

2016 ANNUAL REPORT



BUILDING VALUE



FIRST RELIANCE[®]
BANCSHARES

Building Value



Over the last several years I have shared with you our progress as we focused on protecting our brand while at the same time realigning the financial elements of our core business. Our brand which promises “To Make the Lives of Customers Better” is a commitment we never wavered from even during the most difficult days of realigning our bank. The strength of our brand has allowed us to build a strong foundation, a foundation that will support our continued focus on growth and building value for our associates, our customers and our Shareholders.

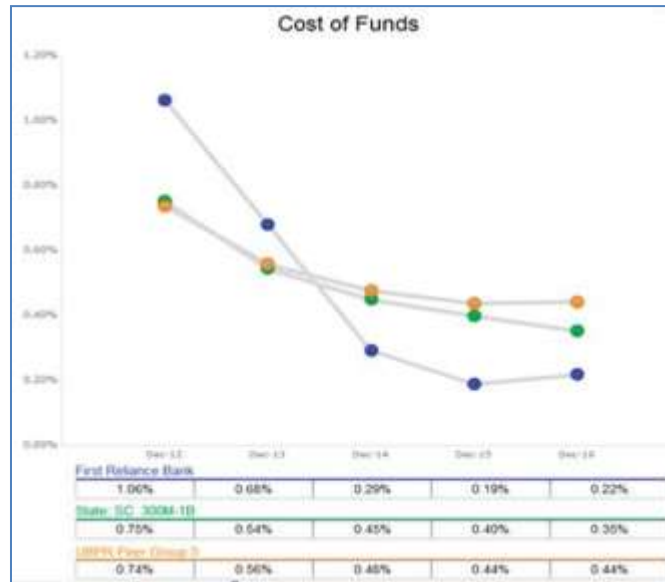
As I stated in my message to you last year, we have spent the last eight years reshaping the way we do business and the way we grow our bank. In 2016 we can say with confidence that we were able to successfully shift our focus from repairing the bank to growing the bank. We are now well on our way to leveraging our brand, restoring the yield on our assets, gathering more income from our business diversification initiatives and continuing to provide our customers with an exceptional banking experience. As a result we had a great year filled with many note worthy successes. I would like to share with you some of the successes we are especially proud of, as well as share with you our plan to continually grow our business in ways that generate value for our customers, our associates and our shareholders.

Strong Business Model

The strength of our business model and strategy is clearly evident in our financial results. Our commitment to maintaining our asset quality adds to the health of our franchise and allows us to allocate our capital growth initiatives.

Our low cost of funds is a result of the effort our retail team places on growing relationships with our current deposit customers. By delivering exceptional customer service we are able to attract new customers primarily through word of mouth from our satisfied and loyal customers. We have a tremendous track record over the last 8 years of continually delivering on deposit growth goals. This gives us a unique strategic advantage in how we structure and price our lending, helping us attract more earning assets and producing high performing margins.

Results speak for themselves; our loan growth at the end of 2016 was up \$28 million or 10.9% from the previous year.



Our continued emphasis on loan mix and funding composition has allowed us to break through the 4% net interest margin barrier; an accomplishment our industry struggles to meet.

Strong Diversification

We made a strategic decision to diversify our revenue sources and in early 2015 we expanded our mortgage business line to better serve our customers and to bolster our fee income sources. Our strategy has been focused on shifting our fee income contribution to revenue to 35-40%; and we accomplished this. This strategy has added significantly to our profit margins. Our strong residential mortgage team is able to provide a comprehensive selection of products to customers that meet almost any mortgage need while providing outstanding service and turnaround times for a better customer experience.



Our approach to the auto finance business line has been deliberate, slow and with an emphasis on local lending. It is now into its fourth profitable year and is an important channel that provides us access to new customers and gives us another diverse source of income.

Strategically, we will continue to focus on growing our market presence through the Carolina's where the community banking model remains strong. We will aggressively recruit local talent who understand the markets they live in and can quickly leverage their relationships into business opportunities. We will provide our market teams with strong centralized support to ensure we effectively manage our risk, maintain excellent loan quality, provide fast loan decisions, and well managed products and services.

Look for us to build out our presence with the same unique branch layout and strong branding we have always had, only in a smaller footprint, reflective of our customers desire to do banking at the branch as well as through their mobile devices.

Strong Culture

The strength of our culture is at the core of our success. It carried us through our tough times and now it is our strong culture that will fuel our growth and value building initiatives.

Our exceptional customer satisfaction results and our consistently high levels of associate engagement are major contributors to our success, now and in the future. We will place considerable effort in the next few years on building a culture of operational excellence which will improve our efficiency ratio and customer experience.

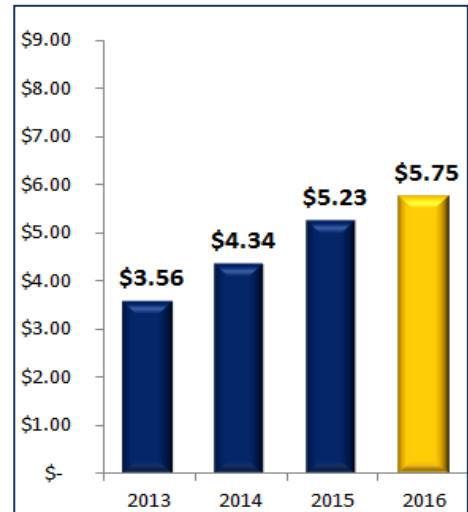
Some areas of particular focus will be to utilize technology more effectively, reduce our dependency on manual/paper based processes by moving toward a fully digital environment. These initiatives will result in reduced costs, improved customers service turnaround times and a more capable and scalable workforce. Our goal is to keep pace with our customers desire to have access to their information anytime and anywhere to allow for optimal convenience.



Strong Value Proposition for the Shareholder

One of our main strengths is building relationships with small businesses that operate in our communities to help them grow and succeed. We have a strong relationship banking team that is knowledgeable in small business lending and in providing deposit services, and banking their employees. In every community we serve we provide a level of customer service to all our customers that is unmatched by our competition. It is critical that we stay laser focused on capturing our fair share of small business and consumer customers in the communities we serve. Consumer customers and small businesses are not only the life blood of our communities they are the life blood of our company and the only path to creating sustainable, true value for our shareholders.

All of our efforts have resulted in an improvement in our Tangible Book Value over the past 4 years and since 2013 we have been realized an increase of 61.5%; an outstanding performance. We do however recognize that we are not an actively traded stock and because of this our company is undervalued in the public markets. So as we move into the next phase of growth we plan on making the necessary strategic moves to improve this.



Along with an aggressive loan and deposit growth plan we have a comprehensive plan to enhance our capital structure. A strong capital structure will allow us to be proactive with our growth initiatives, whether it is organic growth, strategic acquisition, and /or lending team acquisition.

For our shareholders it will also provide the company with an increased stock liquidity. Our capital raise plan is outlined in detail as part of the proxy vote and I encourage you to vote yes for this initiative which we will deploy to grow the business with a goal to increasing value to the customer, associates and shareholders.

Thank you and best regards,

Rick Saunders
President and CEO

First Reliance Bancshares, Inc. and Subsidiary

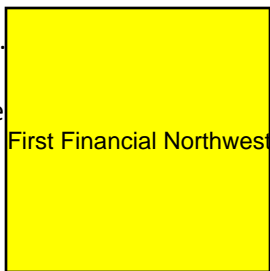
Report on Consolidated Financial Statements

For the years ended December 31, 2016 and 2015

First Reliance Bancshares, Inc. and Subsidiary

Contents

	<u>Page</u>
Independent Auditor's Report	1-2
Consolidated Financial Statements	
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Comprehensive Income	5
Consolidated Statements of Changes in Shareholders' Equity	6
Consolidated Statements of Cash Flows	7
Notes to Consolidated Financial Statements	8-45



First Financial Northwest



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 Subsidiary which comprise the consolidated balance sheets as of December 31, 2016 and 2015, 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, 2016 and 2015, 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.

Elliott Davis Decosimo, LLC

Columbia, South Carolina
February 28, 2017

First Reliance Bancshares, Inc. and Subsidiary

Consolidated Balance Sheets

As of December 31, 2016 and 2015

	2016	2015
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$ 4,810,304	\$ 3,703,357
Interest-bearing deposits with other banks	<u>22,287,560</u>	<u>16,357,619</u>
Total cash and cash equivalents	<u>27,097,864</u>	<u>20,060,976</u>
Time deposits in other banks	101,816	101,612
Securities available-for-sale	17,862,635	11,255,855
Securities held-to-maturity (Estimated fair value of \$20,842,142 and \$26,270,623 at December 31, 2016 and 2015, respectively)	20,438,084	25,470,171
Nonmarketable equity securities	<u>734,300</u>	<u>813,400</u>
Total investment securities	<u>39,035,019</u>	<u>37,539,426</u>
Mortgage loans held for sale	5,355,532	8,070,283
Loans receivable	288,126,331	259,806,101
Less allowance for loan losses	<u>(2,648,535)</u>	<u>(2,693,985)</u>
Loans, net	<u>285,477,796</u>	<u>257,112,116</u>
Premises, furniture and equipment, net	18,873,718	22,856,744
Accrued interest receivable	961,449	979,347
Other real estate owned	2,870,484	2,506,733
Cash surrender value life insurance	13,964,986	13,615,610
Net deferred tax assets	8,463,657	9,950,018
Mortgage servicing rights	4,211,582	1,015,403
Other assets	<u>1,707,519</u>	<u>1,502,230</u>
Total assets	<u>\$ 408,121,422</u>	<u>\$ 375,310,498</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	\$ 76,175,393	\$ 68,147,262
Interest-bearing transaction accounts	76,736,892	76,304,111
Savings	115,741,395	99,870,631
Time deposits \$250,000 and over	17,757,192	14,990,007
Other time deposits	<u>50,124,647</u>	<u>44,612,452</u>
Total deposits	336,535,519	303,924,463
Securities sold under agreement to repurchase	11,088,526	8,201,396
Advances from Federal Home Loan Bank	8,000,000	10,000,000
Notes payable	6,893,211	-
Junior subordinated debentures	10,310,000	10,310,000
Subordinated debentures	4,896,398	-
Accrued interest payable	298,950	54,002
Other liabilities	<u>3,431,091</u>	<u>2,586,907</u>
Total liabilities	<u>381,453,695</u>	<u>335,076,768</u>
Commitments and contingencies - Notes 4 and 18		
Shareholders' Equity		
Preferred stock		
Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding at December 31, 2015	-	15,179,709
Series B cumulative perpetual preferred stock - 767 shares issued and outstanding at December 31, 2015	-	767,000
Series D non-cumulative preferred stock - 600 and 612 shares issued and outstanding at December 31, 2016 and 2015, respectively	600	612
Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,679,881 and 4,680,481 shares issued and outstanding at December 31, 2016 and 2015, respectively	46,798	46,804
Capital surplus	25,071,543	26,007,698
Treasury stock, at cost, 39,069 and 38,663 shares at December 31, 2016 and 2015, respectively	(219,106)	(217,230)
Nonvested restricted stock	(262,153)	(326,481)
Retained earnings (deficit)	2,262,742	(1,259,166)
Accumulated other comprehensive income (loss)	<u>(232,697)</u>	<u>34,784</u>
Total shareholders' equity	<u>26,667,727</u>	<u>40,233,730</u>
Total liabilities and shareholders' equity	<u>\$ 408,121,422</u>	<u>\$ 375,310,498</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Consolidated Statements of Operations

For the years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Interest income:		
Loans, including fees	\$ 14,363,973	\$ 13,866,514
Investment securities:		
Taxable	801,878	925,411
Tax exempt	113,099	113,599
Other interest income	<u>109,578</u>	<u>129,247</u>
Total	<u>15,388,528</u>	<u>15,034,771</u>
Interest expense:		
Time deposits	366,955	327,768
Other deposits	300,580	209,324
Other interest expense	<u>630,250</u>	<u>303,036</u>
Total	<u>1,297,785</u>	<u>840,128</u>
Net interest income	14,090,743	14,194,643
Provision for loan losses	<u>9,075</u>	<u>777,678</u>
Net interest income after provision for loan losses	<u>14,081,668</u>	<u>13,416,965</u>
Noninterest income:		
Service charges on deposit accounts	1,385,517	1,430,808
Income from mortgage operations	6,153,308	2,949,877
Income from bank owned life insurance	349,374	333,046
Other service charges, commissions, and fees	1,236,026	1,161,788
Gain on sale of available-for-sale securities	13,261	9,562
Gain on sale of premises	652,367	-
Other	<u>240,780</u>	<u>328,365</u>
Total	<u>10,030,633</u>	<u>6,213,446</u>
Noninterest expenses:		
Salaries and benefits	11,270,540	9,747,542
Occupancy	1,572,271	1,628,527
Furniture and equipment related expenses	1,517,840	1,583,048
Other	<u>4,428,482</u>	<u>4,185,607</u>
Total	<u>18,789,133</u>	<u>17,144,724</u>
Income before income taxes	5,323,168	2,485,687
Income tax expense (benefit)	<u>1,801,260</u>	<u>(6,326,661)</u>
Net income	3,521,908	8,812,348
Preferred stock dividends accrued	<u>937,848</u>	<u>1,450,440</u>
Net income available to common shareholders	<u>\$ 2,584,060</u>	<u>\$ 7,361,908</u>
Average common shares outstanding, basic	4,438,570	4,491,053
Average common shares outstanding, diluted	4,554,138	4,595,204
Income per common share:		
Basic income per common share	\$ 0.58	\$ 1.64
Diluted income per common share	0.57	1.60

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary**Consolidated Statements of Comprehensive Income****For the years ended December 31, 2016 and 2015**

	<u>2016</u>	<u>2015</u>
Net income	<u>\$ 3,521,908</u>	<u>\$ 8,812,348</u>
Other comprehensive loss, net of tax:		
Securities available-for-sale		
Unrealized holding losses arising during the period	(354,501)	(54,140)
Income tax benefit	<u>120,530</u>	<u>18,408</u>
Net of income taxes	<u>(233,971)</u>	<u>(35,732)</u>
Reclassification adjustment for gains realized in net income	(13,261)	(9,562)
Income tax expense	<u>4,509</u>	<u>3,251</u>
Net of income taxes	<u>(8,752)</u>	<u>(6,311)</u>
Other comprehensive loss attributable to securities available-for-sale	<u>(242,723)</u>	<u>(42,043)</u>
Securities held-to-maturity		
Amortization of net unrealized gains capitalized on securities transferred from available-for-sale	(37,513)	(67,950)
Income tax benefit	<u>12,755</u>	<u>23,103</u>
Net of income taxes	<u>(24,758)</u>	<u>(44,847)</u>
Other comprehensive loss	<u>(267,481)</u>	<u>(86,890)</u>
Comprehensive income	<u>\$ 3,254,427</u>	<u>\$ 8,725,458</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, 2016 and 2015

	<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 Compre- hensive Income (Loss)</u>	<u>Total</u>
Balance, December 31, 2014	\$ 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)
Balance, December 31, 2015	15,947,321	46,804	26,007,698	(217,230)	(326,481)	(1,259,166)	34,784	40,233,730
Net income						3,521,908		3,521,908
Other comprehensive loss, net of tax							(267,481)	(267,481)
Redemption of preferred stock - Series A and B	(15,946,709)							(15,946,709)
Dividend payment on preferred stock			(937,848)					(937,848)
Conversion of Preferred Stock - Series D to Common Stock	(12)	12						-
Net issuance (forfeiture) of Common Stock		(18)	1,693					1,675
Net Change in Restricted Stock					64,328			64,328
Purchase of Treasury Stock				(1,876)				(1,876)
Balance, December 31, 2016	<u>\$ 600</u>	<u>\$ 46,798</u>	<u>\$ 25,071,543</u>	<u>\$ (219,106)</u>	<u>\$ (262,153)</u>	<u>\$ 2,262,742</u>	<u>\$ (232,697)</u>	<u>\$ 26,667,727</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash flows from operating activities:		
Net income	\$ 3,521,908	\$ 8,812,348
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan losses	9,075	777,678
Depreciation and amortization expense	908,827	930,789
Gain on sales of securities available-for-sale	(13,261)	(9,562)
Discount accretion and premium amortization	81,041	188,173
Net gain on sale of other real estate owned	(11,031)	(366,898)
Gain on sale of premises	(652,367)	-
Write down of other real estate owned	17,370	33,580
Disbursements for mortgages held for sale	(327,583,115)	(141,957,066)
Proceeds from sales of mortgages held for sale	330,297,866	135,856,851
Deferred income taxes	1,617,635	(6,751,247)
Decrease in interest receivable	17,898	54,969
Increase (decrease) in interest payable	244,948	(752,077)
Increase in cash surrender value of life insurance	(349,374)	(333,045)
Increase in deferred compensation on restricted stock	64,328	58,849
Increase in other assets	(292,606)	(486,919)
Increase in mortgage servicing rights	(3,196,179)	(1,015,403)
Increase in other liabilities	<u>844,183</u>	<u>206,354</u>
Net cash provided (used) by operating activities	<u>5,527,146</u>	<u>(4,752,626)</u>
Cash flows from investing activities:		
Purchases of securities available-for-sale	(14,200,128)	(5,000,000)
Maturities of securities available-for-sale	6,348,470	1,546,426
Maturities of securities held-to-maturity	4,922,467	5,749,484
Proceeds from sale of securities available-for-sale	881,445	5,179,670
Net decrease in nonmarketable equity securities	79,100	689,000
Net increase in time deposits in other banks	(204)	(203)
Net increase in loans receivable	(29,246,249)	(9,649,939)
Purchases of premises, furniture and equipment	(487,575)	(279,351)
Proceeds from sale of premises, furniture and equipment	4,307,979	-
Proceeds from sale of other real estate owned	<u>501,400</u>	<u>4,416,734</u>
Net cash (used) provided by investing activities	<u>(26,893,295)</u>	<u>2,651,821</u>
Cash flows from financing activities:		
Net increase in demand deposits, interest-bearing transaction accounts and savings accounts	24,331,676	32,824,382
Net increase (decrease) in certificates of deposit and other time deposits	8,279,380	(14,218,537)
Net decrease in advances from Federal Home Loan Bank	(2,000,000)	(15,000,000)
Net increase in securities sold under agreements to repurchase	2,887,130	627,993
Net proceeds from issuance of common stock	1,675	7,988
Increase in notes payable	6,893,211	-
Redemption of preferred stock	(15,946,709)	-
Proceeds from issuance of subordinated debentures	4,896,398	-
Purchase of treasury stock	(1,876)	(11,718)
Payment of dividends on preferred stock	<u>(937,848)</u>	<u>(4,914,514)</u>
Net cash provided (used) by financing activities	<u>28,403,037</u>	<u>(684,406)</u>
Net increase (decrease) in cash and cash equivalents	7,036,888	(2,785,211)
Cash and cash equivalents, beginning of year	<u>20,060,976</u>	<u>22,846,187</u>
Cash and cash equivalents, end of year	<u>\$ 27,097,864</u>	<u>\$ 20,060,976</u>
Cash paid during the year for:		
Income taxes	\$ 93,000	\$ 597,270
Interest	1,052,837	1,592,205
Supplemental noncash investing and financing activities:		
Foreclosures on loans	\$ 871,490	\$ 4,145,896
Net change in unrealized losses on investment securities	(267,481)	(86,890)

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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 throughout 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 throughout South Carolina. At December 31, 2016 and 2015, 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, 2016 and 2015

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, 2016 and 2015, non-marketable equity securities consist of the following:

	<u>2016</u>	<u>2015</u>
Federal Home Loan Bank stock	\$ 676,200	\$ 755,300
Community Bankers Bank stock	<u>58,100</u>	<u>58,100</u>
Total	<u>\$ 734,300</u>	<u>\$ 813,400</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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, 2016 and 2015, the Company had \$71,515 and \$11,353, respectively, 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 \$201,459 and \$268,836 were included in the Company's results of operations for 2016 and 2015, 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 \$173,178 and \$147,119 to earnings for the retirement savings plan in 2016 and 2015, respectively. In addition, the Company made an elective contribution to the retirement savings plan during 2016 totaling \$231,726 recorded within salaries and employee benefits expense. No elective contribution was made during 2015.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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 2016 and 2015 the supplemental retirement expense was \$237,161 and \$192,057, respectively. The current accrued but unfunded amount is \$1,818,588 and \$1,642,646 at December 31, 2016 and 2015, 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 \$13,964,986 and \$13,615,610 at December 31, 2016 and 2015, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2016 and 2015, the split-dollar liability relating to these arrangements totaled \$304,468 and \$286,558, respectively. For 2016 and 2015, the Company recognized net expenses of \$17,910 and \$16,857, 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 19.

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, 2016 and 2015, the ESOP owned 435,492 and 419,106 shares of the Company's common stock with an estimated value of \$1,542,673 and \$1,542,673, 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 20).

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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 May 2014, the Financial Accounting Standards Board ("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 reporting periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In April 2015, the FASB issued guidance which changes the presentation of debt issuance costs. The amendments will be effective for fiscal years beginning after December 15, 2015, and interim periods beginning after December 15, 2016, with early adoption permitted for financial statements that have not been previously issued. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2015, the FASB deferred the effective date of Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. 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 ASC 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements, continued:

In February 2016, the FASB amended the Leases topic of the ASC to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In March 2016, the FASB amended several topics of the ASC to make the guidance in all private company accounting alternatives effective immediately by removing their effective dates. The amendments also include transition provisions that provide that private companies are able to forgo a preferability assessment the first time they elect the private company accounting alternatives. The amendments were effective immediately. These amendments did not have a material effect on its financial statements.

In March 2016, the FASB amended the Revenue from Contracts with Customers topic of the ASC to clarify the implementation guidance on principal versus agent considerations and address how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In April 2016, the FASB amended the Revenue from Contracts with Customers topic of the ASC to clarify guidance related to identifying performance obligations and accounting for licenses of intellectual property. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2016, the FASB amended the Revenue from Contracts with Customers topic of the ASC to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In August 2016, the FASB amended the Statement of Cash Flows topic of the ASC to clarify how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements, continued:

In October 2016, the FASB amended the Income Taxes topic of the ASC to modify the accounting for intra-entity transfers of assets other than inventory. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In December 2016, the FASB issued amendments to clarify the ASC, correct unintended application of guidance, and make minor improvements to the ASC that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. The amendments were effective upon issuance (December 14, 2016) for amendments that do not have transition guidance. Amendments that are subject to transition guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In December 2016, the FASB issued technical corrections and improvements to the Revenue from Contracts with Customers Topic. These corrections make a limited number of revisions to several pieces of the revenue recognition standard issued in 2014. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

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 operations or cash flows.

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.

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 2015 consolidated financial statements were reclassified to conform with the 2016 presentation. The reclassifications did not have an impact on net income or shareholders' equity.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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, 2016 and 2015, this requirement was \$2,435,000 and \$2,892,000, 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>	
December 31, 2016				
U.S. Government sponsored agencies	\$ 9,028,395	\$ -	\$ 226,553	\$ 8,801,842
Mortgage-backed securities	6,382,063	10,149	180,915	6,211,297
Corporate bonds	2,833,723	-	14,227	2,819,496
Equity security	30,000	-	-	30,000
Total	<u>\$ 18,274,181</u>	<u>\$ 10,149</u>	<u>\$ 421,695</u>	<u>\$ 17,862,635</u>
December 31, 2015				
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>

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

	<u>Amortized Cost</u>	<u>Gross Unrealized</u>		<u>Estimated Fair Value</u>
		<u>Gains</u>	<u>Losses</u>	
December 31, 2016				
U.S. Government sponsored agencies	\$ 4,768,428	\$ 85,579	\$ -	\$ 4,854,007
Mortgage-backed securities	12,489,025	313,488	91,123	12,711,390
Municipals	3,121,658	155,087	-	3,276,745
	20,379,111	<u>\$ 554,154</u>	<u>\$ 91,123</u>	<u>\$ 20,842,142</u>
Capitalization of net unrealized gains on securities transferred from available-for-sale in 2013	58,973			
Total	<u>\$ 20,438,084</u>			
December 31, 2015				
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
	25,373,685	<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>			

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3. Investment Securities, Continued

The following is a summary of maturities of securities available-for-sale and held-to-maturity as of December 31, 2016. 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 one year but within five years	\$ 5,000,000	\$ 4,958,566	\$ 503,038	\$ 515,555
Due after five years through ten years	6,862,118	6,662,772	7,387,048	7,615,197
Due after ten years	-	-	-	-
	<u>11,862,118</u>	<u>11,621,338</u>	<u>7,890,086</u>	<u>8,130,752</u>
Mortgage-backed securities	6,382,063	6,211,297	12,489,025	12,711,390
Equity security	30,000	30,000	-	-
Total	<u>\$ 18,274,181</u>	<u>\$ 17,862,635</u>	<u>\$ 20,379,111</u>	<u>\$ 20,842,142</u>

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, 2016 and 2015.

	December 31, 2016		December 31, 2015	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities Available-for-Sale				
Less Than 12 Months				
U.S. Government sponsored agencies	\$ 8,801,842	\$ 226,553	\$ 4,970,150	\$ 29,850
Mortgage-backed securities	4,802,134	180,915	-	-
Corporate bonds	-	-	<u>2,765,331</u>	<u>45,759</u>
Total	<u>13,603,976</u>	<u>407,468</u>	<u>7,735,481</u>	<u>75,609</u>
12 Months or More				
Corporate bonds	<u>2,819,496</u>	<u>14,227</u>	-	-
Total securities available-for-sale	<u>\$ 16,423,472</u>	<u>\$ 421,695</u>	<u>\$ 7,735,481</u>	<u>\$ 75,609</u>
Securities Held-to-Maturity				
Less Than 12 Months				
Mortgage-backed securities	<u>\$ 4,100,521</u>	<u>\$ 91,213</u>	<u>\$ 2,927,507</u>	<u>\$ 33,201</u>
Total	<u>4,100,521</u>	<u>91,213</u>	<u>2,927,507</u>	<u>33,201</u>
12 Months or More				
Mortgage-backed securities	-	-	<u>815,344</u>	<u>24,614</u>
Total securities held-to-maturity	<u>\$ 4,100,521</u>	<u>\$ 91,213</u>	<u>\$ 3,742,951</u>	<u>\$ 57,815</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3. Investment Securities, Continued

At December 31, 2016, seven securities classified as available-for-sale and three 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 2016 and 2015, gross proceeds from the sale of available-for-sale securities were \$881,445 and \$5,179,670, respectively. During these periods, gross gains totaled \$13,261 and \$13,546, while gross losses totaled \$0 and \$3,984, respectively.

At December 31, 2016 and 2015, investment securities with a par value of \$15,299,708 and \$13,233,612 and a fair market value of \$15,220,970 and \$13,295,031, respectively, were pledged as collateral to secure public deposits and borrowings.

Note 4. Loans and Allowance for Loan Losses

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

	<u>2016</u>	<u>2015</u>
Real estate loans:		
Construction	\$ 21,712,531	\$ 21,818,648
Residential	84,722,824	74,442,236
Nonresidential	<u>93,071,267</u>	<u>92,029,160</u>
Total real estate loans	199,506,622	188,290,044
Commercial and industrial	32,087,777	29,182,335
Consumer and other	<u>56,531,932</u>	<u>42,333,722</u>
Total loans	<u>\$ 288,126,331</u>	<u>\$ 259,806,101</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 \$48,524,832 and \$44,338,113 at December 31, 2016 and 2015, 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 2016 and 2015 totaled \$330,297,866 and \$135,856,851, 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an analysis of the allowance for loan losses by class of loans for the years ended December 31, 2016 and 2015.

	December 31, 2016						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Beginning balance	\$ 2,693,985	\$ 274,660	\$ 716,885	\$ 974,122	\$ 1,965,667	\$ 38,498	\$ 689,820
Provisions	9,075	108,632	504,942	(507,202)	106,372	(19,999)	(77,298)
Recoveries	418,368	209,433	49,528	4,771	263,732	25,538	129,098
Charge-offs	(472,893)	-	(161,955)	(23,508)	(185,463)	(12,501)	(274,929)
Ending balance	<u>\$ 2,648,535</u>	<u>\$ 592,725</u>	<u>\$ 1,109,400</u>	<u>\$ 448,183</u>	<u>\$ 2,150,308</u>	<u>\$ 31,536</u>	<u>\$ 466,691</u>

	December 31, 2015						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
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	(1,561,135)	(552,768)	(343,744)	(385,000)	(1,281,512)	(30,230)	(249,393)
Ending balance	<u>\$ 2,693,985</u>	<u>\$ 274,660</u>	<u>\$ 716,885</u>	<u>\$ 974,122</u>	<u>\$ 1,965,667</u>	<u>\$ 38,498</u>	<u>\$ 689,820</u>

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the years ended December 31, 2016 and 2015.

	December 31, 2016						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Allowance							
Evaluated for impairment							
Individually	\$ 38,348	\$ -	\$ 4,028	\$ 16,683	\$ 20,711	\$ -	\$ 17,637
Collectively	<u>2,610,187</u>	<u>592,725</u>	<u>1,105,372</u>	<u>431,500</u>	<u>2,129,597</u>	<u>31,536</u>	<u>449,054</u>
Allowance for loan losses	<u>\$ 2,648,535</u>	<u>\$ 592,725</u>	<u>\$ 1,109,400</u>	<u>\$ 448,183</u>	<u>\$ 2,150,308</u>	<u>\$ 31,536</u>	<u>\$ 466,691</u>
Total Loans							
Evaluated for impairment							
Individually	\$ 5,186,870	\$ 1,574,732	\$ 1,749,022	\$ 1,699,489	\$ 5,023,243	\$ -	\$ 163,627
Collectively	<u>282,939,461</u>	<u>20,137,799</u>	<u>82,973,802</u>	<u>91,371,778</u>	<u>194,483,379</u>	<u>32,087,777</u>	<u>56,368,305</u>
Loans receivable	<u>\$ 288,126,331</u>	<u>\$ 21,712,531</u>	<u>\$ 84,722,824</u>	<u>\$ 93,071,267</u>	<u>\$ 199,506,622</u>	<u>\$ 32,087,777</u>	<u>\$ 56,531,932</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans and Allowance for Loan Losses, Continued

	December 31, 2015						
	Total	Real Estate Loans			Total Real Estate Loans	Commercial and Industrial	Consumer and Other
		Construction	Residential	Non-Residential			
Allowance							
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>1,920,554</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>\$ 1,965,667</u>	<u>\$ 38,498</u>	<u>\$ 689,820</u>
Total Loans							
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>

The following summarizes the Company's impaired loans as of December 31, 2016.

	Recorded Investments	Unpaid Principal	Related Allowance	Average Balance	Interest Income Recognized
With no related allowance recorded:					
Real estate					
Construction	\$ 1,574,732	\$ 1,574,732	\$ -	\$ 1,660,238	\$ -
Residential mortgages	1,178,355	1,178,355	-	1,046,333	17,300
Nonresidential	<u>1,601,918</u>	<u>1,601,918</u>	-	<u>1,936,093</u>	<u>20,442</u>
Total real estate loans	4,355,005	4,355,005	-	4,642,664	37,742
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>145,990</u>	<u>145,990</u>	-	<u>186,019</u>	<u>5,155</u>
	<u>\$ 4,500,995</u>	<u>\$ 4,500,995</u>	<u>\$ -</u>	<u>\$ 4,828,683</u>	<u>\$ 42,897</u>
With an allowance recorded:					
Real estate					
Construction	\$ -	\$ -	\$ -	\$ -	\$ -
Residential mortgages	570,667	570,667	4,028	591,642	11,361
Nonresidential	<u>97,571</u>	<u>97,571</u>	<u>16,683</u>	<u>95,357</u>	<u>15</u>
Total real estate loans	668,238	668,238	20,711	686,999	11,376
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>17,637</u>	<u>17,637</u>	<u>17,637</u>	<u>20,182</u>	<u>344</u>
	<u>\$ 685,875</u>	<u>\$ 685,875</u>	<u>\$ 38,348</u>	<u>\$ 707,181</u>	<u>\$ 11,720</u>
Total					
Real estate					
Construction	\$ 1,574,732	\$ 1,574,732	\$ -	\$ 1,660,238	\$ -
Residential mortgages	1,749,022	1,749,022	4,028	1,637,975	28,661
Nonresidential	<u>1,699,489</u>	<u>1,699,489</u>	<u>16,683</u>	<u>2,031,450</u>	<u>20,457</u>
Total real estate loans	5,023,243	5,023,243	20,711	5,329,663	49,118
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>163,627</u>	<u>163,627</u>	<u>17,637</u>	<u>206,201</u>	<u>5,499</u>
Total	<u>\$ 5,186,870</u>	<u>\$ 5,186,870</u>	<u>\$ 38,348</u>	<u>\$ 5,535,864</u>	<u>\$ 54,617</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans and Allowance for Loan Losses, Continued

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

	<u>Recorded Investment</u>	<u>Unpaid Principal</u>	<u>Related Allowance</u>	<u>Average Balance</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
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>
With an allowance recorded:					
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>
Total					
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>

The following is an aging analysis of the Company's loan portfolio at December 31, 2016:

	<u>30 - 59 Days Past Due</u>	<u>60 - 89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Recorded Investment > 90 Days and Accruing</u>
Real estate							
Construction	\$ -	\$ -	\$ 1,574,732	\$ 1,574,732	\$ 20,137,799	\$ 21,712,531	\$ -
Residential	84,505	130,442	101,226	316,173	84,406,651	84,722,824	-
Nonresidential	<u>24,029</u>	<u>97,571</u>	-	<u>121,600</u>	<u>92,949,667</u>	<u>93,071,267</u>	-
Total real estate loans	108,534	228,013	1,675,958	2,012,505	197,494,117	199,506,622	-
Consumer and industrial	-	12,838	-	12,838	32,074,939	32,087,777	-
Consumer and other	<u>277,575</u>	<u>73,102</u>	<u>51,499</u>	<u>402,176</u>	<u>56,129,756</u>	<u>56,531,932</u>	-
Total	<u>\$ 386,109</u>	<u>\$ 313,953</u>	<u>\$ 1,727,457</u>	<u>\$ 2,427,519</u>	<u>\$ 285,698,812</u>	<u>\$ 288,126,331</u>	<u>\$ -</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans and Allowance for Loan Losses, Continued

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>

The following is an analysis of the Company's nonaccrual loan portfolio recorded at December 31, 2016 and 2015:

	2016	2015
Real Estate		
Construction	\$ 1,574,732	\$ 1,746,744
Residential	631,360	881,221
Nonresidential	<u>97,571</u>	<u>461,668</u>
Total real estate loans	2,303,663	3,089,633
Commercial and industrial	-	-
Consumer and other	<u>286,925</u>	<u>135,738</u>
	<u>\$ 2,590,588</u>	<u>\$ 3,225,371</u>

Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2016 and 2015:

	2016	2015
Performing TDRs	\$ 2,274,303	\$ 4,257,699
Nonperforming TDRs	<u>1,574,732</u>	-
Total TDRs	<u>\$ 3,849,035</u>	<u>\$ 4,257,699</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, 2016 and 2015

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an analysis of TDRs identified during 2016:

	For the year ended December 31, 2016		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real Estate			
Construction	1	\$ 1,574,732	\$ 1,574,732
Residential	2	362,993	362,993
Nonresidential	<u>2</u>	<u>74,372</u>	<u>74,372</u>
Total real estate	5	2,012,097	2,012,097
Commercial and industrial	-	-	-
Consumer and other	6	88,209	88,209

During the year ended December 31, 2016, we modified eleven loans that were considered to be troubled debt restructuring. We provided rate concessions for four of these loans, and extensions for seven of the loans. During the year ended December 31, 2016, no loans that had previously been restructured during the year subsequently defaulted during the year.

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
Troubled Debt Restructurings			
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.

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, 2016 and 2015

Note 4. Loans 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, 2016:

	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</u>
		<u>Construction</u>	<u>Residential</u>	<u>Non-Residential</u>			
Pass	\$ 269,367,262	\$ 18,901,733	\$ 79,957,949	\$ 83,879,694	\$ 182,739,376	\$ 30,780,707	\$ 55,847,179
Special mention	13,538,416	1,236,066	3,155,103	7,582,776	11,973,945	1,242,125	322,346
Substandard	5,220,653	1,574,732	1,609,772	1,608,797	4,793,301	64,945	362,407
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 288,126,331</u>	<u>\$ 21,712,531</u>	<u>\$ 84,722,824</u>	<u>\$ 93,071,267</u>	<u>\$ 199,506,622</u>	<u>\$ 32,087,777</u>	<u>\$ 56,531,932</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, 2015:

	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial</u>	<u>Consumer and Other</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>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans 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>2016</u>	<u>2015</u>
Commitments to extend credit	\$ 38,247,248	\$ 35,891,328
Standby letters of credit	239,089	229,089

Note 5. Premises, Furniture and Equipment

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

	<u>2016</u>	<u>2015</u>
Land	\$ 6,808,794	\$ 10,464,406
Buildings	13,655,456	13,685,643
Leasehold improvements	543,087	521,657
Furniture and equipment	6,810,566	6,609,932
Construction in progress	<u>1,374,551</u>	<u>1,177,988</u>
Total	29,192,454	32,459,626
Less, accumulated depreciation	<u>10,318,736</u>	<u>9,602,882</u>
Premises and equipment, net	<u>\$ 18,873,718</u>	<u>\$ 22,856,744</u>

Depreciation expense for the years ended December 31, 2016 and 2015 amounted to \$806,145 and \$817,913, respectively.

At December 31, 2016 and 2015, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2016, there were no material commitments outstanding for the construction or purchase of premises, furniture and equipment. During 2016, the Company sold a parcel of land originally acquired for future facilities expansion, recording a gain on sale of premises totaling \$652,367. There were no material sales of premises, furniture or equipment during 2015.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 6. Other Real Estate Owned

Transactions in other real estate owned for the years ended December 31, 2016 and 2015 are summarized below:

	<u>2016</u>	<u>2015</u>
Beginning balance	\$ 2,506,733	\$ 2,444,253
Additions	871,490	4,145,896
Sales	(490,369)	(4,049,836)
Write downs	<u>(17,370)</u>	<u>(33,580)</u>
Ending balance	<u>\$ 2,870,484</u>	<u>\$ 2,506,733</u>

The Company recognized net gains of \$11,031 and \$366,898 on the sale of other real estate owned for the years ended December 31, 2016 and 2015, respectively.

Other real estate owned expense for the years ended December 31, 2016 and 2015 was \$92,604 and \$349,561, 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, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Balances, beginning of year	\$ 1,015,403	\$ -
Additions	2,980,477	1,174,973
Change in MSR market value	<u>215,702</u>	<u>(159,570)</u>
Balances, end of year	<u>\$ 4,211,582</u>	<u>\$ 1,015,403</u>

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, 2016, the aggregate amount of loans serviced by the Company for the benefit of others totaled \$358,616,362.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 7. Mortgage Servicing Rights, Continued

The characteristics and sensitivity analysis of the MSRs are included in the following table as of December 31, 2016 and 2015.

	<u>2016</u>	<u>2015</u>
Composition of residential loans serviced for others		
Fixed-rate mortgage loans	100.00%	100.00%
Weighted average life	8.95 years	8.53 years
Constant prepayment rate ("CPR")	10.55%	11.05%
Weighted average discount rate	9.67%	9.88%

Note 8. Derivatives

The derivative positions of the Company for the years ended December 31, 2016 and 2015 are reported as other assets and are as follows:

Derivative assets:	<u>2016</u>		<u>2015</u>	
	<u>Fair value</u>	<u>Notional value</u>	<u>Fair value</u>	<u>Notional value</u>
Mortgage loan interest rate lock commitments	\$ 282,949	\$ 18,015,138	\$ 304,460	\$ 16,663,588
Mortgage loan forward sales commitments	39,141	16,500,000	3,203	15,500,000

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, 2016, the scheduled maturities of time deposits were as follows:

<u>Maturing In</u>	<u>Amount</u>
2017	\$ 61,425,371
2018	4,012,098
2019	1,164,006
2020	1,048,154
2021	232,210
Total	<u>\$ 67,881,839</u>

Included in total time deposits at December 31, 2016 and 2015 were brokered time deposits of \$9,510,000 and \$9,331,836, respectively.

Time deposits that meet or exceed the FDIC insurance limits of \$250,000 at year-end 2016 and 2015 were \$17,757,192 and \$14,990,007, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

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>2016</u>	<u>2015</u>
Balance at end of the year	\$ 11,088,526	\$ 8,201,396
Maximum month-end balance during the year	11,088,526	9,332,381
Average balance during the year	9,694,287	8,403,014
Average interest rate at the end of the year	0.17%	0.08%
Average interest rate during the year	0.15%	0.07%

At December 31, 2016 and 2015, investment securities with a par value of \$11,310,819 and \$8,461,452 and a fair market value of \$11,259,662 and \$8,561,157, 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		
	<u>Rate</u>	<u>2016</u>	<u>2015</u>
Fixed rate			
January 19, 2016	0.36%	\$ -	\$ 6,000,000
February 29, 2016	0.37%	-	4,000,000
March 14, 2017	0.70%	<u>8,000,000</u>	-
		<u>\$ 8,000,000</u>	<u>\$ 10,000,000</u>

At December 31, 2016 and 2015, the Company has pledged certain loans totaling \$48,524,832 and \$44,338,113, respectively, as collateral to secure its borrowings from the FHLB. Additionally, the Company's FHLB stock is pledged to secure the borrowings.

Note 12. Junior Subordinated Debentures

On June 30, 2005, the Trust (a non-consolidated subsidiary) 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 2.75%. 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, 2016 and 2015, the Company had accrued and unpaid interest totaling \$30,655 and \$24,025, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 13. Borrowings

On August 5, 2016, the Company entered into subordinated debt agreements with eight lenders which totaled \$5,000,000. The debt initially bears interest at a fixed rate of 7.00% per annum until August 1, 2021 and then variable at three-month LIBOR plus 5.86%, payable quarterly with principal and unpaid interest due at maturity, August 5, 2026. The Company recorded \$111,450 in issuance costs associated with the subordinated debt, which is recorded net within subordinated debentures and to be amortized over five years. As of December 31, 2016, remaining issuance costs to be amortized totaled \$103,602.

On July 8, 2016, the Company obtained a note with CresCom Bank in the amount of \$7,000,000. The debt initially bears interest at a fixed rate of 4.95% per annum with principal and interest due quarterly based on a nine year amortization of the principal amount outstanding and any outstanding principal and unpaid interest due at maturity, July 8, 2021. The Company recorded \$115,284 in issuance costs associated with the note payable, which is recorded net within the note payable and to be amortized over five years. As of December 31, 2016, remaining issuance costs to be amortized totaled \$105,789. The debt is securitized by the assignment of Bank common stock. Principal reductions over the next five years are as follows:

2017	\$	310,858
2018		649,172
2019		682,045
2020		716,583
2021		<u>4,641,342</u>
Total	\$	<u>7,000,000</u>

Proceeds from the subordinated debt and note payable were used to repay the Series A and Series B Preferred Stock as described in Note 14.

Note 14. Shareholders' Equity

Common Stock - The following is a summary of the changes in common shares outstanding for the years ended December 31, 2016 and 2015.

	<u>2016</u>	<u>2015</u>
Common shares outstanding at beginning of the period	4,680,481	4,739,823
Conversion of common stock to Series D preferred stock	1,200	(61,182)
Conversion of restricted stock to common stock	2,200	1,840
Issuance of non-vested restricted shares	-	-
Forfeiture of restricted shares	<u>(4,000)</u>	-
Common shares outstanding at end of the period	<u>4,679,881</u>	<u>4,680,481</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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 14. Shareholders' Equity, Continued

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 had a liquidation preference of \$1,000 per share, paid 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 were payable quarterly. At any time, the Company could, 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.

The Series B Preferred Stock is a cumulative perpetual preferred stock that had the same rights, preferences, privileges, voting rights and other terms as the Series A Preferred Stock, except that dividends were to be paid at the rate of 9% per year so long as the Series A Preferred Stock was outstanding and could not be redeemed until all the Series A Preferred Stock had 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.

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

During 2016, the Company redeemed both Series A and Series B Preferred Stock outstanding totaling \$15,179,709 and \$767,000, respectively. The preferred stock was repaid through borrowings obtained as described in Note 13.

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, 2016, the Bank had undivided profits of \$9,269,741. 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

December 31, 2016 and 2015

Note 15. Other Operating Expense

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

	<u>2016</u>	<u>2015</u>
Advertising	\$ 201,683	\$ 268,836
Office supplies, postage and printing	274,990	318,075
Telephone	189,128	157,785
Professional fees and services	724,002	787,077
Supervisory fees and assessments	326,617	523,176
Debit and credit card expenses	970,586	810,624
Other real estate owned expenses	92,604	280,432
Insurance expenses	316,543	329,627
Loss on purchased loan	-	336,926
Income from legal settlement	-	(849,227)
Other	<u>1,332,329</u>	<u>1,222,276</u>
Total	<u>\$ 4,428,482</u>	<u>\$ 4,185,607</u>

Note 16. Income Taxes

Income tax provision for the years ended December 31, 2016 and 2015 is summarized as follows:

	<u>2016</u>	<u>2015</u>
Provision		
Current income tax expense		
Federal	\$ 35,862	\$ -
State	<u>147,763</u>	<u>379,824</u>
Total current	<u>183,625</u>	<u>379,824</u>
Deferred income tax expense (benefit)		
Federal	1,617,635	586,316
State	<u>(11,030)</u>	<u>(12,401)</u>
Total deferred	<u>1,606,605</u>	<u>573,916</u>
Change in valuation allowance	<u>11,030</u>	<u>(7,280,400)</u>
Total income tax expense (benefit)	<u>\$ 1,801,260</u>	<u>\$ (6,326,661)</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16. Income Taxes, Continued

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

	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Allowance for loan losses	\$ 900,502	\$ 915,955
Net operating losses	8,190,326	8,641,888
Non-accrual interest	67,151	85,063
Unrealized loss on securities available for sale	119,874	-
Deferred compensation	673,542	593,738
Federal and state credits	458,427	429,954
Other real estate owned	-	79,926
Other	<u>124,829</u>	<u>258,326</u>
Gross deferred tax assets	10,534,651	11,004,850
Less, valuation allowance	<u>(219,370)</u>	<u>(208,340)</u>
Net deferred tax assets	<u>10,315,281</u>	<u>10,795,510</u>
Deferred tax liabilities:		
Accumulated depreciation	183,804	272,830
Prepaid expenses	84,145	81,946
Unrealized gains on securities available for sale	-	17,918
Market to market adjustments	1,541,449	449,842
Other	<u>42,226</u>	<u>23,956</u>
Total gross deferred tax liabilities	<u>1,851,624</u>	<u>846,492</u>
Net deferred tax assets recognized	<u>\$ 8,463,657</u>	<u>\$ 9,950,018</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, 2016, 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 2016, the balance in the valuation allowance changed by \$11,030. 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 \$23,450,783 and \$24,850,153 for the years ended December 31, 2016 and 2015, respectively. The Company has state net operating losses of \$6,577,572 and \$5,843,509 for the years ended December 31, 2016 and 2015, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16. 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, 2016 and 2015 follows:

	<u>2016</u>	<u>2015</u>
Tax expense (benefit) at statutory rate	\$ 1,809,877	\$ 845,134
State income tax, net of federal income tax benefit	90,244	242,499
Tax-exempt interest income	(38,454)	(38,624)
Disallowed interest expense	395	340
Life insurance surrender value	(118,787)	(113,236)
Change in valuation allowance	11,030	(7,280,400)
Other, net	46,955	17,626
Total	<u>\$ 1,801,260</u>	<u>\$ (6,326,661)</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 2013 and subsequent years are subject to review by taxing authorities.

Note 17. 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, 2016 and 2015, the Company had related party loans totaling \$1,624,090 and \$1,418,178, respectively.

Deposits from directors and executive officers and their related interests totaled \$2,947,072 and \$3,344,237 at December 31, 2016 and 2015, respectively.

Note 18. 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, 2016, 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.

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, 2016 and 2015 were \$504,424 and \$467,503, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 18. Commitments and Contingencies

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>
2017	\$ 488,889
2018	462,487
2019	417,195
2020	417,195
2021	385,115
Thereafter	<u>3,193,477</u>
Total	<u>\$ 5,364,358</u>

Note 19. 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

December 31, 2016 and 2015

Note 19. Equity Incentive Plan, Continued

During 2016 and 2015, the Company issued 2,200 and 1,840 shares, respectively, of restricted stock pursuant to the 2006 Equity Incentive Plan, as amended. As of December 31, 2016 and 2015, 197,100 and 213,100 shares, respectively, 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 2016 and 2015, 2,200 and 1,840 shares, respectively, were issued which vested during each of the respective years. The weighted-average fair value of restricted stock issued during 2016 and 2015 was \$4.54 and \$4.34 per share, respectively. During 2016 and 2015, 4,000 and 0 shares, respectively, were either forfeited or cancelled having a weighted average price of \$2.05 and \$0, respectively. Also, during 2016 and 2015, 14,200 and 1,840 shares were exercised, respectively. The weighted-average fair value of restricted stock exercised during 2016 and 2015 was \$3.32 and \$4.34, respectively. Deferred compensation expense of \$58,777 and \$58,849 during 2016 and 2015, respectively, and income of \$81,993 was recognized during 2015 relating to restricted stock.

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 2016 and 2015.

At December 31, 2016, there were 752,900 stock awards available for grant under the 2006 Equity Incentive Plan, as amended.

Note 20. 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, 2016 and 2015.

	<u>2016</u>	<u>2015</u>
Income available to common shareholders		
Net income	\$ 3,521,908	\$ 8,812,348
Preferred stock dividends	<u>937,848</u>	<u>1,450,440</u>
Net income available to common shareholders	<u>\$ 2,584,060</u>	<u>\$ 7,361,908</u>
Basic income per common share:		
Net income available to common shareholders	<u>\$ 2,584,060</u>	<u>\$ 7,361,908</u>
Average common shares outstanding - basic	<u>4,438,570</u>	<u>4,491,053</u>
Basic income per common share	<u>\$ 0.58</u>	<u>\$ 1.64</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 20. Income Per Common Share, Continued

	<u>2016</u>	<u>2015</u>
Diluted income per common share:		
Net income available to common shareholders	\$ <u>2,584,060</u>	\$ <u>7,361,908</u>
Average common shares outstanding - basic	4,438,570	4,491,053
Dilutive potential common shares	<u>115,568</u>	<u>104,151</u>
Average common shares outstanding - diluted	<u>4,554,138</u>	<u>4,595,204</u>
Diluted income per common share	\$ <u>0.57</u>	\$ <u>1.60</u>

Note 21. 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, 2016 and 2015

Note 21. 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 at 0.625% 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 capital conservation buffer in effect for the year ended December 31, 2016 was 0.625%.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements at December 31, 2016 and 2015.

<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>
December 31, 2016						
The Bank						
Total capital (to risk-weighted assets)	\$ 42,138	13.03%	\$ 25,872	8.00%	\$ 32,341	10.00%
Tier 1 capital (to risk-weighted assets)	39,486	12.21	19,404	6.00	25,872	8.00
Tier 1 capital (to average assets)	39,486	9.97	15,845	4.00	16,170	5.00
Common Equity Tier 1 Capital (to risk-weighted assets)	39,486	12.21	14,553	4.50	21,021	6.50
December 31, 2015						
The Bank						
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

Note 22. Unused Lines of Credit

The Bank had available at December 31, 2016 several unsecured lines of credit, which were unused, to purchase up to \$34,000,000 of federal funds from four unrelated correspondent institutions. Also, as of December 31, 2016, the Bank had the ability to borrow funds from the FHLB of up to \$122,063,700. At that date, \$8,000,000 had been advanced. Additionally, an unused line of credit of approximately \$3,848,481 was available from the Federal Reserve. The FHLB and the Federal Reserve lines can be revoked at the lender’s discretion.

Note 23. 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).

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 23. Fair Value Measurements, Continued

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.

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 23. Fair Value Measurements, Continued

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, 2016 and 2015, 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.

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 23. Fair Value Measurements, Continued

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.

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, 2016 and 2015.

December 31, 2016	December 31, 2016			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored agencies	\$ 8,801,842	\$ -	\$ 8,801,842	\$ -
Mortgage-backed securities	6,211,297	-	6,211,297	-
Corporate bonds	2,819,496	-	2,819,496	-
Equity security	30,000	-	30,000	-
Total available-for-sale securities	<u>17,862,635</u>	-	<u>17,862,635</u>	-
Mortgage loans held for sale	5,355,532	-	5,355,532	-
Mortgage servicing rights	4,211,582	-	-	4,211,582
Derivative asset:				
Mortgage loan interest rate lock commitments	282,949	-	282,949	-
Mortgage loan forward sales commitments	39,141	-	39,141	-
	<u>\$ 27,751,839</u>	<u>\$ -</u>	<u>\$ 23,540,257</u>	<u>\$ 4,211,582</u>
December 31, 2015				
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>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 23. Fair Value Measurements, Continued

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

	<u>Mortgage Servicing Rights</u>
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	<u>(159,570)</u>
Balance, December 31, 2015	1,015,403
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	2,980,477
Total net gains (losses) included in:	
Net income	<u>215,702</u>
Balance, December 31, 2016	<u>\$ 4,211,582</u>

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

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, 2016 and December 31, 2015, 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>
December 31, 2016				
Impaired loans, net specific reserve	\$ 5,148,522	\$ -	\$ 5,148,522	\$ -
Other real estate owned	<u>2,870,484</u>	<u>-</u>	<u>2,870,484</u>	<u>-</u>
Total assets at fair value	<u>\$ 8,019,006</u>	<u>\$ -</u>	<u>\$ 8,019,006</u>	<u>\$ -</u>
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2015				
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>

Note 24. 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 February 28, 2017, 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, 2016 and 2015

Note 25. First Reliance Bancshares, Inc. (Parent Company Only)

Condensed Balance Sheets

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
Assets		
Cash	\$ 2,398,475	\$ 605,170
Investment in banking subsidiary	45,105,360	47,630,328
Marketable investments	30,000	30,000
Nonmarketable investments	58,100	58,100
Premises	-	3,655,612
Investment in trust	310,000	310,000
Deferred tax asset	1,122,730	1,009,085
Total assets	<u>\$ 49,024,665</u>	<u>\$ 53,298,295</u>
Liabilities		
Notes payable	\$ 6,893,211	\$ 2,720,432
Junior subordinated debentures	10,310,000	10,310,000
Subordinated debentures	4,896,398	-
Accrued interest payable	257,329	24,658
Other liabilities	-	9,475
Total liabilities	<u>22,356,938</u>	<u>13,064,565</u>
Shareholders' equity	<u>26,667,727</u>	<u>40,233,730</u>
Total liabilities and shareholders' equity	<u>\$ 49,024,665</u>	<u>\$ 53,298,295</u>

Condensed Statements of Operations

	<u>For the years ended</u>	
	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
Income		
Rental income from banking subsidiary	\$ 5,400	\$ 9,659
Interest income	7,711	29,598
Gain on sale of premises	652,367	-
Dividend from banking subsidiary	<u>6,000,000</u>	<u>3,890,588</u>
Total income	<u>6,665,478</u>	<u>3,929,845</u>
Expenses		
Interest expense	672,023	321,603
Other expenses	<u>327,705</u>	<u>93,450</u>
Total expenses	<u>999,728</u>	<u>415,953</u>
Income before income taxes and equity in undistributed income of banking subsidiary	5,665,750	3,514,752
Equity in undistributed earnings (losses) of banking subsidiary	<u>(2,257,487)</u>	<u>4,549,922</u>
Net income before income taxes	3,408,263	8,064,714
Income tax benefit	<u>(113,645)</u>	<u>(747,634)</u>
Net income	<u>\$ 3,521,908</u>	<u>\$ 8,812,348</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 25. First Reliance Bancshares, Inc. (Parent Company Only), Continued

Condensed Statements of Cash Flows

	For the years ended	
	December 31,	
	<u>2016</u>	<u>2015</u>
Cash flows from operating activities		
Net income	\$ 3,521,908	\$ 8,812,348
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of premises	(652,367)	-
Deferred income tax benefit	(113,645)	(747,634)
Increase (decrease) in deferred compensation on restricted stock	64,328	58,849
Increase (decrease) in accrued interest payable	232,671	(749,953)
Decrease in other assets	-	4,706
Decrease in other liabilities	(9,475)	-
Net equity in undistributed losses (earnings) of banking subsidiary	<u>2,257,487</u>	<u>(4,549,922)</u>
Net cash provided by operating activities	<u>5,300,907</u>	<u>2,828,394</u>
Cash flows from by investing activities		
Purchase of premises	-	(96,157)
Proceeds from sale of premises	<u>4,307,979</u>	<u>-</u>
Net cash used (provided) by investing activities	<u>4,307,979</u>	<u>(96,157)</u>
Cash flows from financing activities		
Net increase (decrease) in notes payable	4,172,779	(224,332)
Payment of dividend on preferred stock	(937,848)	(4,914,514)
Net proceeds from issuance of common stock	1,675	7,988
Redemption of preferred stock	(15,946,709)	-
Increase in subordinated debentures	4,896,398	-
Purchase of treasury stock	<u>(1,876)</u>	<u>(11,718)</u>
Net cash used by financing activities	<u>(7,815,581)</u>	<u>(5,142,576)</u>
Increase (decrease) in cash	1,793,305	(2,410,339)
Cash and cash equivalents, beginning of year	<u>605,170</u>	<u>3,015,509</u>
Cash and cash equivalents, ending of year	<u>\$ 2,398,475</u>	<u>\$ 605,170</u>



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