

2017 ANNUAL REPORT



BUILDING VALUE



Building Value

As I look back over the past year, I find it remarkable what we have accomplished toward building value for our shareholders, our customers and our associates. We have done this by focusing on growing the bank and are leveraging the strength of our purpose ‘To Make the Lives of Our Customers Better.’ I would like to share with you some of the successes we are especially proud of as well as our future plans for continued growth and serving our customers and communities.



We have kept a laser focus on our business model that outlines our value proposition and have made excellent progress on growing core deposits, market expansion, increasing wallet share, customer retention, customer experience and convenience through digital solutions. And we have been steadfast in helping our communities grow by supporting them with business lending expertise, residential mortgages and serving our customers.

Expansion Opportunities

We see an opportunity to take our brand of community banking into new markets and compete on providing customers with unique programs, developing strong long lasting customer relationships and an exceptional customer experience both in our branches and digitally.

We will have the same unique branch layout and strong branding we have always had, only in a smaller footprint, reflective of our customer desire to do banking at the branch as well as through their mobile devices.

To expand rapidly, we completed a successful capital raise of \$25.1 million in September 2017 along with the announcement to acquire Independence Bancshares, Greenville, South Carolina which was completed in March 2018. We believe that the Greenville expansion will continue to broaden our footprint throughout South Carolina and have an immediate positive impact on profitability. There has been a massive volume of community bank consolidation in the North Carolina region. As a result, we are finding that there is banking talent and community bank customers looking for options like FRB. Because of this, we opened a loan production office in Winston-Salem, North Carolina during the third quarter of 2017 and have applied for full branch status with the banking regulators and expect

approval in May. We are prepared to launch expansions throughout North Carolina in the near term and have recently added a loan production office in Lake Norman. In early first quarter of 2018, we opened our Myrtle Beach branch location.

We have aggressively hired local talent who understand the markets they live in and who quickly leverage their relationships into business opportunities.

While increased costs of opening branch offices negatively impacts earnings in the short term we anticipate increased profitability within these locations over the next 12 months which would be accretive to earnings.

Customer Experience and Convenience

In conjunction with the strength of the economy, we see growth opportunities in our new and existing markets for both deposits and loans and along with that we have added many tools that will help our customers manage their financial affairs.

- Our low cost of funds is a result of the effort our retail team places on growing relationships with our current deposit customers and by delivering exceptional customer service. We are able to attract new customers primarily through word of mouth from our satisfied and loyal customers. Total deposits increased \$16.5 million from one year ago. This gives us a unique strategic advantage in how we structure and price our lending, which helps us attract more earning assets. Results speak for themselves; our loan growth at the end of 2017 was up \$45.5 million or 16% from the previous year.
- We have to continuously improve the products and services we provide customers. In 2017, we launched many new exciting products and have made several improvements around the customer experience. We now offer a feature which allows our customers to turn on or off their debit card for greater security and protection. We also introduced a new payment platform which allows customers to easily, safely and in real-time, send money to their friends and family. We plan to add financial planning, budget and money management tools, and insights that help customers make the most of their money. We've also added an additional layer of security for customers who use online banking where they receive notifications of any changes within their online banking settings. We expect these new products to drive lots of customer interactions as payments and money management become easier with smart technology.
- Our services per household have increased as customers use more services of the bank and take



advantage of convenient services. This starts during customer on-boarding and continues to expand as customers receive ongoing marketing to make them aware of products and services which enhance their lives and help them manage their money successfully. The longer a customer stays with us the more products and services they use. Our customer retention remains above industry benchmarks.

Strong Culture

We've said it before and it continues to ring true, the strength of our culture is at the core of our success. Our experience shows if you build the right culture you can create great clarity about what the opportunities are and you can deliver on them easily. Our strong leaders have the blueprint to execute on a disciplined and forward-looking plan for growth.

Our ultimate goal is to have long-tenured employees and satisfied customers who stay with us year after year and who are willing to refer family and friends to the Bank. First Reliance Bank's exceptional customer satisfaction results and consistently high levels of associate engagement are major contributors to our success, now and in the future. We have placed considerable effort this past year and ongoing into the next few years on **building** a culture of operational excellence which will **improve our efficiency ratio and customer experience.**

Customers of the bank have given it a 95% customer satisfaction rating for five consecutive years. First Reliance is also one of three companies throughout South Carolina who have received the Best Place to Work in South Carolina award all twelve years since the program began. This recognition reinforces that our associates are engaged and committed to the Bank's brand and the communities we serve.

Even though we are a small community bank, we have always been obsessed with measuring our results both financial and operational. We set targets for ourselves and we always compare ourselves to best practices. These targets help us achieve progress toward our immediate goals and toward our forward-looking goals.

Our successes have been in areas which include loan mix and funding composition which has allowed us to break through the 4% net interest margin barrier an accomplishment our industry struggles to meet.



We have also placed a high value on revenue diversity with a **strong** emphasis on our fee income contribution to revenue to 35-40%. This strategy has added significantly to our profit margins. This is attributable to our strong residential mortgage team and the wide selection of products offered to

meet most any customers needs while providing outstanding service and turn-around times. The strong growth in the retail mortgage channel continues to build core franchise value and provide customer acquisition opportunities.

Our indirect auto loan program has also grown steadily over the past five years and has contributed steadily toward the diversification of fee income and access to new customers.

Our shared technology infrastructure – our networks, data centers, and the cloud – decrease cost, enhance efficiency and make our business more productive. Some areas of particular focus will be to **utilize** technology more effectively and build everything digital. These initiatives will result in **reduced costs**, **improved customer 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

Building shareholder value is the primary responsibility of a company, but it cannot do it well if the company is not providing an exceptional customer experience, hiring the right employees and giving them the opportunity to do what they do best, and being a good citizen in the community. If all these things are done well, it enhances shareholder value.

The value of your investment is a measure of the progress we have made over the years. Over the past few years, our value has consistently seen positive momentum, outperforming most of the bank indices. As we continue to expand, we will continue to focus on the development of new products, operational efficiency, investing in our employees, and providing an exceptional customer experience.

Thank you and best regards,



F.R."Rick" Saunders Jr.
President and CEO

First Reliance Bancshares, Inc. and Subsidiary

Report on Consolidated Financial Statements

For the years ended December 31, 2017 and 2016

First Reliance Bancshares, Inc. and Subsidiary

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Independent Auditor's Report

The Board of Directors and Shareholders
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, 2017 and 2016, and the related consolidated statements of operations, comprehensive income (loss), 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, 2017 and 2016, 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, LLC

Columbia, South Carolina
March 23, 2018

First Reliance Bancshares, Inc. and Subsidiary

Consolidated Balance Sheets

As of December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$ 3,494,469	\$ 4,810,304
Interest-bearing deposits with other banks	<u>21,136,350</u>	<u>22,287,560</u>
Total cash and cash equivalents	<u>24,630,819</u>	<u>27,097,864</u>
Time deposits in other banks	102,020	101,816
Securities available-for-sale	26,894,719	17,862,635
Securities held-to-maturity (fair value of \$17,372,834 and \$20,842,142 at December 31, 2017 and 2016, respectively)	17,018,132	20,438,084
Nonmarketable equity securities	<u>1,359,200</u>	<u>734,300</u>
Total investment securities	<u>45,272,051</u>	<u>39,035,019</u>
Mortgage loans held for sale	7,885,938	5,355,532
Loans receivable	333,675,253	288,126,331
Less allowance for loan losses	<u>(2,453,875)</u>	<u>(2,648,535)</u>
Loans, net	<u>331,221,378</u>	<u>285,477,796</u>
Premises, furniture and equipment, net	18,463,156	18,873,718
Accrued interest receivable	1,094,740	961,449
Other real estate owned	1,706,765	2,870,484
Cash surrender value life insurance	14,293,702	13,964,986
Net deferred tax assets	4,461,063	8,463,657
Mortgage servicing rights	6,357,666	4,211,582
Other assets	<u>3,132,443</u>	<u>1,707,519</u>
Total assets	<u>\$ 458,621,741</u>	<u>\$ 408,121,422</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	\$ 86,209,099	\$ 76,175,393
Interest-bearing transaction accounts	70,642,041	76,736,892
Savings	118,996,069	115,741,395
Time deposits \$250,000 and over	13,874,405	17,757,192
Other time deposits	<u>63,372,449</u>	<u>50,124,647</u>
Total deposits	353,094,063	336,535,519
Securities sold under agreement to repurchase	13,929,651	11,088,526
Advances from Federal Home Loan Bank	22,000,000	8,000,000
Notes payable	-	6,893,211
Subordinated debentures	4,911,963	4,896,398
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	253,679	298,950
Other liabilities	<u>3,969,060</u>	<u>3,431,091</u>
Total liabilities	<u>408,468,416</u>	<u>381,453,695</u>
Shareholders' Equity		
Preferred stock		
Series D non-cumulative preferred stock - 599 and 600 shares issued and outstanding at December 31, 2017 and 2016, respectively	599	600
Series E cumulative perpetual preferred stock - 410,499 and 0 shares issued and outstanding at December 31, 2017 and 2016, respectively	2,955,593	-
Common stock, \$0.01 par value; 20,000,000 shares authorized, 7,887,486 and 4,679,881 shares issued and outstanding at December 31, 2017 and 2016, respectively	78,875	46,798
Capital surplus	46,941,229	25,071,543
Treasury stock, at cost, 40,177 and 39,069 shares at December 31, 2017 and 2016, respectively	(229,844)	(219,106)
Nonvested restricted stock	(868,399)	(262,153)
Retained earnings	1,573,382	2,262,742
Accumulated other comprehensive loss	<u>(298,110)</u>	<u>(232,697)</u>
Total shareholders' equity	<u>50,153,325</u>	<u>26,667,727</u>
Total liabilities and shareholders' equity	<u>\$ 458,621,741</u>	<u>\$ 408,121,422</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Consolidated Statements of Operations

For the years ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Interest income:		
Loans, including fees	\$ 16,321,881	\$ 14,363,973
Investment securities:		
Taxable	802,815	801,878
Tax exempt	118,969	113,099
Other interest income	<u>225,924</u>	<u>109,578</u>
Total	<u>17,469,589</u>	<u>15,388,528</u>
Interest expense:		
Time deposits	732,399	366,955
Other deposits	410,459	300,580
Other interest expense	<u>1,028,926</u>	<u>630,250</u>
Total	<u>2,171,784</u>	<u>1,297,785</u>
Net interest income	15,297,805	14,090,743
Provision for loan losses	<u>-</u>	<u>9,075</u>
Net interest income after provision for loan losses	<u>15,297,805</u>	<u>14,081,668</u>
Noninterest income:		
Service charges on deposit accounts	1,502,286	1,385,517
Income from mortgage operations	4,845,075	6,153,308
Income from bank owned life insurance	328,716	349,374
Other service charges, commissions, and fees	1,341,171	1,236,026
Gain on sale of available-for-sale securities	-	13,261
Gain on sale of premises	-	652,367
Other	<u>324,003</u>	<u>240,780</u>
Total	<u>8,341,251</u>	<u>10,030,633</u>
Noninterest expenses:		
Salaries and benefits	12,075,338	11,270,540
Occupancy	1,685,622	1,572,271
Furniture and equipment related expenses	1,646,687	1,517,840
Acquisition-related costs	501,265	-
Other	<u>4,803,246</u>	<u>4,428,482</u>
Total	<u>20,712,158</u>	<u>18,789,133</u>
Income before income taxes	2,926,898	5,323,168
Income tax expense related to ordinary operations	949,716	1,801,260
Income tax expense related to change in tax rate	<u>2,666,542</u>	<u>-</u>
Total income tax expense	<u>3,616,258</u>	<u>1,801,260</u>
Net (loss) income	(689,360)	3,521,908
Preferred stock dividends accrued	<u>-</u>	<u>937,848</u>
Net (loss) income available to common shareholders	<u>\$ (689,360)</u>	<u>\$ 2,584,060</u>
Average common shares outstanding, basic	5,465,868	4,438,570
Average common shares outstanding, diluted	5,465,868	4,554,138
Income (loss) per common share:		
Basic income (loss) per common share	\$ (0.13)	\$ 0.58
Diluted income (loss) per common share	(0.13)	0.57

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income (Loss)
For the years ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Net (loss) income	<u>\$ (689,360)</u>	<u>\$ 3,521,908</u>
Other comprehensive loss, net of tax:		
Securities available-for-sale		
Unrealized holding losses arising during the period	(76,530)	(354,501)
Income tax benefit	<u>26,020</u>	<u>120,530</u>
Net of income taxes	<u>(50,510)</u>	<u>(233,971)</u>
Reclassification adjustment for gains realized in net income	-	(13,261)
Income tax expense	<u>-</u>	<u>4,509</u>
Net of income taxes	<u>-</u>	<u>(8,752)</u>
Other comprehensive loss attributable to securities available-for-sale	<u>(50,510)</u>	<u>(242,723)</u>
Securities held-to-maturity		
Amortization of net unrealized gains capitalized on securities transferred from available-for-sale	(22,581)	(37,513)
Income tax benefit	<u>7,678</u>	<u>12,755</u>
Net of income taxes	<u>(14,903)</u>	<u>(24,758)</u>
Other comprehensive loss	<u>(65,413)</u>	<u>(267,481)</u>
Comprehensive (loss) income	<u>\$ (754,733)</u>	<u>\$ 3,254,427</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, 2017 and 2016

	Preferred Stock	Common Stock	Capital Surplus	Treasury Stock	Nonvested Restricted Stock	Retained Earnings (Deficit)	Accumulated Other Compre- hensive Income (Loss)	Total
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	\$ 600	\$ 46,798	\$ 25,071,543	\$ (219,106)	\$ (262,153)	\$ 2,262,742	\$ (232,697)	\$ 26,667,727
Net loss						(689,360)		(689,360)
Other comprehensive loss, net of tax							(65,413)	(65,413)
Issuance of preferred stock - Series E	2,955,593							2,955,593
Conversion of Preferred Stock - Series D to Common Stock	(1)	1						-
Net issuance (forfeiture) of Common Stock		32,076	21,824,283					21,856,359
Net change in restricted stock					(606,246)			(606,246)
Stock based compensation			45,403					45,403
Purchase of Treasury Stock				(10,738)				(10,738)
Balance, December 31, 2017	<u>\$ 2,956,192</u>	<u>\$ 78,875</u>	<u>\$ 46,941,229</u>	<u>\$ (229,844)</u>	<u>\$ (868,399)</u>	<u>\$ 1,573,382</u>	<u>\$ (298,110)</u>	<u>\$ 50,153,325</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the years ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:		
Net income (loss)	\$ (689,360)	\$ 3,521,908
Adjustments to reconcile net (loss) income to net cash provided (used) by operating activities:		
Provision for loan losses	-	9,075
Depreciation and amortization expense	882,785	908,827
Gain on sales of securities available-for-sale	-	(13,261)
Discount accretion and premium amortization	69,555	81,041
Net gain on sale of other real estate owned	(216,079)	(11,031)
Gain on sale of premises	-	(652,367)
Write down of other real estate owned	550,338	17,370
Disbursements for mortgages held for sale	(273,360,068)	(327,583,115)
Proceeds from sales of mortgages held for sale	275,580,706	336,648,506
Gain on sale of mortgage loans	(4,751,044)	(6,350,640)
Deferred income taxes	3,543,946	1,617,635
(Increase) decrease in interest receivable	(133,291)	17,898
Increase (decrease) in interest payable	(45,271)	244,948
Increase in cash surrender value of life insurance	(328,716)	(349,374)
(Increase) decrease in restricted stock	(606,246)	64,328
Stock based compensation expense	45,403	-
Increase in other assets	(1,025,921)	(292,606)
Increase in mortgage servicing rights	(2,146,084)	(3,196,179)
Increase in other liabilities	<u>537,969</u>	<u>844,183</u>
Net cash (used) provided by operating activities	<u>(2,571,378)</u>	<u>5,527,146</u>
Cash flows from investing activities:		
Purchases of securities available-for-sale	(10,668,957)	(14,200,128)
Maturities of securities available-for-sale	1,541,157	6,348,470
Maturities of securities held-to-maturity	3,347,000	4,922,467
Proceeds from sale of securities available-for-sale	-	881,445
Net (increase) decrease in nonmarketable equity securities	(624,900)	79,100
Net increase in time deposits in other banks	(204)	(204)
Net increase in loans receivable	(45,881,122)	(29,246,249)
Purchases of premises, furniture and equipment	(378,878)	(487,575)
Proceeds from sale of premises, furniture and equipment	-	4,307,979
Proceeds from sale of other real estate owned	<u>967,000</u>	<u>501,400</u>
Net cash used by investing activities	<u>(51,698,904)</u>	<u>(26,893,295)</u>
Cash flows from financing activities:		
Net increase in demand deposits, interest-bearing transaction accounts and savings accounts	7,193,529	24,331,676
Net increase in certificates of deposit and other time deposits	9,365,015	8,279,380
Net increase (decrease) in advances from Federal Home Loan Bank	14,000,000	(2,000,000)
Net increase in securities sold under agreements to repurchase	2,841,125	2,887,130
Net proceeds from issuance of common stock	21,856,359	1,675
(Decrease) increase in notes payable	(6,893,211)	6,893,211
Issuance (redemption) of preferred stock	2,955,593	(15,946,709)
(Repayment) for proceeds from issuance of subordinated debentures	-	4,888,450
Accretion of debt issuance costs	15,565	7,848
Purchase of treasury stock	(10,738)	(1,876)
Payment of dividends on preferred stock	<u>-</u>	<u>(937,848)</u>
Net cash provided by financing activities	<u>51,323,237</u>	<u>28,402,937</u>
Net increase (decrease) in cash and cash equivalents	(2,467,045)	7,036,888
Cash and cash equivalents, beginning of year	<u>27,097,864</u>	<u>20,060,976</u>
Cash and cash equivalents, end of year	<u>\$ 24,630,819</u>	<u>\$ 27,097,864</u>
Cash paid during the year for:		
Income taxes	\$ 158,502	\$ 93,000
Interest	2,217,055	1,052,837
Supplemental noncash investing and financing activities:		
Foreclosures on loans	\$ 137,540	\$ 871,490
Net change in unrealized losses on investment securities	(65,413)	(267,481)

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies

Organization:

First Reliance Bancshares, Inc. (the "Company") was incorporated under the laws of the State of South Carolina on April 12, 2001 to serve as a bank holding company for its subsidiary, First Reliance Bank (the "Bank"), and acquired all of the shares of the Bank on April 1, 2002 in a statutory share exchange. 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, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans and evaluating other-than-temporary-impairment of investment securities. 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, 2017 and 2016, 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, 2017 and 2016

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, 2017 and 2016, non-marketable equity securities consist of the following:

	<u>2017</u>	<u>2016</u>
Federal Home Loan Bank stock	\$ 1,301,100	\$ 676,200
Community Bankers Bank stock	<u>58,100</u>	<u>58,100</u>
Total	<u>\$ 1,359,200</u>	<u>\$ 734,300</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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 of Atlanta ("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 uncollectability 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 collectability 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, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for Loan Losses, continued:

The allowance consists of specific and general 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. 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, 2017 and 2016

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 lower of cost or market of accounting for residential mortgage loans held for sale. These loans are initially recorded and carried at lower of cost or market 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 based on fair value. 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, 2017 and 2016

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, 2017 and 2016, the Company had \$125,910 and \$71,515, 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 \$261,116 and \$201,459 were included in the Company's results of operations for 2017 and 2016, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

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 \$195,469 and \$173,178 to earnings for the retirement savings plan in 2017 and 2016, respectively. In addition, the Company made an elective contribution to the retirement savings plan during 2017 and 2016 totaling \$145,920 and \$231,726, respectively, recorded within salaries and employee benefits expense.

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 2017 and 2016, the supplemental retirement expense was \$0 and \$237,161, respectively. The current accrued but unfunded amount is \$1,756,679 and \$1,818,588 at December 31, 2017 and 2016, 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 \$14,293,702 and \$13,964,986 at December 31, 2017 and 2016, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2017 and 2016, the split-dollar liability relating to these arrangements totaled \$323,497 and \$304,468, respectively. For 2017 and 2016, the Company recognized net expenses of \$19,029 and \$17,910, respectively, related to these arrangements.

Equity Incentive Plan:

On January 19, 2006, the Company approved the 2006 Equity Incentive Plan (the "2006 Plan") which expired January 19, 2016. The Company approved on April 20, 2017, the 2017 Equity Incentive Plan (the "2017 Plan"). These plans provide 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 2006 Plan allowed 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. The 2017 Plan allows granting up to 500,000 shares. The maximum aggregate shares subject to options is restricted to 80,000 in any calendar year to any one participant. The aggregate number of restricted stock shares available to be granted during any calendar to any one participant is limited to 50,000 shares. Awards may be granted for a term of up to five years from the effective date of the grant. Under these Plans, 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 plans are further described in Note 19.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

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, 2017 and 2016, the ESOP owned 491,353 and 435,492 shares of the Company's common stock with an estimated value of \$1,741,061 and \$1,542,673, respectively. All of these shares were allocated to participants.

Income (Loss) Per Common Share:

Basic earnings (loss) per common share represents income (loss) 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).

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting 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 annual periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. The Company's revenue is comprised of net interest income and noninterest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of the Company's revenues will not be affected. The Company has performed an assessment of revenue contracts related to revenue streams that are within the scope of the standard. The Company's accounting policies are not expected to change materially since the principles of revenue recognition from the Accounting Standards Update (ASU) are largely consistent with existing guidance and current practices applied by the Company's businesses. The Company has not identified material changes to the timing or amount of revenue recognition. Based on the updated guidance, the Company does anticipate changes in disclosures associated with revenues. The Company will provide qualitative disclosures of performance obligations related to revenue recognition and will continue to evaluate disaggregation for significant categories of revenue in the scope of the guidance.

In August 2015, the FASB deferred the effective date of 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 annual 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 Accounting Standards Codification (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, 2017. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB 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, 2018. Early adoption is permitted. The Company expects to adopt the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow the Company to largely account for existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The Company has started an initial evaluation of our leasing contracts and activities. The Company has also started developing our methodology to estimate the right-of use assets and lease liabilities, which is based on the present value of lease payments. The Company does not expect a material change to the timing of expense recognition, but we are early in the implementation process and will continue to evaluate the impact. The Company is evaluating the existing disclosures and may need to provide additional information as a result of adoption of the ASU.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements, continued:

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 annual 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 annual 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 annual 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 annual reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. While early adoption is permitted beginning in first quarter 2019, the Company does not expect to elect that option. The Company is evaluating the impact of the ASU on the consolidated financial statements with regards to the impact on the recorded allowance for loan losses given the change to estimated losses over the contractual life of the loans adjusted for expected prepayments. In addition to the allowance for loan losses, the Company will also record an allowance for credit losses on held-to-maturity debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

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.

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. 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, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements, continued:

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 annual 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 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2020. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2017, the FASB issued guidance to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendment to the Business Combinations Topic is intended to address concerns that the existing definition of a business has been applied too broadly and has resulted in many transactions being recorded as business acquisitions that in substance are more akin to asset acquisitions. The guidance will be effective for the Company for annual periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2017, the FASB amended the Other Income Topic of the ASC to clarify the scope of the guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets. The amendments conform the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. The amendments will be effective for the Company for annual periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2017, the FASB amended the requirements in the Receivables-Nonrefundable Fees and Other Costs Topic of the ASC related to the amortization period for certain purchased callable debt securities held at a premium. The amendments shorten the amortization period for the premium to the earliest call date. The amendments will be effective for the Company for annual periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2017, the FASB amended the requirements in the Compensation-Stock Compensation Topic of the Accounting Standards Codification related to changes to the terms or conditions of a share-based payment award. The amendments provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The amendments will be effective for the Company for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted. 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 1. Summary of Significant Accounting Policies, Continued

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 2016 consolidated financial statements were reclassified to conform with the 2017 presentation. The reclassifications did not have an impact on net income (loss) or shareholders' equity.

Note 2. Cash and Due From Banks

The Company is required to maintain balances with the Federal Reserve computed as a percentage of deposits. At December 31, 2017 and 2016, this requirement was \$4,210,000 and \$2,435,000, 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>Fair Value</u>
		<u>Gains</u>	<u>Losses</u>	
December 31, 2017				
U.S. Government sponsored agencies	\$ 9,701,287	\$ -	\$ 290,378	\$ 9,410,909
Municipal securities	1,381,692	18,917	-	1,400,609
Mortgage-backed securities	13,313,523	3,047	255,642	13,060,928
Corporate bonds	2,856,293	35,980	-	2,892,273
Equity securities	<u>130,000</u>	<u>-</u>	<u>-</u>	<u>130,000</u>
Total	<u>\$ 27,382,795</u>	<u>\$ 57,944</u>	<u>\$ 546,020</u>	<u>\$ 26,894,719</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	<u>30,000</u>	<u>-</u>	<u>-</u>	<u>30,000</u>
Total	<u>\$ 18,274,181</u>	<u>\$ 10,149</u>	<u>\$ 421,695</u>	<u>\$ 17,862,635</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 3. Investment Securities, Continued

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

	Amortized	Gross Unrealized		Fair Value
	Cost	Gains	Losses	
December 31, 2017				
U.S. Government sponsored agencies	\$ 3,927,737	\$ 70,886	\$ -	\$ 3,998,623
Mortgage-backed securities	9,947,188	214,947	78,497	10,083,638
Municipals	3,106,815	183,758	-	3,290,573
	<u>16,981,740</u>	<u>\$ 469,591</u>	<u>\$ 78,497</u>	<u>\$ 17,372,834</u>
Capitalization of net unrealized gains on securities transferred from available-for-sale	<u>36,392</u>			
Total	<u>\$ 17,018,132</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
	<u>20,379,111</u>	<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	<u>58,973</u>			
Total	<u>\$ 20,438,084</u>			

The following is a summary of maturities of securities available-for-sale and held-to-maturity as of December 31, 2017. The amortized cost and 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	Fair Value	Amortized	Fair Value
	Cost		Cost	
Due within one year	\$ -	\$ -	\$ 537,524	\$ 505,420
Due after one year but within five years	5,000,000	4,937,438	656,689	695,052
Due after five years through ten years	7,557,508	7,365,744	5,876,731	6,088,724
Due after ten years	1,381,764	1,400,609	-	-
	<u>13,939,272</u>	<u>13,703,791</u>	<u>7,070,944</u>	<u>7,289,196</u>
Mortgage-backed securities	13,313,523	13,060,928	9,947,188	10,083,638
Equity securities	130,000	130,000	-	-
Total	<u>\$ 27,382,795</u>	<u>\$ 26,894,719</u>	<u>\$ 17,018,132</u>	<u>\$ 17,372,834</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 3. Investment Securities, Continued

The following tables show gross unrealized losses and fair value of securities available-for-sale and securities held-to-maturity, aggregated by investment category, and length of time that individual securities have been in a continuous realized loss position at December 31, 2017 and 2016.

	December 31, 2017		December 31, 2016	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities Available-for-Sale				
Less Than 12 Months				
U.S. Government sponsored agencies	\$ 925,323	\$ 11,919	\$ 8,801,842	\$ 226,553
Mortgage-backed securities	<u>8,622,681</u>	<u>88,739</u>	<u>4,802,134</u>	<u>180,915</u>
Total	<u>9,548,004</u>	<u>100,658</u>	<u>13,603,976</u>	<u>407,468</u>
12 Months or More				
U.S. Government sponsored agencies	8,485,586	278,459	-	-
Mortgage-backed securities	4,181,259	166,903	-	-
Corporate bonds	-	-	<u>2,819,496</u>	<u>14,227</u>
Total	<u>12,666,845</u>	<u>445,362</u>	<u>2,819,496</u>	<u>14,227</u>
Total securities available-for-sale	<u>\$ 22,214,849</u>	<u>\$ 546,020</u>	<u>\$ 16,423,472</u>	<u>\$ 421,695</u>
Securities Held-to-Maturity				
Less Than 12 Months				
Mortgage-backed securities	\$ -	\$ -	\$ 4,100,521	\$ 91,123
Total	-	-	<u>4,100,521</u>	<u>91,123</u>
12 Months or More				
Mortgage-backed securities	<u>3,376,656</u>	<u>78,497</u>	-	-
Total	<u>3,376,656</u>	<u>78,497</u>	-	-
Total securities held-to-maturity	<u>\$ 3,376,656</u>	<u>\$ 78,497</u>	<u>\$ 4,100,521</u>	<u>\$ 91,123</u>

At December 31, 2017, twelve 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 2017, no available-for-sale securities were sold. During 2016, gross proceeds from the sale of available-for-sale securities were \$881,445. During 2016, gross gains totaled \$13,261.

At December 31, 2017 and 2016, investment securities with a par value of \$16,591,994 and \$15,299,708 and a fair market value of \$16,466,616 and \$15,220,970, respectively, were pledged as collateral to secure public deposits and borrowings.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses

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

	<u>2017</u>	<u>2016</u>
Real estate loans:		
Construction	\$ 22,889,185	\$ 21,712,531
Residential	101,809,108	84,722,824
Nonresidential	<u>103,960,522</u>	<u>93,071,267</u>
Total real estate loans	228,658,815	199,506,622
Commercial and industrial	37,246,193	32,087,777
Consumer and other	<u>67,770,245</u>	<u>56,531,932</u>
Total loans	<u>\$ 333,675,253</u>	<u>\$ 288,126,331</u>

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank which totaled \$50,787,298 and \$48,524,832 at December 31, 2017 and 2016, 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 2017 and 2016 totaled \$273,360,068 and \$330,297,866, respectively. The Company uses the same credit policies in making loans held for sale as it does for on-balance-sheet instruments. Sales commitments are to sell loans at an agreed upon price and are generally funded within 60 days.

The following is an analysis of the allowance for loan losses by class of loans for the years ended December 31, 2017 and 2016.

	<u>December 31, 2017</u>						
	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>
		<u>Construction</u>	<u>Residential</u>	<u>Non-Residential</u>			
Beginning balance	\$ 2,648,535	\$ 592,725	\$ 1,109,400	\$ 448,183	\$ 2,150,308	\$ 31,536	\$ 466,691
Provisions	-	(592,978)	(76,548)	(63,604)	(733,130)	175,374	557,756
Recoveries	371,635	184,284	53,778	14,768	252,830	78,897	39,908
Charge-offs	<u>(566,295)</u>	<u>(15,490)</u>	<u>(100,733)</u>	<u>(26,991)</u>	<u>(143,214)</u>	<u>(28,509)</u>	<u>(394,572)</u>
Ending balance	<u>\$ 2,453,875</u>	<u>\$ 168,541</u>	<u>\$ 985,897</u>	<u>\$ 372,356</u>	<u>\$ 1,526,794</u>	<u>\$ 257,298</u>	<u>\$ 669,783</u>
	<u>December 31, 2016</u>						
	<u>Total</u>	<u>Real Estate Loans</u>			<u>Total Real Estate Loans</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>
		<u>Construction</u>	<u>Residential</u>	<u>Non-Residential</u>			
Beginning balance	\$ 2,693,985	\$ 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	<u>(472,893)</u>	<u>-</u>	<u>(161,955)</u>	<u>(23,508)</u>	<u>(185,463)</u>	<u>(12,501)</u>	<u>(274,929)</u>
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>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses, Continued

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the years ended December 31, 2017 and 2016.

		December 31, 2017						
		Real Estate Loans			Total	Commercial	Consumer	
		Construction	Residential	Non-Residential	Real Estate Loans	and Industrial	and Other	
		Total						
Allowance								
Evaluated for impairment								
Individually	\$ 26,856	\$ -	\$ -	\$ -	\$ -	\$ 13,378	\$ 13,478	
Collectively	<u>2,427,019</u>	<u>168,541</u>	<u>985,897</u>	<u>372,356</u>	<u>1,526,794</u>	<u>243,920</u>	<u>656,305</u>	
Allowance for loan losses								
	<u>\$ 2,453,875</u>	<u>\$ 168,541</u>	<u>\$ 985,897</u>	<u>\$ 372,356</u>	<u>\$ 1,526,794</u>	<u>\$ 257,298</u>	<u>\$ 669,783</u>	
Total Loans								
Evaluated for impairment								
Individually	\$ 3,441,508	\$ -	\$ 1,759,518	\$ 1,480,027	\$ 3,239,545	\$ 41,101	\$ 160,862	
Collectively	<u>330,233,745</u>	<u>22,889,185</u>	<u>100,049,590</u>	<u>102,480,495</u>	<u>225,419,270</u>	<u>37,205,092</u>	<u>67,609,383</u>	
Loans receivable								
	<u>\$ 333,675,253</u>	<u>\$ 22,889,185</u>	<u>\$ 101,809,108</u>	<u>\$ 103,960,522</u>	<u>\$ 228,658,815</u>	<u>\$ 37,246,193</u>	<u>\$ 67,770,245</u>	
		December 31, 2016						
		Real Estate Loans			Total	Commercial	Consumer	
		Construction	Residential	Non-Residential	Real Estate Loans	and Industrial	and Other	
		Total						
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, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2017.

	<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					
Residential mortgages	\$ 1,759,518	\$ 1,759,518	\$ -	\$ 1,838,208	\$ 99,814
Nonresidential	<u>1,480,027</u>	<u>1,480,027</u>	-	<u>1,503,787</u>	<u>93,134</u>
Total real estate loans	3,239,545	3,239,545	-	3,341,995	192,948
Commercial and industrial	23,362	23,362	-	23,362	1,349
Consumer and other	<u>143,034</u>	<u>143,034</u>	-	<u>159,772</u>	<u>8,479</u>
Total	<u>\$ 3,405,941</u>	<u>\$ 3,405,941</u>	<u>\$ -</u>	<u>\$ 3,525,129</u>	<u>\$ 202,776</u>
With an allowance recorded:					
Commercial and industrial	\$ 17,739	\$ 17,739	\$ 13,378	\$ 19,668	\$ 899
Consumer and other	<u>17,828</u>	<u>17,828</u>	<u>13,478</u>	<u>25,084</u>	<u>1,569</u>
Total	<u>\$ 35,567</u>	<u>\$ 35,567</u>	<u>\$ 26,856</u>	<u>\$ 44,752</u>	<u>\$ 2,468</u>
Total					
Real estate					
Residential mortgages	\$ 1,759,518	\$ 1,759,518	\$ -	\$ 1,838,208	\$ 99,814
Nonresidential	<u>1,480,027</u>	<u>1,480,027</u>	-	<u>1,503,787</u>	<u>93,134</u>
Total real estate loans	3,239,545	3,239,545	-	3,341,995	192,948
Commercial and industrial	41,101	41,101	13,378	43,030	2,248
Consumer and other	<u>160,862</u>	<u>160,862</u>	<u>13,478</u>	<u>184,856</u>	<u>10,048</u>
Total	<u>\$ 3,441,508</u>	<u>\$ 3,441,508</u>	<u>\$ 26,856</u>	<u>\$ 3,569,881</u>	<u>\$ 205,244</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses, Continued

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

	<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	\$ 1,574,732	\$ 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
Consumer and other	<u>145,990</u>	<u>145,990</u>	-	<u>186,019</u>	<u>5,155</u>
Total	<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					
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>
Total	<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
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>

The following is an aging analysis of the Company's loan portfolio at December 31, 2017:

	<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	\$ -	\$ -	\$ -	\$ -	\$ 22,889,185	\$ 22,889,185	\$ -
Residential	13,517	688,983	207,230	909,370	100,899,378	101,809,108	-
Nonresidential	<u>2,282,710</u>	-	-	<u>2,282,710</u>	<u>101,677,812</u>	<u>103,960,522</u>	-
Total real estate loans	2,296,227	688,983	207,230	3,192,440	225,466,375	228,658,815	-
Consumer and industrial	371,172	-	-	371,172	36,875,021	37,246,193	-
Consumer and other	<u>229,165</u>	<u>62,691</u>	<u>77,714</u>	<u>369,570</u>	<u>67,400,675</u>	<u>67,770,245</u>	-
Total	<u>\$ 2,896,564</u>	<u>\$ 751,674</u>	<u>\$ 284,944</u>	<u>\$ 3,933,182</u>	<u>\$ 329,742,071</u>	<u>\$ 333,675,253</u>	<u>\$ -</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses, Continued

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

	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	\$ -	\$ -	\$ 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	24,029	97,571	-	121,600	92,949,667	93,071,267	-
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	277,575	73,102	51,499	402,176	56,129,756	56,531,932	-
Total	\$ 386,109	\$ 313,953	\$ 1,727,457	\$ 2,427,519	\$ 285,698,812	\$ 288,126,331	\$ -

The following is an analysis of the Company's nonaccrual loan portfolio recorded at December 31, 2017 and 2016:

	2017	2016
Real Estate		
Construction	\$ -	\$ 1,574,732
Residential	970,712	631,360
Nonresidential	-	97,571
Total real estate loans	970,712	2,303,663
Commercial and industrial	17,739	-
Consumer and other	364,274	286,925
	\$ 1,352,725	\$ 2,590,588

Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2017 and 2016:

	2017	2016
Performing TDRs	\$ 1,207,264	\$ 2,274,303
Nonperforming TDRs	519,281	1,574,732
Total TDRs	\$ 1,726,545	\$ 3,849,035

Loans classified as TDRs may be removed from this status for disclosure purposes after a specified period of time if the TDR is subsequently restructured, and the newly 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. The Company has not removed any loans from TDR status through subsequent restructurings during 2017 or 2016.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 4. Loans and Allowance for Loan Losses, Continued

The following is an analysis of TDRs identified during 2017:

	For the year ended December 31, 2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real Estate			
Residential	3	\$ 228,512	\$ 228,512
Commercial and industrial	1	8,549	8,549
Consumer and other	3	70,761	70,761

During the year ended December 31, 2017, we modified seven loans that were considered to be troubled debt restructuring. We provided rate concessions for five of these loans, and extensions for two of the loans. During the year ended December 31, 2017, one loan with an unpaid principal balance of \$8,549 as of December 31, 2017 that had previously been restructured during the year subsequently defaulted during the year.

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	2	74,372	74,372
Total real estate	5	2,012,097	2,012,097
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.

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, 2017 and 2016

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, 2017:

	<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	\$ 317,446,886	\$ 22,839,453	\$ 97,919,614	\$ 95,727,012	\$ 216,486,079	\$ 34,318,105	\$ 66,662,702
Special mention	11,278,760	49,732	2,023,889	5,656,005	7,729,626	2,886,987	662,147
Substandard	4,949,607	-	1,865,605	2,577,505	4,443,110	41,101	445,396
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 333,675,253</u>	<u>\$ 22,889,185</u>	<u>\$ 101,809,108</u>	<u>\$ 103,960,522</u>	<u>\$ 228,658,815</u>	<u>\$ 37,246,193</u>	<u>\$ 67,770,245</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, 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>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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>2017</u>	<u>2016</u>
Commitments to extend credit	\$ 43,591,232	\$ 38,247,248
Standby letters of credit	189,089	239,089

Note 5. Premises, Furniture and Equipment

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

	<u>2017</u>	<u>2016</u>
Land	\$ 6,808,794	\$ 6,808,794
Buildings	13,782,574	13,685,642
Leasehold improvements	551,498	543,087
Furniture and equipment	7,076,492	6,810,566
Construction in progress	<u>1,382,160</u>	<u>1,374,551</u>
Total	29,601,518	29,222,640
Less, accumulated depreciation	<u>(11,138,362)</u>	<u>(10,348,922)</u>
Premises and equipment, net	<u>\$ 18,463,156</u>	<u>\$ 18,873,718</u>

Depreciation expense for the years ended December 31, 2017 and 2016 amounted to \$789,440 and \$806,145, respectively.

At December 31, 2017 and 2016, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2017, 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 6. Other Real Estate Owned

Transactions in other real estate owned for the years ended December 31, 2017 and 2016 are summarized below:

	<u>2017</u>	<u>2016</u>
Beginning balance	\$ 2,870,484	\$ 2,506,733
Additions	137,540	871,490
Sales	(750,921)	(490,369)
Write downs	<u>(550,338)</u>	<u>(17,370)</u>
Ending balance	<u>\$ 1,706,765</u>	<u>\$ 2,870,484</u>

The Company recognized net gains of \$216,079 and \$11,031 on the sale of other real estate owned for the years ended December 31, 2017 and 2016, respectively.

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, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Balances, beginning of year	\$ 4,211,582	\$ 1,015,403
Additions	2,469,977	2,980,477
Change in MSR market value	<u>(323,893)</u>	<u>215,702</u>
Balances, end of year	<u>\$ 6,357,666</u>	<u>\$ 4,211,582</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, 2017, the aggregate amount of loans serviced by the Company for the benefit of others totaled \$558,339,699.

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Notes to Consolidated Financial Statements

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Note 7. Mortgage Servicing Rights, Continued

The characteristics and sensitivity analysis of the MSRs are included in the following table as of December 31, 2017 and 2016.

	<u>2017</u>	<u>2016</u>
Composition of residential loans serviced for others		
Fixed-rate mortgage loans	100.00%	100.00%
Weighted average life	8.22 years	8.95 years
Constant prepayment rate ("CPR")	11.46%	10.55%
Weighted average discount rate	9.43%	9.67%

Note 8. Derivatives

The derivative positions of the Company for the years ended December 31, 2017 and 2016 are reported as other assets and are as follows:

Derivative assets:	<u>2017</u>		<u>2016</u>	
	<u>Fair value</u>	<u>Notional value</u>	<u>Fair value</u>	<u>Notional value</u>
Mortgage loan interest rate lock commitments	\$ 226,712	\$ 19,427,832	\$ 282,949	\$ 18,015,138
Mortgage loan forward sales commitments	2,305	19,250,000	39,141	16,500,000

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, 2017, the scheduled maturities of time deposits were as follows:

<u>Maturing In</u>	<u>Amount</u>
2018	\$ 45,842,670
2019	27,392,515
2020	1,959,423
2021	736,302
2022	1,315,944
Total	<u>\$ 77,246,854</u>

Included in total time deposits at December 31, 2016 were brokered time deposits of \$9,510,000. The Company had no brokered time deposits as of December 31, 2017.

Time deposits that meet or exceed the FDIC insurance limits of \$250,000 at December 31, 2017 and 2016 were \$13,874,405 and \$17,757,192, respectively.

First Reliance Bancshares, Inc. and Subsidiary

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Note 10. Securities Sold Under Agreements To Repurchase

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

	<u>2017</u>	<u>2016</u>
Balance at December 31	\$ 13,929,651	\$ 11,088,526
Maximum month-end balance during the year	16,852,236	11,088,526
Average balance during the year	14,676,308	9,694,287
Average interest rate at the end of the year	0.45%	0.17%
Average interest rate during the year	0.47%	0.15%

At December 31, 2017 and 2016, investment securities with a par value of \$16,591,994 and \$11,310,819 and a fair market value of \$16,466,616 and \$11,259,662, respectively, were pledged as collateral for the underlying agreements.

Note 11. Advances From Federal Home Loan Bank

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

Advances maturing	Interest		
	Rate	<u>2017</u>	<u>2016</u>
Fixed rate			
March 14, 2017	0.70%	\$ -	\$ 8,000,000
January 19, 2018	1.42%	10,000,000	-
Daily rate			
January 17, 2018	1.59%	<u>12,000,000</u>	<u>-</u>
		<u>\$ 22,000,000</u>	<u>\$ 8,000,000</u>

At December 31, 2017 and 2016, the Company has pledged certain loans totaling \$50,787,298 and \$48,524,832, 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, 2017 and 2016, the Company had accrued and unpaid interest totaling \$35,739 and \$30,655, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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, 2017, remaining issuance costs to be amortized totaled \$88,037.

On July 8, 2016, the Company obtained a note with CresCom Bank in the amount of \$7,000,000. The debt bore 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 was recorded net within the note payable and to be amortized over five years. The debt was securitized by the assignment of Bank common stock. The note was paid in full during 2017.

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, 2017 and 2016.

	<u>2017</u>	<u>2016</u>
Common shares outstanding at beginning of the period	4,679,881	4,680,481
Conversion of common stock to Series D preferred stock	100	1,200
Restricted stock vested	2,212	2,200
Issuance of non-vested restricted shares	11,000	-
Issuance of common stock	3,100,893	-
Forfeiture of restricted shares	<u>(5,600)</u>	<u>(4,000)</u>
Common shares outstanding at end of the period	<u>7,887,486</u>	<u>4,679,881</u>

During 2017, the Company initiated and completed a capital raise where 3,074,195 shares of common stock were issued at \$7.20 per share for total proceeds of \$22,134,204. The Company also issued 410,499 shares of preferred stock for \$2,955,593. Costs associated with the capital raise totaled \$1,178,567, and are netted against proceeds received within the statement of shareholders' equity. In addition, the ESOP purchased 26,698 shares of common stock at \$5.86 per share during 2017 for total proceeds of \$146,450.

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 of Directors 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, 2017 and 2016

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.

On September 22, 2017, the Company issued 410,499 shares of Series E Preferred Stock ("Series E Shares"). The Series E Shares were created in conjunction with the common stock issuance. The Series E Shares have no voting rights, and are entitled to receive dividends as declared in the same per share amount as common stock.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 14. Shareholders' Equity, Continued

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, 2017, the Bank had undivided profits of \$10,804,190. 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.

Note 15. Other Operating Expense

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

	<u>2017</u>	<u>2016</u>
Advertising	\$ 261,116	\$ 201,459
Office supplies, postage and printing	294,568	274,990
Telephone	226,392	189,128
Professional fees and services	590,887	724,002
Supervisory fees and assessments	254,470	326,617
Debit and credit card expenses	852,903	970,586
Insurance expenses	252,253	316,543
Net cost of other real estate owned	451,569	92,604
Other	<u>1,619,088</u>	<u>1,332,553</u>
Total	<u>\$ 4,803,246</u>	<u>\$ 4,428,482</u>

Note 16. Income Taxes

On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act (the "2017 Tax Act"). The 2017 Tax Act includes a number of changes to existing U.S. tax laws that impact the Company, most notably a reduction of the U.S. corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017.

The Company recognized the income tax effects of the 2017 Tax Act in its 2017 financial statements in accordance with Staff Accounting Bulletin 118, which provides guidance for the application of ASC Topic 740, *Income Taxes*, in the reporting period in which the 2017 Tax Act was signed into law. As such, the Company's financial results reflect the income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is complete and provisional amounts for those specific income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is incomplete but a reasonable estimate could be determined. The Company did not identify items for which the income tax effects of the 2017 Tax Act have not been completed and a reasonable estimate could not be determined as of December 31, 2017.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 16. Income Taxes, Continued

Income tax provision for the years ended December 31, 2017 and 2016 is summarized as follows:

	<u>2017</u>	<u>2016</u>
Provision		
Current income tax expense		
Federal	\$ 30,912	\$ 35,862
State	<u>41,400</u>	<u>147,763</u>
Total current	<u>72,312</u>	<u>183,625</u>
Deferred income tax expense		
Federal	3,543,946	1,617,635
State	<u>(104,591)</u>	<u>(11,030)</u>
Total deferred	<u>3,439,355</u>	<u>1,606,605</u>
Change in valuation allowance	<u>104,591</u>	<u>11,030</u>
Total income tax expense	<u>\$ 3,616,258</u>	<u>\$ 1,801,260</u>

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

	<u>2017</u>	<u>2016</u>
Deferred tax assets:		
Allowance for loan losses	\$ 515,314	\$ 900,502
Net operating losses	4,917,421	8,190,326
Non-accrual interest	18,478	67,151
Unrealized loss on securities available for sale	153,572	119,874
Deferred compensation	433,955	673,542
Federal and state credits	-	458,427
Other real estate owned	115,571	-
Other	<u>139,463</u>	<u>124,829</u>
Gross deferred tax assets	6,293,774	10,534,651
Less, valuation allowance	<u>(323,961)</u>	<u>(219,370)</u>
Net deferred tax assets	<u>5,969,813</u>	<u>10,315,281</u>
Deferred tax liabilities:		
Accumulated depreciation	71,713	183,804
Prepaid expenses	25,141	84,145
Market to market adjustments	1,383,094	1,541,449
Other	<u>28,802</u>	<u>42,226</u>
Total gross deferred tax liabilities	<u>1,508,750</u>	<u>1,851,624</u>
Net deferred tax assets recognized	<u>\$ 4,461,063</u>	<u>\$ 8,463,657</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, 2017, 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 2017, the balance in the valuation allowance changed by \$104,591. The remaining valuation allowance relates to the parent company's state operating loss carryforwards for which realizability is uncertain.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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Note 16. Income Taxes, Continued

The Company has federal net operating losses of \$21,910,113 and \$23,450,783 for the years ended December 31, 2017 and 2016, respectively. The Company has state net operating losses of \$8,007,529 and \$6,577,572 for the years ended December 31, 2017 and 2016, respectively. In addition, the Company has Alternative Minimum Tax ("AMT") credit carryforwards which have been reclassified to taxes receivable to reflect the refundable nature of the credits under the Tax Cuts and Jobs Act.

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid. Accordingly, the Company's deferred tax assets and liabilities were remeasured to reflect the reduction in the U.S. corporate income tax rate from 34 percent to 21 percent, resulting in a \$2,666,542 increase in income tax expense for the year ended December 31, 2017 and a corresponding \$2,666,542 decrease in net deferred tax asset as of December 31, 2017.

A reconciliation between the income tax expense and the amount computed by applying the federal statutory rate of 34% to income before income taxes for the years ended December 31, 2017 and 2016 follows:

	<u>2017</u>	<u>2016</u>
Tax expense at statutory rate	\$ 995,145	\$ 1,809,877
State income tax (benefit), net of federal income tax benefit	(41,706)	90,244
Tax-exempt interest income	(40,395)	(38,454)
Disallowed interest expense	615	395
Life insurance surrender value	(111,764)	(118,787)
Impact of tax rate change	2,666,542	-
Change in valuation allowance	104,591	11,030
Other, net	<u>43,230</u>	<u>46,955</u>
Total	<u>\$ 3,616,258</u>	<u>\$ 1,801,260</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 2014 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, 2017 and 2016, the Company had related party loans totaling \$1,408,086 and \$1,624,090, respectively.

Deposits from directors and executive officers and their related interests totaled \$1,100,287 and \$2,947,072 at December 31, 2017 and 2016, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

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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, 2017, 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, 2017 and 2016 were \$564,876 and \$504,424, respectively.

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

	<u>Amount</u>
2018	\$ 500,187
2019	417,196
2020	417,196
2021	385,115
2022	385,115
Thereafter	<u>2,808,362</u>
	<u>\$ 4,913,171</u>

Note 19. Equity Incentive Plan

On January 19, 2006, the Company adopted the the 2006 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 2006 Plan. The 2006 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 2006 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 Plan expired January 19, 2016.

On April 20, 2017, the Company approved the the 2017 Plan (collectively "the Plans"). The 2017 Plan allows granting up to 500,000 shares. The maximum aggregate shares subject to options is restricted to 80,000 in any calendar year to any one participant. The aggregate number of shares subject to awards of restricted stock is restricted to 50,000 any calendar year to any one participant. Awards may be granted for a term of up to five years from the effective date of the grant.

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Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 19. Equity Incentive Plan, Continued

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 Plans, 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 Plans, the restricted shares will vest completely based on the individual grants vesting period, which is between four and seven years. The shares are forfeited entirely if the participant terminates employment for any reason other than changes in control. 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.

During 2017 and 2016, the Company issued 112,212 and 2,200 shares, respectively, of restricted stock pursuant to the 2017 and 2006 Equity Incentive Plans, respectively, as amended. As of December 31, 2017 and 2016, 461,500 and 197,100 shares, respectively, issued vest between the fourth and seventh anniversary of the date of grant, depending on the individual restricted stock grant and thus will be fully vested in 2025, subject to meeting the performance criteria of the Plan. During 2017 and 2016, 2,212 and 2,200 shares, respectively, were issued which vested during each of the respective years. The weighted-average fair value of restricted stock issued during 2017 and 2016 was \$7.00 and \$4.54 per share, respectively. During 2017 and 2016, 5,600 and 4,000 shares, respectively, were either forfeited or cancelled having a weighted average price of \$2.05. Also, during 2017 and 2016, 2,212 and 14,200 shares were exercised, respectively. The weighted-average fair value of restricted stock exercised during 2017 and 2016 was \$6.33 and \$3.32, respectively. Deferred compensation expense of \$127,659 and \$58,777 during 2017 and 2016, respectively.

During 2017, the Company issued 160,000 stock options pursuant to the 2017 Equity Incentive Plan.

The fair value of each option granted was estimated on the date of the grant using the Black-Scholes option pricing, resulting in a total expense of \$316,844. The Black-Scholes model with assumptions is presented below:

Grant date	September 25, 2017
Total number of options granted	160,000
Expected volatility	20.58%
Expected term	7 years
Expected dividend	0.00%
Risk-free rate	2.12%
Grant date fair value	7.20

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 19. Equity Incentive Plan, Continued

	<u>Options</u>	<u>Weighted- Average Grant Date Fair Value</u>	<u>Weighted- Average Exercise Price</u>
Outstanding at December 31, 2016	-	\$ -	\$ -
Granted	160,000	7.20	7.20
Exercised	-	-	-
Forfeited	-	-	-
Outstanding at December 31, 2017	160,000	7.20	7.20
Options exercisable as of December 31, 2017	-		

The Company recognized stock-based compensation costs related to stock options of \$45,403 for the year ended December 31, 2017.

As of December 31, 2017, there was \$271,441 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over the remainder of their vesting schedule.

At December 31, 2017, there were 390,000 stock awards available for grant under the 2017 Equity Incentive Plan.

Note 20. Income (Loss) Per Common Share

Net income (loss) available to common shareholders represents net income (loss) 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 (loss) per common share calculations for the years ended December 31, 2017 and 2016.

	<u>2017</u>	<u>2016</u>
Income (loss) available to common shareholders		
Net income (loss)	\$ (689,360)	\$ 3,521,908
Preferred stock dividends	-	937,848
Net income (loss) available to common shareholders	<u>\$ (689,360)</u>	<u>\$ 2,584,060</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 20. Income (Loss) Per Common Share, Continued

	<u>2017</u>	<u>2016</u>
Basic income (loss) per common share:		
Net income (loss) available to common shareholders	\$ (689,360)	\$ 2,584,060
Average common shares outstanding - basic	<u>5,465,868</u>	<u>4,438,570</u>
Basic income (loss) per common share	\$ (0.13)	\$ 0.58
Diluted income (loss) per common share:		
Net income (loss) available to common shareholders	\$ (689,360)	\$ 2,584,060
Average common shares outstanding - basic	5,465,868	4,438,570
Dilutive potential common shares	<u>-</u>	<u>115,568</u>
Average common shares outstanding - diluted	<u>5,465,868</u>	<u>4,554,138</u>
Diluted income (loss) per common share	\$ (0.13)	\$ 0.57

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 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 shareholders' 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, 2017 and 2016

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 began to be phased in incrementally over time, beginning January 1, 2016 at 0.625% and will be fully effective on January 1, 2019, and will ultimately consist of an additional amount of Tier 1 capital equal to 2.5% of risk-weighted assets.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements at December 31, 2017 and 2016.

<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, 2017						
The Bank						
Total capital (to risk-weighted assets)	\$ 44,979	12.32%	\$ 29,211	8.00%	\$ 36,514	10.00%
Tier 1 capital (to risk-weighted assets)	42,514	11.64	21,908	6.00	29,211	8.00
Tier 1 capital (to average assets)	42,514	9.50	17,893	4.00	18,257	5.00
Common Equity Tier 1 Capital (to risk-weighted assets)	42,514	11.64	16,432	4.50	23,734	6.50
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

Note 22. Unused Lines of Credit

The Bank had available at December 31, 2017 several unsecured lines of credit, which were unused, to purchase up to \$20,145,203 of federal funds from four unrelated correspondent institutions. Also, as of December 31, 2017, the Bank had the ability to borrow funds from the FHLB of up to \$136,193,400. At that date, \$22,000,000 had been advanced.

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, 2017 and 2016

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.

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, 2017 and 2016

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, 2017 and 2016, 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, 2017 and 2016

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, 2017 and 2016.

	December 31, 2017			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored agencies	\$ 9,410,909	\$ -	\$ 9,410,909	\$ -
Municipal securities	1,400,609	-	1,400,609	-
Mortgage-backed securities	13,060,928	-	13,060,928	-
Corporate bonds	2,892,273	-	2,892,273	-
Equity security	130,000	-	130,000	-
Total available-for-sale securities	<u>26,894,719</u>	-	<u>26,894,719</u>	-
Mortgage loans held for sale	7,885,938	-	7,885,938	-
Mortgage servicing rights	6,357,666	-	-	6,367,666
Derivative assets:				
Mortgage loan interest rate lock commitments	226,712	-	226,712	-
Mortgage loan forward sales commitments	2,305	-	2,305	-
	<u>\$ 41,367,340</u>	<u>\$ -</u>	<u>\$ 35,009,674</u>	<u>\$ 6,367,666</u>
	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 assets:				
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>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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, 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	4,211,582
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	2,469,977
Total net gains included in:	
Net income	<u>(323,893)</u>
Balance, December 31, 2017	<u>\$ 6,357,666</u>

The Company has no liabilities measured at fair value on a recurring 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, 2017 and December 31, 2016, 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, 2017				
Impaired loans, net specific reserve	\$ 3,414,651	\$ -	\$ -	\$ 3,414,651
Other real estate owned	<u>1,706,765</u>	<u>-</u>	<u>-</u>	<u>1,706,765</u>
Total assets at fair value	<u>\$ 5,121,416</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,121,416</u>
	<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>-</u>	<u>2,870,484</u>
Total assets at fair value	<u>\$ 8,019,006</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 8,019,006</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 23. Fair Value Measurements, Continued

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of December 31, 2017 and December 31, 2016, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value as of December 31, 2017	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans, net of specific reserve	\$ 3,414,651	Appraisal Value	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost
Other real estate owned	\$ 1,706,765	Appraisal Value/Comparison Sales/Other estimates	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost
	Fair Value as of December 31, 2016	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans, net of specific reserve	\$ 5,148,522	Appraisal Value	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost
Other real estate owned	\$ 2,870,484	Appraisal Value/Comparison Sales/Other estimates	Appraisals and/or sales of comparable properties	Appraisals discounted 10% to 20% for sales commissions and other holding cost

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 23. Fair Value Measurements, Continued

Fair Value of Financial Instruments

The following table includes the estimated fair value of the Company's financial assets and financial liabilities. The methodologies for estimating the fair value of financial assets and financial liabilities measured on a recurring and nonrecurring basis are discussed above. The methodologies for estimating the fair value for other financial assets and financial liabilities are discussed below. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgement is required to interpret market data in order to develop the estimates of fair value. Accordingly, the estimates presented below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation techniques may have a material effect on the estimated fair value amounts at December 31, 2017 and 2016.

	December 31,			
	2017		2016	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	\$ 24,630,819	\$ 24,630,819	\$ 27,097,864	\$ 27,097,864
Securities available-for-sale	26,894,719	26,894,719	17,862,635	17,862,635
Securities held-to-maturity	17,018,132	17,372,834	20,438,084	20,842,142
Loans held for sale	7,885,938	7,885,938	5,335,532	5,355,532
Loans held for investment, net	331,221,378	330,393,325	285,477,796	285,791,822
Nonmarketable equity securities	1,359,200	1,359,200	734,300	734,300
Deposits	353,094,063	354,507,494	336,535,519	336,627,827
Federal Home Loan Bank advances	22,000,000	22,013,200	8,000,000	8,000,000
Subordinated debentures	15,221,963	16,135,281	15,206,398	15,510,526
Notes payable	-	-	6,893,211	7,031,075

Cash and cash equivalents

The carrying amount approximates fair value for these instruments.

Investment securities

The fair value of investment securities are generally determined using widely accepted valuation techniques including matrix pricing and broker-quote-based applications.

Loans held for sale

Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of on-to-four family residential real estate loans originated for sale to qualified third parties. Fair value is based upon the contractual price to be received from these third parties, which may be different than cost.

Loans held for investment

Fair values are estimated for portfolios of loans with similar financial characteristics if collateral-dependent. Loans are segregated by type. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect observable market information incorporating the credit, liquidity, yield and other risks inherent in the loan. The estimate of maturity is based upon the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of the current economic and lending conditions.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

Note 23. Fair Value Measurements, Continued

Fair value for significant non-performing loans is generally based upon recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discounted rates are judgmentally determined using available market information and specific borrower information.

Nonmarketable equity securities

Nonmarketable equity securities are carried at original cost basis, as cost approximates fair value and there is no ready market for such investments.

Deposits

The fair value of deposits with no stated maturity date, such as noninterest-bearing demand deposits, savings and money market and checking accounts, is based on the discounted value of estimated cash flows. The fair value of time deposits is based upon the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Notes payable

The fair carrying value of notes payable is estimated by using discounted cash flow analyses based on incremental borrowing rates for similar types of instruments These are classified as Level 2.

Subordinated debentures

The fair value of subordinated debentures is estimated by using discounted cash flow analyses based on incremental borrowing rates for similar types of instruments These are classified as Level 2.

Federal Home Loan Bank advances

Fair value is estimated based on discounted cash flows using current market rates for borrowing with similar terms and are classified as of Level 2.

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. Effective September 25, 2017, the Company entered into a merger agreement with Independence Bancshares, Inc. headquartered in Easley, South Carolina. The merger was completed January 22, 2018. Acquisition costs as of December 31, 2017 totaled \$501,265. The following assets and liabilities were acquired as a result of the merger as of January 22, 2018 in exchange for cash of \$2,562,845 and repayment of preferred stock totaling \$8,425,000:

<u>(Unaudited)</u>	<u>January 22, 2018</u>
Total assets	\$ 88,042,893
Total liabilities	80,424,570
Total loans	53,686,229
Total deposits	80,254,665

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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

Condensed Balance Sheets

	<u>December 31,</u>	
	<u>2017</u>	<u>2016</u>
Assets		
Cash	\$ 17,814,362	\$ 2,398,475
Investment in banking subsidiary	46,161,089	45,105,360
Equity securities	130,000	30,000
Nonmarketable equity securities	58,100	58,100
Investment in trust	310,000	310,000
Deferred tax asset	1,019,787	1,122,730
Other assets	66,439	-
Total assets	<u>\$ 65,559,777</u>	<u>\$ 49,024,665</u>
Liabilities		
Notes payable	\$ -	\$ 6,893,211
Junior subordinated debentures	10,310,000	10,310,000
Subordinated debentures	4,911,963	4,896,398
Accrued interest payable	184,489	257,329
Total liabilities	15,406,452	22,356,938
Shareholders' equity	<u>50,153,325</u>	<u>26,667,727</u>
Total liabilities and shareholders' equity	<u>\$ 65,559,777</u>	<u>\$ 49,024,665</u>

Condensed Statements of Operations

	<u>For the years ended</u>	
	<u>December 31,</u>	
	<u>2017</u>	<u>2016</u>
Income		
Rental income from banking subsidiary	\$ 450	\$ 5,400
Interest income	9,296	7,711
Gain on sale of premises	-	652,367
Dividend from banking subsidiary	-	6,000,000
Total income	<u>9,746</u>	<u>6,665,478</u>
Expenses		
Salaries and employee benefits	169,427	-
Equipment expense	19,034	-
Interest expense	922,867	672,023
Other expenses	104,712	327,705
Acquisition-related costs	501,265	-
Total expenses	<u>1,717,305</u>	<u>999,728</u>
Income (loss) before income taxes and equity in undistributed income (losses) of banking subsidiary	(1,707,559)	5,665,750
Equity in undistributed earnings (losses) of banking subsidiary	<u>1,121,142</u>	<u>(2,257,487)</u>
Net income (loss) before income taxes	(586,417)	3,408,263
Income tax expense (benefit)	<u>102,943</u>	<u>(113,645)</u>
Net (loss) income	<u>\$ (689,360)</u>	<u>\$ 3,521,908</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

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

Condensed Statements of Cash Flows

	For the years ended	
	December 31,	
	2017	2016
Cash flows from operating activities		
Net income (loss)	\$ (689,360)	\$ 3,521,908
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of premises	-	(652,367)
Deferred income tax (expense) benefit	102,943	(113,645)
Increase (decrease) in stock compensation	(606,246)	64,328
(Decrease) increase in accrued interest payable	(72,840)	232,671
Increase in other assets	(66,439)	-
Decrease in other liabilities	-	(9,475)
Net equity in undistributed (earnings) losses of banking subsidiary	<u>(1,121,142)</u>	<u>2,257,487</u>
Net cash (used) provided by operating activities	<u>(2,453,084)</u>	<u>5,300,907</u>
Cash flows from by investing activities		
Purchase of securities available for sale	(100,000)	-
Proceeds from sale of premises	-	<u>4,307,979</u>
Net cash (used) provided by investing activities	<u>(100,000)</u>	<u>4,307,979</u>
Cash flows from financing activities		
Net (decrease) increase in notes payable	(6,893,211)	4,172,779
Payment of dividend on preferred stock	-	(937,848)
Net proceeds from issuance of common stock	21,901,762	1,675
Net increase (redemption) of preferred stock	2,955,593	(15,946,709)
(Decrease) increase in subordinated debentures	-	4,888,550
Accretion of debt issuance costs	15,565	7,848
Purchase of treasury stock	<u>(10,738)</u>	<u>(1,876)</u>
Net cash provided (used) by financing activities	<u>17,968,971</u>	<u>(7,815,581)</u>
Increase in cash	15,415,887	1,793,305
Cash and cash equivalents, beginning of year	<u>2,398,475</u>	<u>605,170</u>
Cash and cash equivalents, ending of year	<u>\$ 17,814,362</u>	<u>\$ 2,398,475</u>



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