012</u>	-	<u>461,668</u>	<u>477,680</u>	<u>91,551,480</u>	<u>92,029,160</u>	-
Total real estate loans	16,012	115,520	1,044,806	1,176,338	187,113,706	188,290,044	84,969
Consumer and industrial	-	14,144	-	14,144	29,168,191	29,182,335	-
Consumer and other	<u>120,400</u>	<u>49,279</u>	<u>18,998</u>	<u>188,677</u>	<u>42,145,045</u>	<u>42,333,722</u>	<u>508</u>
Total	<u>\$ 136,412</u>	<u>\$ 178,943</u>	<u>\$ 1,063,804</u>	<u>\$ 1,379,159</u>	<u>\$ 258,426,942</u>	<u>\$ 259,806,101</u>	<u>\$ 85,477</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The following is an aging analysis of the Company's loan portfolio at December 31, 2014:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment 90 Days and Accruing
Real estate							
Construction	\$ -	\$ -	\$ -	\$ -	\$ 26,547,868	\$ 26,547,868	\$ -
Residential	204,842	23,399	539,562	767,802	69,527,986	70,295,788	-
Nonresidential	<u>125,820</u>	<u>-</u>	<u>105,569</u>	<u>231,389</u>	<u>99,219,038</u>	<u>99,450,427</u>	<u>-</u>
Total real estate loans	330,662	23,399	645,131	999,191	195,294,892	196,294,083	-
Consumer and industrial	11,453	-	24,810	36,264	31,467,335	31,503,599	24,810
Consumer and other	<u>70,497</u>	<u>1,009</u>	<u>-</u>	<u>71,505</u>	<u>27,511,827</u>	<u>27,583,332</u>	<u>-</u>
Total	<u>\$ 412,612</u>	<u>\$ 24,408</u>	<u>\$ 669,941</u>	<u>\$ 1,106,960</u>	<u>\$ 254,274,054</u>	<u>\$ 255,381,014</u>	<u>\$ 24,810</u>

The following is an analysis of the Company's nonaccrual loan portfolio recorded at December 31, 2015 and 2014:

	<u>2015</u>	<u>2014</u>
Real Estate		
Construction	\$ 1,746,744	\$ 2,937,762
Residential	881,221	1,289,743
Nonresidential	<u>461,667</u>	<u>104,568</u>
Total real estate loans	3,089,632	4,332,073
Commercial and industrial	-	4,069
Consumer and other	<u>135,738</u>	<u>45,583</u>
	<u>\$ 3,225,370</u>	<u>\$ 4,381,725</u>

#### Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2015 and 2014:

	<u>2015</u>	<u>2014</u>
Performing TDRs	\$ 4,257,699	\$ 3,125,057
Nonperforming TDRs	<u>-</u>	<u>496,430</u>
Total TDRs	<u>\$ 4,257,699</u>	<u>\$ 3,621,487</u>

Loans classified as TDRs may be removed from this status for disclosure purposes after a specified period of time if the restructured agreement specifies an interest rate equal to or greater than the rate that the lender was willing to accept at the time of the restructuring for a new loan with comparable risk, the loan is performing in accordance with the terms specified by the restructured agreement, and certain other criteria are met.



## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The following is an analysis of TDRs identified during 2015:

	For the year ended December 31, 2015		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
<b>Troubled Debt Restructurings</b>			
Real Estate			
Construction	-	\$ -	\$ -
Residential	3	208,648	208,648
Nonresidential	<u>2</u>	<u>972,995</u>	<u>972,995</u>
Total real estate	5	1,181,643	1,181,643
Commercial and industrial	-	-	-
Consumer and other	1	15,886	15,886

During the year ended December 31, 2015, we modified six loans that were considered to be troubled debt restructuring. We provided rate concessions for three of these loans, and extensions for three of the loans. During the year ended December 31, 2015, no loans that had previously been restructured during the year subsequently defaulted during the year.

The following is an analysis of TDRs identified during 2014:

	For the year ended December 31, 2014		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
<b>Troubled Debt Restructurings</b>			
Real Estate			
Construction	-	\$ -	\$ -
Residential	1	62,109	62,109
Nonresidential	<u>1</u>	<u>2,737,752</u>	<u>2,737,752</u>
Total real estate	2	2,799,861	2,799,861
Commercial and industrial	-	-	-
Consumer and other	-	-	-

During the year ended December 31, 2014, we modified two loans that were considered to be troubled debt restructuring. We provided a rate concession for one loan, and a maturity extension for one loan. During the year ended December 31, 2014, one consumer loan totaling \$11 thousand which was restructured during 2014 subsequently defaulted.

All loans modified in troubled debt restructurings are evaluated for impairment. The nature and extent of impairment of TDRs, including those which have experienced a subsequent default, are considered in determining an appropriate level of allowance for credit losses.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

##### Credit Indicators

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt, including, among other factors: current financial information, historical payment experience, credit documentation, public information, and current economic trends. The following definitions are utilized for risk ratings, which are consistent with the definitions used in supervisory guidance:

**Special Mention** - Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard** - Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful** - Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

The following table lists the loan guides used by the Bank as credit quality indicators and the balance in each category at December 31, 2015:

	<u>Real Estate Loans</u>				<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</u>
	<u>Total</u>	<u>Construction</u>	<u>Residential</u>	<u>Non- Residential</u>			
Pass	\$ 230,530,869	\$ 16,376,423	\$ 68,046,394	\$ 76,703,998	\$ 161,126,815	\$ 27,371,549	\$ 42,032,505
Special mention	20,169,191	3,696,480	3,848,370	10,681,266	18,226,116	1,781,086	161,989
Substandard	9,106,041	1,745,745	2,547,472	4,643,896	8,937,113	29,700	139,228
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 259,806,101</u>	<u>\$ 21,818,648</u>	<u>\$ 74,442,236</u>	<u>\$ 92,029,160</u>	<u>\$ 188,290,044</u>	<u>\$ 29,182,335</u>	<u>\$ 42,333,722</u>

The following table lists the loan guides used by the Bank as credit quality indicators and the balance in each category at December 31, 2014:

	<u>Real Estate Loans</u>				<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</u>
	<u>Total</u>	<u>Construction</u>	<u>Residential</u>	<u>Non- Residential</u>			
Pass	\$ 215,707,053	\$ 17,422,959	\$ 62,189,119	\$ 79,398,037	\$ 159,010,115	\$ 29,279,171	\$ 27,417,767
Special mention	27,358,434	4,434,507	5,681,045	14,929,166	25,044,718	2,212,521	101,195
Substandard	12,315,527	4,690,402	2,425,624	5,123,224	12,239,250	11,907	64,370
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 255,381,014</u>	<u>\$ 26,547,868</u>	<u>\$ 70,295,788</u>	<u>\$ 99,450,427</u>	<u>\$ 196,294,083</u>	<u>\$ 31,503,599</u>	<u>\$ 27,583,332</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 4. Loans Receivable and Allowance for Loan Losses, Continued

The Company enters into financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. 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. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other parties to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company uses the same credit policies in making commitments to extend credit as it does for on-balance-sheet instruments. Letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities.

Collateral held for commitments to extend credit and standby letters of credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes the Company's off-balance sheet financial instruments whose contract amounts represent credit risk for the years ended December 31:

	<u>2015</u>	<u>2014</u>
Commitments to extend credit	\$ 35,891,328	\$ 32,670,070
Standby letters of credit	229,089	225,463

#### Note 5. Premises, Furniture and Equipment

Premises, furniture and equipment consisted of the following for the years ended December 31:

	<u>2015</u>	<u>2014</u>
Land	\$ 10,464,406	\$ 10,368,249
Buildings	13,685,643	13,629,945
Leasehold improvements	521,657	521,657
Furniture and equipment	6,609,932	6,402,364
Construction in progress	<u>1,177,988</u>	<u>1,258,060</u>
Total	32,459,626	32,180,275
Less, accumulated depreciation	<u>9,602,882</u>	<u>8,784,969</u>
Premises and equipment, net	<u>\$ 22,856,744</u>	<u>\$ 23,395,306</u>

Depreciation expense for the years ended December 31, 2015 and 2014 amounted to \$817,913 and \$866,280, respectively.

At December 31, 2015 and 2014, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2015, there were no material commitments outstanding for the construction or purchase of premises, furniture and equipment. Also, there were no material sales of premises, furniture or equipment during 2015 or 2014.

The Company recorded an impairment loss of \$339,812 during 2014, on a parcel of land that was originally acquired for future facilities expansion. In August of 2014, after deciding not to expand on this parcel, the Company entered into a tentative contract to sell it for approximately \$3,600,000. This contract expired on December 31, 2014, without being consummated.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 6. Other Real Estate Owned

Transactions in other real estate owned for the years ended December 31, 2015 and 2014 are summarized below:

	<u>2015</u>	<u>2014</u>
Beginning balance	\$ 2,444,253	\$ 8,932,634
Additions	4,145,896	1,197,443
Sales	(4,049,836)	(7,619,951)
Write downs	<u>(33,580)</u>	<u>(65,873)</u>
Ending balance	<u>\$ 2,506,733</u>	<u>\$ 2,444,253</u>

The Company recognized net gains of \$436,028 and \$141,868 on the sale of OREO for the years ended December 31, 2015 and 2014, respectively.

Other real estate owned expense for the years ended December 31, 2015 and 2014 was \$280,431 and \$539,897, respectively, which includes gains and losses on sales.

#### Note 7. Mortgage Servicing Rights

The Company retains right to service the residential mortgage loans that it sells to the Federal National Mortgage Association ("FNMA"). The Company accounts for residential mortgage servicing rights ("MSRs") at fair value. The changes in fair value are recorded in income from mortgage operations.

The following table presents the activity for residential MSRs for the years ended December 31, 2015:

	<u>2015</u>
Balances, beginning of year	\$ -
Additions	1,174,973
Change in MSR market value	<u>(159,570)</u>
Balances, end of year	<u>\$ 1,015,403</u>

The Company had no MSRs as of or during the year-ended December 31, 2014.

The fair value of MSRs is highly sensitive to changes in assumptions and fair value is determined by estimating the present value of the asset's future cash flows utilizing market-based prepayment rates, discount rates and other assumptions validated through comparison to trade information, industry surveys and with the use of independent third party appraisals. Changes in prepayment speed assumptions have the most significant impact on the fair value of MSRs. Generally, as interest rates decline, mortgage loan prepayments accelerate due to increased refinance activity, which results in a decrease in the fair value of the MSR. Measurement of fair value is limited to the conditions existing and the assumptions utilized as of a particular point in time, and those assumptions may not be appropriate if they are applied at a different time.

At December 31, 2015, the aggregate amount of loans serviced by the Company for the benefit of others totaled \$85,977,991. The Company had no loans serviced for the benefit of others as of December 31, 2014.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 7. Mortgage Servicing Rights, Continued

The characteristics and sensitivity analysis of the MSRs are included in the following table as of December 31, 2015.

	<u>2015</u>
Composition of residential loans serviced for others	
Fixed-rate mortgage loans	100.00%
Weighted average life	8.53 years
Constant prepayment rate ("CPR")	11.05%
Weighted average discount rate	9.88%

#### Note 8. Derivatives

The derivative positions of the Company for the year ended December 31, 2015 are reported as other assets and are as follows:

	<u>2015</u>	
	<u>Fair value</u>	<u>Notional value</u>
<b>Derivative assets:</b>		
Mortgage loan interest rate lock commitments	\$ 304,460	\$ 16,663,588
Mortgage loan forward sales commitments	3,203	15,500,000

The Company had no derivative positions for the year ended December 31, 2014.

The Company uses derivatives to reduce interest rate risk incurred as a result of market movements. These derivatives primarily consist of mortgage loan interest rate lock commitments. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or reference interest rate. The Company uses derivatives primarily to minimize interest rate risk related to its pipeline of loan interest rate lock commitments issued on residential mortgage loans in the process of origination for sale or loans held for sale. The Company's derivative positions are classified as trading assets and liabilities, and as such, the changes in the fair market value of the derivative positions are recognized in the consolidated statements of operations within income from mortgage operations.

#### Note 9. Deposits

At December 31, 2015, the scheduled maturities of time deposits were as follows:

<u>Maturing In</u>	<u>Amount</u>
2016	\$ 49,141,409
2017	7,283,004
2018	1,415,676
2019	782,189
2020	980,181
Total	<u>\$ 59,602,459</u>

Included in total time deposits at December 31, 2015 and 2014 were brokered time deposits of \$9,331,836 and \$22,719,000, respectively.

Time deposits that meet or exceed the FDIC insurance limits of \$250,000 at year-end 2015 and 2014 were \$14,990,007 and \$27,814,120, respectively.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 10. Securities Sold Under Agreements To Repurchase

Securities sold under agreements to repurchase generally mature on a one to thirty day basis. Under the terms of the repurchase agreement, the Company sells an interest in securities issued by United States Government agencies and agrees to repurchase the same securities the following business day. Information concerning securities sold under agreements to repurchase is summarized as follows at December 31:

	<u>2015</u>	<u>2014</u>
Balance at end of the year	\$ 8,201,396	\$ 7,573,403
Maximum month-end balance during the year	9,332,381	7,639,859
Average balance during the year	8,403,014	6,216,888
Average interest rate at the end of the year	0.08%	0.11%
Average interest rate during the year	0.07%	0.25%

At December 31, 2015 and 2014, investment securities with a par value of \$8,461,452 and \$7,938,768 and a fair market value of \$8,561,157 and \$7,985,434, respectively, were pledged as collateral for the underlying agreements.

#### Note 11. Advances From Federal Home Loan Bank

Advances from the Federal Home Loan Bank consisted of the following at December 31:

Advances maturing	Interest		
	Rate	<u>2015</u>	<u>2014</u>
<b>Fixed rate</b>			
January 2, 2015	0.24%	\$ -	\$ 6,000,000
April 1, 2015	0.22%	-	6,000,000
May 13, 2015	0.25%	-	8,000,000
October 9, 2015	0.30%	-	5,000,000
January 19, 2016	0.36%	6,000,000	-
February 29, 2016	0.37%	<u>4,000,000</u>	-
		<u>\$ 10,000,000</u>	<u>\$ 25,000,000</u>

At December 31, 2015 and 2014 the Company has pledged certain loans totaling \$44,338,113 and \$87,493,033, respectively, as collateral to secure its borrowings from the FHLB. Investment securities with a par value of \$4,438,676 and a fair market value of \$4,578,026 were also pledged as collateral to secure the borrowings at December 31, 2014. No investment securities were pledged as collateral to secure borrowings at December 31, 2015. Additionally, the Company's FHLB stock is pledged to secure the borrowings.

Subsequent to December 31, 2015, the Company has renewed the FHLB borrowing scheduled to mature January 19, 2016, and paid off the borrowing scheduled to mature February 29, 2016.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 12. Junior Subordinated Debentures

On June 30, 2005, the Trust (a non-consolidated affiliate) issued \$10,000,000 in trust preferred securities (callable without penalty) with a maturity of November 23, 2035. Interest on these securities is payable quarterly at the three-month LIBOR rate plus 2.21%. In accordance with generally accepted accounting principles, the Trust has not been consolidated in these financial statements. The Company received from the trust the \$10,000,000 proceeds from the issuance of the securities and the \$310,000 initial proceeds from the capital investment in the Trust, and accordingly has shown the funds due to the trust as \$10,310,000 junior subordinated debentures. Current regulations allow the entire amount of junior subordinated debentures to be included in the calculation of regulatory capital. As of December 31, 2015 and 2014, the Company had accrued and unpaid interest totaling \$24,025 and \$784,806, respectively.

#### Note 13. Shareholders' Equity

**Common Stock** - The following is a summary of the changes in common shares outstanding for the years ended December 31, 2015 and 2014.

	<u>2015</u>	<u>2014</u>
Common shares outstanding at beginning of the period	4,739,823	4,568,695
Conversion of common stock to Series D preferred stock	(61,182)	-
Conversion of restricted stock to common stock	1,840	2,653
Issuance of non-vested restricted shares	-	213,100
Forfeiture of restricted shares	-	(44,625)
Common shares outstanding at end of the period	<u>4,680,481</u>	<u>4,739,823</u>

**Preferred Stock** - The Company's Articles of Incorporation authorizes the issuance of a class of 10,000,000 shares of preferred stock, having no par value. Subject to certain conditions, the Company's Board of Directors is authorized to issue preferred stock without shareholder approval. Under the Articles of Incorporation, the Board is authorized to determine the terms of one or more series of preferred stock, including the preferences, rights, and limitations of each series.

On March 6, 2009, the Company completed a transaction with the United States Treasury (the "Treasury") under the Troubled Asset Relief Program Capital Purchase Program, whereby the Company sold 15,349 shares of its Series A Cumulative Perpetual Preferred Stock (the "Series A Shares") to the Treasury. In addition, the Treasury received a warrant to purchase 767 shares of the Company's Series B Cumulative Perpetual Preferred Stock (the "Series B Shares"), which was immediately exercised for a nominal exercise price. The preferred shares issued to the Treasury qualify as Tier 1 capital for regulatory purposes. On March 1, 2013, the Treasury auctioned the subject securities in a private transaction with unaffiliated third-party investors.

The Series A Preferred Stock is a senior cumulative perpetual preferred stock that has a liquidation preference of \$1,000 per share, pays cumulative dividends at a rate of 5% per year (approximately \$767,000 annually) for the first five years and beginning May 15, 2014, at a rate of 9% per year (approximately \$1,381,000 annually). Dividends are payable quarterly. At any time, the Company may, at its option and with regulatory approval, redeem the Series A Preferred Stock at par value plus accrued and unpaid dividends. The Series A Preferred Stock is generally non-voting.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 13. Shareholders' Equity, Continued

The Series B Preferred Stock is a cumulative perpetual preferred stock that has the same rights, preferences, privileges, voting rights and other terms as the Series A Preferred Stock, except that dividends will be paid at the rate of 9% per year so long as the Series A Preferred Stock is outstanding and may not be redeemed until all the Series A Preferred Stock has been redeemed. The Series A and Series B Preferred Shares will receive preferential treatment in the event of liquidation, dissolution or winding up of the Company.

As of December 31, 2014, dividends in arrears on the Series A and Series B Shares totaled \$3,102,285. As of December 31, 2015, there were no unpaid dividends on the Series A or Series B Shares.

The proceeds from the issuance of the Series A Shares and Series B Shares were allocated based on the relative fair value of each series based on a discounted cash flow model. As a result of the valuations, \$14,492,526 and \$856,474 was allocated to the Series A Preferred Stock and Series B Preferred Stock, respectively. This resulted in a discount of \$973,260 for the Series A Shares and a premium of \$82,572 for the Series B Shares. The discount and premium are being accreted and amortized, respectively, through retained earnings over a five-year estimated life using the effective interest method and have been fully recognized as of December 31, 2014.

The following is a summary of the accretion of the Series A Shares discount and the amortization of the Series B Shares premium for the years ended December 31, 2015 and 2014.

	<u>2015</u>	<u>2014</u>
Accretion of Series A Preferred Stock discount	\$ -	\$ 34,112
Amortization of Series B Preferred Stock premium	-	(2,894)
Accretion net of amortization	<u>\$ -</u>	<u>\$ 31,218</u>

The net amount of the accretion and amortization was treated as a deemed dividend to preferred shareholders in the computation of income per share.

The Series D Preferred Stock ("Series D Shares") is a fixed rate non-cumulative perpetual preferred stock, created July 16, 2015, with the authorized issuance of 70,000 shares. The Series D shares were created for the purpose of converting Common Stock holders with 200 shares or less to Series D Shares. The Series D Shares have no voting rights, and in the event dividends are declared on Common Stock, will be entitled to 4% more than those paid on the Common Stock. Series D Shares will, with respect to ranking to include but not limited to dividends and rights upon liquidation, be junior to the Series A Preferred Stock and the Series B Preferred Stock, and will rank senior to all Common Stock.

**Restrictions on Shareholders' Equity** - South Carolina banking regulations restrict the amount of dividends that can be paid to shareholders. All of the Bank's dividends to the Company are payable only from the undivided profits of the Bank. At December 31, 2015, the Bank had undivided profits of \$5,527,229. The Bank is authorized to upstream 100% of net income in any calendar year without obtaining the prior approval of the South Carolina Commissioner of Banks provided that the Bank received a composite CAMELS rating of one or two at the last Federal or State regulatory examination. Under Federal Reserve regulations, the amounts of loans or advances from the Bank to the parent company are also restricted.



## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 14. Other Operating Expense

Other operating expenses are summarized below for the years ended December 31:

	<u>2015</u>	<u>2014</u>
Advertising	\$ 268,836	\$ 119,463
Office supplies, postage and printing	318,075	234,876
Telephone	157,785	159,474
Professional fees and services	787,077	1,330,221
Supervisory fees and assessments	523,176	498,898
Debit and credit card expenses	810,624	776,275
Other real estate owned expenses	280,432	539,897
Insurance expenses	329,627	288,463
Loss on purchased loan	336,926	-
Impairment loss on premises	-	399,812
Income from legal settlement	(849,227)	-
Other	<u>1,382,628</u>	<u>1,276,785</u>
Total	<u>\$ 4,345,959</u>	<u>\$ 5,624,164</u>

#### Note 15. Income Taxes

Income tax provision for the years ended December 31, 2015 and 2014 is summarized as follows:

	<u>2015</u>	<u>2014</u>
Provision		
Current income tax expense (benefit)		
Federal	\$ -	\$ -
State	<u>379,824</u>	<u>180,207</u>
Total current	<u>379,824</u>	<u>180,207</u>
Deferred income tax expense (benefit)		
Federal	586,316	217,519
State	<u>(12,401)</u>	<u>10,791</u>
Total deferred	<u>573,916</u>	<u>228,310</u>
Change in valuation allowance	<u>(7,280,400)</u>	<u>(3,489,761)</u>
Total income tax expense (benefit)	<u>\$ (6,326,661)</u>	<u>\$ (3,081,244)</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 15. Income Taxes, Continued

The components of deferred tax assets and deferred tax liabilities as of December 31, are as follows:

	<u>2015</u>	<u>2014</u>
Deferred tax assets:		
Allowance for loan losses	\$ 915,955	\$ 1,020,993
Net operating losses	8,641,888	8,241,620
Non-accrual interest	85,063	437,122
Deferred compensation	593,738	513,511
Federal and state credits	429,954	429,954
Other real estate owned	79,926	386,426
Other	<u>258,326</u>	<u>245,947</u>
Gross deferred tax assets	11,004,850	11,275,573
Less, valuation allowance	<u>(208,340)</u>	<u>(7,488,740)</u>
Net deferred tax assets	<u>10,795,510</u>	<u>3,786,833</u>
Deferred tax liabilities:		
Accumulated depreciation	272,830	370,444
Prepaid expenses	81,946	128,726
Unrealized gains on securities available for sale	17,918	62,680
Market to market adjustments	449,842	-
Other	<u>23,956</u>	<u>26,212</u>
Total gross deferred tax liabilities	<u>846,492</u>	<u>588,062</u>
Net deferred tax assets recognized	<u>\$ 9,950,018</u>	<u>\$ 3,198,771</u>

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the net deferred tax assets to net realizable value. As of December 31, 2015, management has determined that it is more likely than not that the majority of the deferred tax asset from continuing operations will be realized. In 2015, the valuation allowance decreased by \$7,280,400. The remaining valuation allowance relates to the parent company's state operating loss carryforwards for which realizability is uncertain.

The Company has federal net operating losses of \$24,850,153 and \$23,709,365 for the years ended December 31, 2015 and 2014, respectively. The Company has state net operating losses of \$5,843,509 and \$5,467,713 for the years ended December 31, 2015 and 2014, respectively.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 15. Income Taxes, Continued

A reconciliation between the income tax expense (benefit) and the amount computed by applying the federal statutory rate of 34% to income before income taxes for the years ended December 31, 2015 and 2014 follows:

	<u>2015</u>	<u>2014</u>
Tax expense (benefit) at statutory rate	\$ 845,134	\$ 450,965
State income tax, net of federal income tax benefit	242,499	126,059
Tax-exempt interest income	(38,624)	(38,788)
Disallowed interest expense	340	524
Life insurance surrender value	(113,236)	(114,537)
Change in valuation allowance	(7,280,400)	(3,489,761)
Other, net	17,626	(15,706)
	<u>\$ (6,326,661)</u>	<u>\$ (3,081,244)</u>

The Company had analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. Tax returns for 2012 and subsequent years are subject to review by taxing authorities.

#### Note 16. Related Party Transactions

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) were loan customers of the Company. In compliance with relevant law and regulations, the Company's related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with persons not related to the lender and do not involve more than the normal risk of collectability. As of December 31, 2015 and 2014, the Company had related party loans totaling \$1,418,178 and \$1,904,093, respectively.

Deposits from directors and executive officers and their related interests totaled \$3,344,237 and \$1,913,397 at December 31, 2015 and 2014, respectively.

#### Note 17. Commitments and Contingencies

In the ordinary course of business, the Company may, from time to time, become a party to legal claims and disputes. At December 31, 2015, management and legal counsel are not aware of any pending or threatened litigation or unasserted claims or assessments that could result in losses, if any, that would be material to the consolidated financial statements.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 17. Commitments and Contingencies, Continued

The Company has entered into a number of operating leases for properties relating to its branch banking and mortgage operations. The leases have various initial terms and expire on various dates. The lease agreements generally provide that the Company is responsible for ongoing repairs and maintenance, insurance and real estate taxes. The leases also provide for renewal options and certain scheduled increases in monthly lease payments. Rental expenses recorded under leases for the years ended December 31, 2015 and 2014 were \$467,503 and \$407,848, respectively.

The minimal future rental payments under non-cancelable operating leases having remaining terms in excess of one year, for each of the next five years and thereafter in the aggregate are:

	<u>Amount</u>
2016	\$ 502,307
2017	480,672
2018	449,228
2019	417,195
2020	417,195
Thereafter	<u>3,636,120</u>
<b>Total</b>	<u>\$ 5,902,819</u>

#### Note 18. Equity Incentive Plan

On January 19, 2006, the Company adopted the 2006 Equity Incentive Plan (the "Plan"), which provides for the granting of dividend equivalent rights options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which are subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the Plan. The Plan, which was amended on September 17, 2010, allows the Company to award, subject to approval by the Board of Directors, up to 950,000 shares of stock to officers, employees, and directors, consultants and service providers of the Company or its affiliates. Awards may be granted for a term of up to ten years from the effective date of grant. Under the Plan, our Board of Directors has sole discretion as to the exercise date of any awards granted. The per-share exercise price of incentive stock awards may not be less than the market value of a share of common stock on the date the award is granted. Any awards that expire unexercised or are canceled become available for re-issuance.

The Company can issue the restricted shares as of the grant date either by the issuance of share certificate(s) evidencing restricted shares or by documenting the issuance in uncertificated or book entry form on the Company's stock records. Except as provided by the Plan, the employee does not have the right to make or permit to exist any transfer or hypothecation of any restricted shares. When restricted shares vest, the employee must either pay the Company within two business days the amount of all tax withholding obligations imposed on the Company or make an election pursuant to Section 83(b) of the Internal Revenue Code to pay taxes at grant date.

Restricted shares may be subject to one or more objective employment, performance or other forfeiture conditions established by the Plan Committee at the time of grant. Under the terms of the Plan, the restricted shares will not vest unless the Company's retained earnings at the end of the fiscal quarter preceding the third anniversary of the restricted share award date are greater than the award value of the restricted shares. Any shares of restricted stock that are forfeited will again become available for issuance under the Plan. An employee or director has the right to vote the shares of restricted stock after grant until they are forfeited. Compensation cost for restricted stock is equal to the market value of the shares at the date of the award and is amortized to compensation expense over the vesting period. Dividends, if any, will be paid on awarded but unvested stock.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

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#### Note 18. Equity Incentive Plan, Continued

During 2015 and 2014, the Company issued 1,840 and 215,753 shares, respectively, of restricted stock pursuant to the 2006 Equity Incentive Plan. During 2014, 213,100 shares issued vest on the seventh anniversary of the date of grant and thus will be fully vested in 2021, subject to meeting the performance criteria of the Plan. During 2015 and 2014, 1,840 and 2,653 shares, respectively, were issued which vested during each of the respective years. The weighted-average fair value of restricted stock issued during 2015 and 2014 was \$4.34 and \$2.11 per share, respectively. Compensation cost associated with the issuance in 2015 and 2014 was \$7,988 and \$449,455, respectively. During 2015 and 2014, 0 and 44,625 shares, respectively, were either forfeited or cancelled having a weighted average price of \$0 and \$3.35, respectively. Deferred compensation expense of \$58,849 and income of \$81,993 relating to restricted stock, was recognized to income during 2015 and 2014, respectively.

The Plan also allows for the issuance of Stock Appreciation Rights ("SARs"). The SARs entitle the participant to receive the excess of (1) the market value of a specified or determinable number of shares of the stock at the exercise date over the fair value at grant date or (2) a specified or determinable price which may not in any event be less than the fair market value of the stock at the time of the award. Upon exercise, the Company can elect to settle the awards using either Company stock or cash. The shares start vesting after five years and vest at 20% per year until fully vested. Compensation cost for SARs is amortized to compensation expense over the vesting period. No SARs were issued during 2015 and 2014.

At December 31, 2015, there were 736,900 stock awards available for grant under the 2006 Equity Incentive Plan.

#### Note 19. Income Per Common Share

Net income available to common shareholders represents net income adjusted for preferred dividends including dividends declared, accretions of discounts and amortization of premiums on preferred stock issuances and cumulative dividends related to the current dividend period that have not been declared as of period end.

The following is a summary of the income per common share calculations for the years ended December 31, 2015 and 2014.

	<u>2015</u>	<u>2014</u>
<b>Income available to common shareholders</b>		
Net income	\$ 8,812,348	\$ 4,407,611
Preferred stock dividends	1,450,440	1,220,205
Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium	-	31,218
Net income available to common shareholders	<u>\$ 7,361,908</u>	<u>\$ 3,156,188</u>
<b>Basic income per common share:</b>		
Net income available to common shareholders	<u>\$ 7,361,908</u>	<u>\$ 3,156,188</u>
Average common shares outstanding - basic	<u>4,491,053</u>	<u>4,612,758</u>
Basic income per common share	<u>\$ 1.64</u>	<u>\$ 0.68</u>

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 19. Income Per Common Share, Continued

	<u>2015</u>	<u>2014</u>
<b>Diluted income per common share:</b>		
Net income available to common shareholders	\$ <u>7,361,908</u>	\$ <u>3,156,188</u>
Average common shares outstanding - basic	4,491,053	4,612,758
Dilutive potential common shares	<u>104,151</u>	<u>76,223</u>
Average common shares outstanding - diluted	<u>4,595,204</u>	<u>4,688,981</u>
Diluted income per common share	\$ <u>1.60</u>	\$ <u>0.67</u>

#### Note 20. Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct adverse material effect on the Company's 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 Company's and 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 weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios (set forth in the table below) of Tier 1, Common Equity Tier 1 ("CET1"), and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk-weights ranging from 0% to 150%. Tier 1 capital of the Bank consists of common stockholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets, while CET1 is comprised of Tier 1 capital, adjusted for certain regulatory deductions and limitations. Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital.

The Bank is also required to maintain capital at a minimum level based on total assets, which is known as the leverage ratio. Only the strongest banks are allowed to maintain capital at the minimum requirement of 3%. All others are subject to maintaining ratios 1% to 2% above the minimum.

Effective March 31, 2015, quantitative measures established by applicable regulatory standards, including the newly implemented Basel III revised capital adequacy standards and relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), require the Bank to maintain (i) a minimum ratio of Tier 1 capital to average total assets, after certain adjustments, of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of CET1 to risk-weighted assets of 4.50%. A "well-capitalized" institution must generally maintain capital ratios 2% higher than the minimum guidelines.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 20. Regulatory Matters, Continued

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, the Bank will also be required to maintain a “capital conservation buffer” in addition to its minimum risk-based capital requirements. This buffer will be required to consist solely of CET1, but the buffer will apply to all three risk-based measurements (CET1, Tier 1 and total capital). The capital conservation buffer will be phased in incrementally over time, beginning January 1, 2016 and becoming fully effective on January 1, 2019, and will ultimately consist of an additional amount of Tier 1 capital equal to 2.5% of risk-weighted assets.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements at December 31, 2015 and 2014.

<i>(Dollars in Thousands)</i>	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>December 31, 2015</b>						
<b>The Bank</b>						
Total capital (to risk-weighted assets)	\$ 42,943	13.79%	\$ 24,905	8.00%	\$ 31,132	10.00%
Tier 1 capital (to risk-weighted assets)	40,245	12.93	18,679	6.00	24,905	8.00
Tier 1 capital (to average assets)	40,245	10.87	14,814	4.00	18,817	5.00
Common Equity Tier 1 Capital (to risk-weighted assets)	40,245	12.93	14,009	4.50	20,336	6.50
<b>December 31, 2014</b>						
<b>The Bank</b>						
Total capital (to risk-weighted assets)	\$ 44,056	14.95%	\$ 23,579	8.00%	\$ 29,474	10.00%
Tier 1 capital (to risk-weighted assets)	41,050	13.93	11,790	4.00	17,684	6.00
Tier 1 capital (to average assets)	41,050	11.28	14,559	4.00	18,199	5.00

#### Note 21. Unused Lines of Credit

The Bank had available at the end of 2015 an unsecured line of credit, which was unused, to purchase up to \$34,000,000 of federal funds from four unrelated correspondent institutions. Also, as of December 31, 2015, the Bank had the ability to borrow funds from the FHLB of up to \$115,756,200. At that date \$10,000,000 had been advanced. Additionally, an unused line of credit of approximately \$4,691,296 was available from the Federal Reserve. The FHLB and the Federal Reserve lines can be revoked at lender’s discretion.

#### Note 22. Fair Value Measurements

Generally accepted accounting principles (“GAAP”) provide a framework for measuring and disclosing fair value that requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange in price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 22. Fair Value Measurements, Continued

The Company utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of the lower of cost or market accounting or the writing down of individual assets.

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

#### Fair Value Hierarchy

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

- Level 1** Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2** Valuation is based upon quoted prices for similar instruments in active markets, 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.
- Level 3** Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

#### Assets Recorded at Fair Value on a Recurring Basis

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

**Securities Available-for-Sale** - Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the counter markets and money market funds. Level 2 securities include mortgage backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

**Loans** - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value, and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2015 and 2014, a significant portion of impaired loans were evaluated based upon the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.



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## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

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#### Note 22. Fair Value Measurements, Continued

**Mortgage Loans Held for Sale** - Mortgage loans held for sale are comprised of loans originated for sale in the ordinary course of business. The fair value of mortgage loans originated for sale in the secondary market is based on purchase commitments or quoted prices for the same or similar loans and are classified as recurring Level 2.

**Other Real Estate Owned** - Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charges to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

**Mortgage Servicing Rights** - Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The Company stratifies its mortgage servicing portfolio on the basis of loan type. The assumptions used in the discounted cash flow model are those that market participants would use in estimating future net servicing income. Assumptions in the valuation of mortgage servicing rights may include estimated loan repayment rates, the discount rate, servicing costs, and the timing of cash flows, among other factors. The Company measures mortgage servicing rights as recurring Level 3.

**Derivatives** - The Company's valuation techniques and inputs to internally-developed models depend on the type of derivative and nature of the underlying rate, price or index upon which the derivative's value is based. Key inputs can include yield curves, credit curves, foreign-exchange rates, prepayment rates, volatility measurements and correlation of such inputs. Where model inputs can be observed in a liquid market and the model does not require significant judgment, such derivatives are typically classified as Level 2 of the fair value hierarchy. Examples of derivatives classified as Level 2 include interest rate lock commitments written for our residential mortgage loans that we intend to sell. When instruments are traded in less liquid markets and significant inputs are unobservable, such derivatives are classified as Level 3. Additionally, significant judgments are required when classifying financial instruments within the fair value hierarchy, particularly between Level 2 and 3, as is the case for certain derivatives.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 22. Fair Value Measurements, Continued

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at December 31, 2015 and 2014.

December 31, 2015	December 31, 2015			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored agencies	\$ 4,970,150	\$ -	\$ 4,970,150	\$ -
Mortgage-backed securities	3,490,373	-	3,490,373	-
Corporate bonds	2,765,332	-	2,765,332	-
Equity security	30,000	-	30,000	-
Total available-for-sale securities	<u>11,255,855</u>	-	<u>11,255,855</u>	-
Mortgage loans held for sale	8,070,283	-	8,070,283	-
Mortgage servicing rights	1,015,403	-	-	1,015,403
Derivative asset:				
Mortgage loan interest rate lock commitments	304,460	-	304,460	-
Mortgage loan forward sales commitments	3,203	-	3,203	-
	<u>\$ 20,649,204</u>	<u>\$ -</u>	<u>\$ 19,633,801</u>	<u>\$ 1,015,403</u>
<b>December 31, 2014</b>				
Available-for-sale securities				
Mortgage-backed securities	\$ 10,200,688	\$ -	\$ 10,200,688	\$ -
Corporate bonds	2,814,900	-	2,814,900	-
Equity security	30,000	-	30,000	-
Total available-for-sale securities	<u>13,045,588</u>	-	<u>13,045,588</u>	-
Mortgage loans held for sale	<u>1,970,068</u>	-	<u>1,970,068</u>	-
	<u>\$ 15,015,656</u>	<u>\$ -</u>	<u>\$ 15,015,656</u>	<u>\$ -</u>

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows:

	Mortgage Servicing Rights
Balance, December 31, 2014	\$ -
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	-
Total net gains (losses) included in:	
Net income	-
Balance, December 31, 2014	-
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	1,174,973
Total net gains (losses) included in:	
Net income	(159,570)
Balance, December 31, 2015	<u>\$ 1,015,403</u>

The Company has no liabilities measured at fair value on a recurring basis.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 22. Fair Value Measurements, Continued

##### Assets Recorded at Fair Value on a Nonrecurring Basis

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2015 and December 31, 2014, aggregated by level in the fair value hierarchy within which those measurements fall.

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<b>December 31, 2015</b>				
Impaired loans, net specific reserve	\$ 8,191,285	\$ -	\$ 8,191,285	\$ -
Other real estate owned	<u>2,506,733</u>	<u>-</u>	<u>2,506,733</u>	<u>-</u>
Total assets at fair value	<u>\$ 10,698,018</u>	<u>\$ -</u>	<u>\$ 10,698,018</u>	<u>\$ -</u>
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<b>December 31, 2014</b>				
Impaired loans, net specific reserve	\$ 9,845,266	\$ -	\$ 9,845,266	\$ -
Other real estate owned	<u>2,444,253</u>	<u>-</u>	<u>2,444,253</u>	<u>-</u>
Total assets at fair value	<u>\$ 12,289,519</u>	<u>\$ -</u>	<u>\$ 12,289,519</u>	<u>\$ -</u>

#### Note 23. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before consolidated financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing consolidated financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 31, 2016, the date the consolidated financial statements were available to be issued and no subsequent events occurred requiring accrual or disclosure.

## First Reliance Bancshares, Inc. and Subsidiary

### Notes to Consolidated Financial Statements

December 31, 2015 and 2014

#### Note 24. First Reliance Bancshares, Inc. (Parent Company Only)

##### Condensed Balance Sheets

	December 31,	
	2015	2014
<b>Assets</b>		
Cash	\$ 605,170	\$ 3,015,509
Investment in banking subsidiary	47,630,328	43,167,296
Marketable investments	30,000	30,000
Nonmarketable investments	58,100	58,100
Premises	3,655,612	3,559,455
Investment in trust	310,000	310,000
Deferred tax asset	1,009,085	261,451
Other assets	-	4,706
Total assets	<u>\$ 53,298,295</u>	<u>\$ 50,406,517</u>
<b>Liabilities</b>		
Note payable to banking subsidiary	\$ 2,720,432	\$ 2,944,764
Junior subordinated debentures	10,310,000	10,310,000
Other liabilities	34,133	784,086
Total liabilities	13,064,565	14,038,850
<b>Shareholders' equity</b>	<u>40,233,730</u>	<u>36,367,667</u>
Total liabilities and shareholders' equity	<u>\$ 53,298,295</u>	<u>\$ 50,406,517</u>

##### Condensed Statements of Operations

	For the years ended	
	December 31,	December 31,
	2015	2014
<b>Income</b>		
Rental income from banking subsidiary	\$ 9,659	\$ 58,624
Interest income	29,598	-
Dividend from banking subsidiary	3,890,588	-
Total income	<u>3,929,845</u>	<u>58,624</u>
<b>Expenses</b>	<u>415,053</u>	<u>879,352</u>
<b>(Income) loss before income taxes and equity in undistributed income of banking subsidiary</b>	3,514,752	(820,728)
Equity in undistributed earnings of banking subsidiary	<u>4,549,922</u>	<u>4,966,888</u>
<b>Net income before income taxes</b>	8,064,714	4,146,160
Income tax benefit	(747,634)	(261,451)
<b>Net income</b>	<u>\$ 8,812,348</u>	<u>\$ 4,407,611</u>

## First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2015 and 2014

### Note 24. First Reliance Bancshares, Inc. (Parent Company Only), Continued

#### Condensed Statements of Cash Flows

	For the years ended	
	December 31,	
	<u>2015</u>	<u>2014</u>
<b>Cash flows from operating activities</b>		
Net income	\$ 8,812,348	\$ 4,407,611
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	-	30,188
Impairment loss on premises	-	399,812
Deferred income tax benefit	(747,634)	(261,451)
Increase (decrease) in deferred compensation on restricted stock	58,849	(53,164)
Decrease in other assets	4,706	12,557
(Decrease) Increase in other liabilities	(749,953)	246,596
Net equity in undistributed earnings of banking subsidiary	<u>(4,549,922)</u>	<u>(4,966,888)</u>
Net cash provided (used) by operating activities	<u>2,828,394</u>	<u>(184,739)</u>
<b>Cash flows from by investing activities</b>		
Purchase of premises, furniture and equipment	<u>(96,157)</u>	<u>(3,435)</u>
Net cash used by investing activities	<u>(96,157)</u>	<u>(3,435)</u>
<b>Cash flows from financing activities</b>		
Payments of note payable to banking subsidiary	(224,332)	(217,066)
Payment of dividend on preferred stock	(4,914,514)	-
Net proceeds from issuance of common stock	7,988	6,644
Purchase of treasury stock	<u>(11,718)</u>	<u>(3,826)</u>
Net cash used by financing activities	<u>(5,142,576)</u>	<u>(214,248)</u>
<b>Decrease in cash</b>	(2,410,339)	(402,422)
<b>Cash and cash equivalents, beginning of year</b>	<u>3,015,509</u>	<u>3,417,931</u>
<b>Cash and cash equivalents, ending of year</b>	<u>\$ 605,170</u>	<u>\$ 3,015,509</u>



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