

DRIVEN
BY
OUR
PURPOSE

2019 ANNUAL REPORT


FIRST RELIANCE[®]
BANCSHARES

TO OUR SHAREHOLDERS

I am pleased to report that our company had an exceptional year, highlighted by outstanding financial performance, the addition of key team members and significant progress toward strategic initiatives. Our achievements are a testament to our vision for the company, our ability to execute our long-term plan, and our commitment to shareholder value. We are extremely well-positioned for the future in spite of the recent economic impact from the coronavirus.



Much of our success can be attributed to the tireless commitment of our associates, who focus their efforts every day on our core purpose, which is “to make the lives of our customers better.” By putting our customers first, we continue to set ourselves apart from our competitors, providing intangible benefits that go beyond dollars and cents. We continue to be recognized for our excellent corporate culture as evidenced by our being named one of the Best Places to Work in South Carolina for the 14th consecutive year!

In our 20-year history, 2019 was pivotal. We began to realize the benefits of our Greenville acquisition, as well as our expansions into Winston-Salem, Myrtle Beach and the Lake Norman area - all of which helped us grow total assets by 13% to \$661.6 million. Although we are excited about our success, we recognize that we have significant challenges ahead, including economic uncertainty, increased competition, and an ever-complex regulatory environment. We are well positioned to meet these challenges and continue to achieve our goals of growth, profitability and efficiency.

Our Markets

The markets we serve are one of our greatest strengths. We now have banking operations in three of the fastest growing metropolitan statistical areas (MSA) in the United States (Myrtle Beach, Charleston and Charlotte).

Our Myrtle Beach market grew loans this year by \$15 million and deposits by \$8 million. We are finalizing our plans for a new Myrtle Beach branch on Grissom Parkway that will be constructed in 2020.

The investment we made in North Carolina last year continues to pay off as the market grew loans by \$40 million and deposits by \$9 million. We will relocate our Winston-Salem branch to a new expanded, full-service location, which will better position us for growth. We are also looking for branch sites in the Lake Norman area.

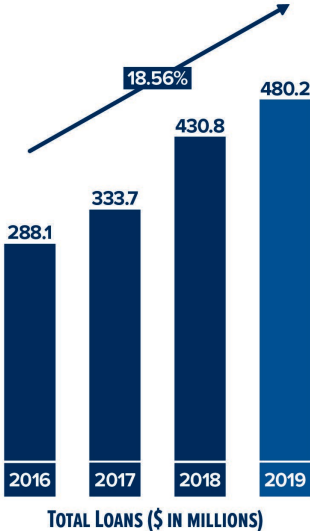
Financial Strength

Net Income

Net income for 2019 grew \$4.1 million or \$0.51 per diluted share compared to \$0.31 per diluted share for the same period a year ago, a 65% increase. That was despite a one-time mortgage servicing rights (MSR) valuation adjustment totaling \$1.1 million, and a declining rate environment which saw a 75% basis point decline in interest rates by the Federal Reserve in the second part of the year.

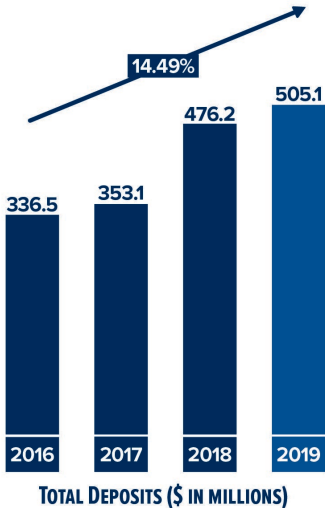
Loan Growth

We had an exceptional year of loan growth in both our new and existing markets, growing loans by \$49.3 million, 11.4% overall, in a highly competitive market. Most of this loan growth came organically through our commercial, mortgage and consumer loan portfolios. Total loans grew to \$480,185,395. While loans increased, our asset quality remained strong with non-performing assets declining overall by \$451,000 to 0.28% compared to 0.39% a year ago.



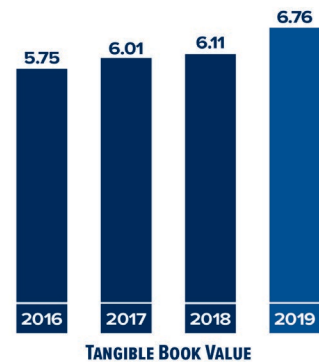
Deposit Growth

Total deposits increased 6.1% to \$505.1 million while growing our non-interest bearing transaction accounts by 33%. We intentionally reduced our exposure to higher cost deposits during the second half of the year to lower our cost of funds going into 2020.



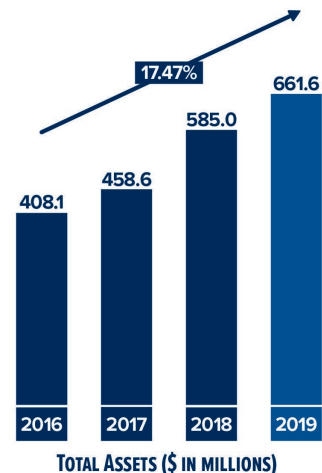
Tangible Book Value

One of the best measures of our success in building value for our shareholders is tangible book value per share. In 2019, we successfully grew tangible book value per share by 10.6% or \$6.76. This reflects the strong underlying performance of our business.



Assets

We achieved double-digit asset growth in 2019, with assets growing by \$76.6 million, or 13.1% to \$661.6 million. Our sales and marketing efforts have been laser focused this year on winning the main checking account for consumers and businesses. Treasury services saw double-digit growth in commercial deposit accounts and treasury service products. Our average services per household are now 5.6, which is a good indication that our customers are doing more business with us overall and like our brand of banking.



Our Mortgage Business

Mortgage production in 2019 was robust. With a favorable mortgage rate environment, production totaled \$363 million, which exceeded our forecast by \$100 million. We expect favorable rates to continue into 2020 and for the refinance market to heat up, which should bode well for our mortgage production team.

Our People

Another key indicator of our success and momentum is our ability to attract and recruit talented and experienced people to our team. This year we welcomed Robert Dozier as our Executive Vice President and Chief Banking Officer. Robert has over 30 years of financial service experience. He

most recently served as Executive Vice President and Chief Business Officer at the Federal Home Loan Bank of Atlanta (FHLBA) where he oversaw Sales, Corporate Communications, Community Investment Services, Government Relations and Financial Operations Management. The FHLBA is a \$135 billion dollar wholesale bank owned by 850 financial service institutions throughout the Southeast. He will be responsible for the bank's commercial platform, corporate strategy and strategic market expansion of our footprint.

In addition, Brent Mackie joined us as our Regional Executive Midlands. Brenton has more than 30 years of banking experience having previously served as Regional President and Senior Vice President for South State Bank, where he managed and supported the commercial, consumer, mortgage and wealth management lines of business.

Most recently, we announced that Frank Bullard has joined us as Market President for Charleston, SC. Frank is responsible for the strategic market expansion of our footprint in the Charleston market, and he will oversee sales management and community development throughout that footprint. Frank has more than 37 years of experience in the banking industry. He began his career in BB&T's Management Development Program in 1981 and has served in retail and commercial banking roles in both Carolinas.

He was Market President for the Charleston/Coastal markets prior to his retirement in 2019. Frank has had an incredible banking career, and we are honored and excited that he is willing to come out of retirement to assist First Reliance Bank as we continue our progress in the Charleston region.

We are excited about all of the new opportunities these talented and highly experienced bankers add to our team. As the banking industry continues to evolve, will continue to seek out and recruit the very best people available and continue to strengthen our team.

Commitment to Technology

Technology continues to be a hot topic in the banking world. As we look to 2020 and beyond, it is clear that we are undergoing a period of transformative change in the way consumers behave and use technology. Customer expectations of a bank's technology platform continue to rise. The big four continue to invest heavily in consumer-facing technology to win the retail-banking customer. Many community banks are handcuffed with old technology provided by their core operating systems. Much of this technology is outdated and inferior to what the larger banks are now offering. Although building personal relationships in the communities we serve will continue to be our top priority, we have made the commitment to pursue best-in-class technology solutions for our customers and not be locked into any one provider. This will allow us the flexibility to offer innovative solutions and an excellent experience to our customers. We have already begun to vet options and plan to roll out significant enhancements in 2020.



Our Brand

We understand the important role that community banks play in the communities they serve. With many of our community bank competitors being acquired by larger banks in 2019, we believe that our brand has the unique opportunity to fill the voids left in our markets. We are still small enough to properly serve the community banking needs of individuals and small businesses in our local markets, and yet big enough to have the resources that will best enable our customers to succeed.

Our customers love our brand and the way we do business. 90% of our customers indicating that they are satisfied with their level of service and 81% stating that they are likely to recommend us to their friends and family. In 2019 we leveraged new digital platforms to enhance our brand awareness, which significantly helped us to grow our non-interest bearing transaction accounts. We plan to continue this effort in 2020.



A New World

As we look ahead to 2020 our world is experiencing unprecedented disruption because of COVID-19. Americans and people around the world are being asked and/or forced to shelter in place, social distance themselves and avoid unnecessary travel. Our global economic outlook is uncertain. But what is certain is that many of our customers and our communities are being negatively impacted. As a result, we have stepped up to help.

We are proactively calling our business customers to check in on them and invite help. We have initiated community-wide efforts to support local restaurants, teachers and healthcare workers, and we stand ready to provide more help where needed. As difficult and uncertain as the road before us might be, we have never been more prepared to help make the lives of our customers BETTER.

The year ahead will be full of new challenges. However, through strong leadership, our fully engaged team of associates and our focus on results, we have never been better positioned for success. Thank you for the support you show our associates, our bank and me.

Thank You and Best Regards,

A handwritten signature in black ink, appearing to read "Rick Saunders".

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

First Reliance Bancshares, Inc. and Subsidiary

Report on Consolidated Financial Statements

For the years ended December 31, 2019 and 2018

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 its Subsidiary which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements (collectively, "the financial statements").

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 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 financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of First Reliance Bancshares, Inc. and its Subsidiary as of December 31, 2019 and 2018, and the results of its operations and its 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 31, 2020

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Balance Sheets
As of December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$ 12,945,355	\$ 4,638,332
Interest-bearing deposits with other banks	27,395,328	29,923,656
Total cash and cash equivalents	<u>40,340,683</u>	<u>34,561,988</u>
Time deposits in other banks	253,911	253,003
Marketable equity securities	30,895	168,151
Securities available-for-sale	35,684,146	33,388,645
Securities held-to-maturity (fair value of \$10,746,649, and \$14,250,850 at December 31, 2019 and 2018, respectively)	10,417,168	14,107,252
Nonmarketable equity securities	<u>2,423,200</u>	<u>1,393,500</u>
Total investment securities	<u>48,555,409</u>	<u>49,057,548</u>
Mortgage loans held for sale	27,901,419	12,713,361
Loans receivable	480,185,395	430,795,891
Less allowance for loan losses	<u>(3,529,855)</u>	<u>(2,788,188)</u>
Loans, net	<u>476,655,540</u>	<u>428,007,703</u>
Premises, furniture and equipment, net	20,420,506	20,310,879
Accrued interest receivable	1,473,581	1,318,104
Other real estate owned	347,552	341,519
Cash surrender value life insurance	17,692,385	17,306,312
Net deferred tax assets	6,579,640	7,923,572
Mortgage servicing rights	11,022,638	9,023,859
Core deposit intangibles	513,035	684,217
Goodwill	690,917	690,917
Right of use asset	5,669,144	-
Other assets	<u>3,496,549</u>	<u>2,796,830</u>
Total assets	<u>\$ 661,612,909</u>	<u>\$ 584,989,812</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	\$ 137,312,316	\$ 103,201,256
Interest-bearing transaction accounts	89,168,078	83,251,127
Savings	120,472,195	120,801,341
Time deposits \$250,000 and over	36,317,110	42,870,456
Other time deposits	<u>121,817,938</u>	<u>126,044,529</u>
Total deposits	<u>505,087,637</u>	<u>476,168,709</u>
Securities sold under agreement to repurchase	14,637,332	16,852,981
Advances from Federal Home Loan Bank	43,300,000	20,000,000
Federal Funds Purchased	16,500,000	-
Subordinated debentures	4,965,214	4,934,877
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	416,302	447,883
Lease liability	5,701,327	-
Other liabilities	<u>3,609,637</u>	<u>4,106,913</u>
Total liabilities	<u>604,527,449</u>	<u>532,821,363</u>
Shareholders' Equity		
Preferred stock		
Series D non-cumulative preferred stock, no par value; 572 and 581 shares issued and outstanding at December 31, 2019 and 2018, respectively	572	581
Common stock, \$0.01 par value; 20,000,000 shares authorized, 8,033,579 and 8,002,172 shares issued and outstanding at December 31, 2019 and 2018, respectively	80,336	80,022
Non voting common stock, \$0.01 par value; 430,000 shares authorized, 410,499 and 410,499 shares issued and outstanding at December 31, 2019 and 2018, respectively	4,105	4,105
Capital surplus	51,136,879	50,904,763
Treasury stock, at cost, 183,591 and 94,505 shares at December 31, 2019 and 2018, respectively	(1,283,469)	(624,120)
Nonvested restricted stock	(1,253,706)	(1,508,630)
Retained earnings	8,092,455	4,003,616
Accumulated other comprehensive income (loss)	<u>308,288</u>	<u>(691,888)</u>
Total shareholders' equity	<u>57,085,460</u>	<u>52,168,449</u>
Total liabilities and shareholders' equity	<u>\$ 661,612,909</u>	<u>\$ 584,989,812</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Operations
For the years ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Interest income:		
Loans, including fees	\$ 26,189,861	\$ 22,010,885
Investment securities:		
Taxable	1,197,956	1,039,259
Tax exempt	136,964	147,950
Other interest income	<u>329,038</u>	<u>426,598</u>
Total	<u>27,853,819</u>	<u>23,624,692</u>
Interest expense:		
Time deposits	4,071,602	2,191,437
Other deposits	562,913	534,572
Other interest expense	<u>1,322,522</u>	<u>964,475</u>
Total	<u>5,957,037</u>	<u>3,690,484</u>
Net interest income	21,896,782	19,934,208
Provision for loan losses	<u>983,803</u>	<u>510,356</u>
Net interest income after provision for loan losses	<u>20,912,979</u>	<u>19,423,852</u>
Noninterest income:		
Service charges on deposit accounts	1,681,812	1,597,211
Income from mortgage operations	6,900,740	4,813,820
Income from bank owned life insurance	386,073	390,557
Gain on sale of investment securities	37,245	800,000
Mortgage servicing rights fair value adjustment	(1,307,299)	324,840
Other service charges, commissions, and fees	1,548,202	1,510,405
Other	<u>456,192</u>	<u>487,529</u>
Total	<u>9,702,965</u>	<u>9,924,362</u>
Noninterest expenses:		
Salaries and benefits	15,369,271	15,373,131
Occupancy	2,376,794	2,227,135
Furniture and equipment related expenses	1,821,523	2,021,351
Acquisition-related costs	-	1,005,195
Other	<u>5,706,284</u>	<u>5,549,562</u>
Total	<u>25,273,872</u>	<u>26,176,374</u>
Income before income taxes	<u>5,342,072</u>	<u>3,171,840</u>
Income tax expense	1,253,233	741,606
Net income	<u>\$ 4,088,839</u>	<u>\$ 2,430,234</u>
Average common shares outstanding, basic	7,937,617	7,738,547
Average common shares outstanding, diluted	8,062,486	7,867,586
Income per common share:		
Basic income per common share	\$ 0.52	\$ 0.31
Diluted income per common share	0.51	0.31

See Notes to Consolidated Financial Statement

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income
For the years ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Net income	\$ 4,088,839	\$ 2,430,234
Other comprehensive loss, net of tax:		
Securities available-for-sale		
Unrealized holding losses arising during the period	1,373,026	(449,738)
Income tax benefit	<u>(336,391)</u>	<u>67,265</u>
Net of income taxes	<u>1,036,635</u>	<u>(382,473)</u>
Securities held-to-maturity		
Amortization of net unrealized gains		
capitalized on securities transferred from available-for-sale	(49,616)	(14,987)
Income tax benefit	<u>13,157</u>	<u>3,680</u>
Net of income taxes	<u>(36,459)</u>	<u>(11,307)</u>
Other comprehensive income (loss)	<u>1,000,176</u>	<u>(393,778)</u>
Comprehensive income	<u>\$ 5,089,015</u>	<u>\$ 2,036,454</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, 2019 and 2018

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Treasury Stock</u>	<u>Nonvested Restricted Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
Balance, December 31, 2017	\$ 2,956,192	\$ 78,875	\$ 46,941,229	\$ (229,844)	\$ (868,399)	\$ 1,573,382	\$ (298,110)	\$ 50,153,325
Net income	-	-	-	-	-	2,430,234	-	2,430,234
Other comprehensive loss, net of tax	-	-	-	-	-	-	(393,778)	(393,778)
Conversion of Preferred Stock - Series E to Common Stock	(2,955,593)	4,105	2,951,488	-	-	-	-	-
Conversion of Preferred Stock - Series D to Common Stock	(18)	18	-	-	-	-	-	-
Net issuance of Common Stock	-	1,129	954,314	-	-	-	-	955,443
Net change in restricted stock	-	-	-	-	(640,231)	-	-	(640,231)
Stock based compensation	-	-	57,732	-	-	-	-	57,732
Purchase of Treasury Stock	-	-	-	(394,276)	-	-	-	(394,276)
Balance, December 31, 2018	581	84,127	50,904,763	(624,120)	(1,508,630)	4,003,616	(691,888)	52,168,449
Net income	-	-	-	-	-	4,088,839	-	4,088,839
Other comprehensive income, net of tax	-	-	-	-	-	-	1,000,176	1,000,176
Conversion of Preferred Stock - Series D to Common Stock	(9)	9	-	-	-	-	-	-
Net issuance of Common Stock	-	305	173,432	-	-	-	-	173,737
Net change in restricted stock	-	-	-	-	254,924	-	-	254,924
Stock based compensation	-	-	58,684	-	-	-	-	58,684
Purchase of Treasury Stock	-	-	-	(659,349)	-	-	-	(659,349)
Balance, December 31, 2019	<u>\$ 572</u>	<u>\$ 84,441</u>	<u>\$ 51,136,879</u>	<u>\$ (1,283,469)</u>	<u>\$ (1,253,706)</u>	<u>\$ 8,092,455</u>	<u>\$ 308,288</u>	<u>\$ 57,085,460</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the years ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Cash flows from operating activities:		
Net income	\$ 4,088,839	\$ 2,430,234
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	983,803	510,356
Depreciation and amortization expense	814,612	900,631
Gain on fair value of marketable equity securities	(13,410)	(38,151)
Discount accretion and premium amortization	60,105	97,010
Discount accretion on purchased loans	277,741	206,394
Amortization of lease liability	491,586	-
Net gain on sale of other real estate owned	(27,676)	(203,685)
Gain on investment securities	(23,834)	(800,000)
Write down of other real estate owned	500	-
Originations of mortgages held for sale	(362,990,674)	(262,987,343)
Proceeds from sales of mortgages held for sale	353,530,732	263,027,079
Gain on sale of mortgage loans	(5,728,116)	(4,867,159)
Core deposit intangible amortization	171,182	195,783
Deferred income taxes, net of allowance	1,020,697	670,812
Increase in interest receivable	(155,477)	(94,058)
Increase (decrease) in interest payable	31,581	177,054
Increase in cash surrender value of life insurance	(386,073)	(390,557)
Stock based compensation expense	58,684	57,732
(Increase) decrease in other assets	(712,875)	650,503
Increase in mortgage servicing rights, net	(1,998,779)	(2,666,193)
Decrease in other liabilities	<u>(497,277)</u>	<u>(40,053)</u>
Net cash used in operating activities	<u>(11,004,129)</u>	<u>(3,163,611)</u>
Cash flows from investing activities:		
Purchases of securities available-for-sale	(8,289,581)	(9,947,760)
Maturities of securities available-for-sale	5,840,439	13,148,433
Maturities of securities held-to-maturity	3,643,639	2,854,814
Proceeds on sales of securities available-for-sale	1,485,000	-
Proceeds from sale of marketable equity securities	153,332	-
Purchase of trust preferred security	-	(2,300,000)
Proceeds from sale of trust preferred security	-	3,100,000
Net increase in nonmarketable equity securities	(1,029,700)	(34,300)
Net (increase) decrease in time deposits in other banks	(908)	4,349,017
Net increase in loans receivable	(50,092,638)	(44,964,315)
Purchases of premises, furniture and equipment	(990,793)	(1,139,657)
Proceeds from disposal of premises, furniture and equipment	66,554	-
Net cash from acquisition of Independence Bancshares, Inc.	-	2,118,594
Proceeds from sale of other real estate owned	<u>204,400</u>	<u>2,618,946</u>
Net cash used in investing activities	<u>(49,010,256)</u>	<u>(30,196,228)</u>

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows
For the years ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Cash flows from financing activities:		
Net increase (decrease) in demand deposits, interest-bearing transaction accounts and savings accounts	39,698,865	(20,352,894)
Net (decrease) increase in certificates of deposit and other time deposits	(10,779,937)	63,189,511
Net increase (decrease) in advances from Federal Home Loan Bank	23,300,000	(2,000,000)
Net increase in federal funds purchased	16,500,000	-
Net increase in securities sold under agreements to repurchase	(2,215,649)	2,923,330
Net proceeds from issuance of common stock	173,737	955,443
Decrease of restricted stock	(254,924)	(640,231)
Accretion of debt issuance costs	30,337	22,914
Purchase of treasury stock	(659,349)	(394,276)
Net cash provided by financing activities	<u>65,793,080</u>	<u>43,703,797</u>
Net increase cash and cash equivalents	5,778,695	9,931,169
Cash and cash equivalents, beginning of year	<u>34,561,988</u>	<u>24,630,819</u>
Cash and cash equivalents, end of year	<u>\$ 40,340,683</u>	<u>\$ 34,561,988</u>
Cash paid during the year for:		
Income taxes	\$ (44,786)	\$ 8,448
Interest	5,988,618	3,496,280
Supplemental noncash investing and financing activities:		
Transfer from loans to other real estate owned	\$ 183,257	\$ 395,565
Net change in unrealized gains (losses) on investment securities	1,000,176	(393,778)
Initial recognition of right-of-use asset	6,192,913	-
Initial recognition of lease liability	6,192,913	-

See Notes to Consolidated Financial Statements

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

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 and North 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 and North Carolina. At December 31, 2019 and 2018, 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, 2019 and 2018

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.

Debt Securities Available-for-Sale:

Debt securities available-for-sale are carried at amortized cost and adjusted to fair 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.

Debt 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.

Marketable Equity Securities:

Marketable equity securities are carried at fair value, with changes in fair value recorded through the consolidated statements of operations. Dividends received on marketable equity securities are included as a separate component of interest income.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Nonmarketable Equity Securities:

At December 31, 2019 and 2018, nonmarketable equity securities consist of the following:

	<u>2019</u>	<u>2018</u>
Federal Home Loan Bank stock	\$ 2,365,100	\$ 1,335,400
Community Bankers Bank stock	<u>58,100</u>	<u>58,100</u>
Total	<u>\$ 2,423,200</u>	<u>\$ 1,393,500</u>

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 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 collectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for Loan Losses, continued:

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.

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 consolidated statements of operations 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, 2019 and 2018

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 in 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 on the consolidated statements of operations.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Core Deposit Intangible:

As a result of an acquisition, the Company may recognize an intangible asset representing the estimated value of core deposits assumed. The Company amortizes the intangible assets over their estimated useful lives. Core deposit intangibles are periodically reviewed for reasonableness and are evaluated for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable.

Goodwill:

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in a business combination. Goodwill is not amortized but tested for impairment on an annual basis, or more often, if events or circumstances indicate there may be impairment. Goodwill impairment exists when a reporting unit's carrying value of goodwill exceeds its implied fair value. Authoritative guidance governing the testing of indefinite lived intangible assets for impairment allows the option to first assess Goodwill by utilizing qualitative factors in determining if it is more likely than not that carrying value exceeds fair value. If, through this analysis, it is determined that it is more likely than not that carrying value exceeds fair value, then the next step requires estimation of the fair value of the reporting unit by quantitative assessment. If the fair value of the reporting unit exceeds its carrying value, no further testing is required. If the carrying value exceeds the fair value, further analysis is required to determine whether an impairment charge must be recorded based upon the implied fair value of goodwill and, if so, the amount of such charge. The Company has performed the annual impairment analysis as of December 31, 2019 and concluded no impairment exists.

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 mortgage loans previously sold to investors due to loan nonperformance. At December 31, 2019, the Company had \$0, recorded for potential indemnifications to other third-party purchasers based on management's analysis.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

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 \$200,187 and \$306,278 were included in the Company's results of operations for 2019 and 2018, respectively.

Retirement Benefits:

A trusted retirement savings plan is sponsored by the Company and provides retirement benefits to substantially all officers and employees who meet certain age and service requirements. The plan includes a "salary reduction" feature pursuant to Section 401(k) of the Internal Revenue Code. In 2004, the Company converted the 401(k) plan to a 404(c) plan. The 404(c) plan changes investment alternatives to include the Company's stock. Under the plan and present policies, participants are permitted to make contributions up to 15% of their annual compensation. At its discretion, the Company can make matching contributions up to 6% of the participants' compensation. The Company charged \$242,670 and \$273,094 to earnings for the retirement savings plan in 2019 and 2018, respectively. In addition, the Company made an elective contribution to the retirement savings plan during 2019 and 2018 totaling \$154,384 and \$142,952, respectively, recorded within salaries and 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 2019 and 2018, the supplemental retirement expense was \$169,881 and \$157,905. The current accrued but unfunded amount is \$2,054,855 and \$1,899,641 at December 31, 2019 and 2018, 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 \$17,692,385 and \$17,306,312 at December 31, 2019 and 2018, respectively.

The Company has split-dollar life insurance arrangements with certain of its officers. At December 31, 2019 and 2018, the split-dollar liability relating to these arrangements totaled \$365,200 and \$343,718, respectively. For 2019 and 2018, the Company recognized net expenses of \$21,482 and \$20,221, respectively, related to these arrangements and recorded within salaries and benefits expense.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

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 21.

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, 2019 and 2018, the ESOP owned 497,684 and 487,820 shares of the Company's common stock with an estimated value of \$3,153,877 and \$2,169,854, respectively. All of these shares were allocated to participants.

Income Per Common Share:

Basic income per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and similar share-based compensation instruments and are determined using the treasury stock method (see Note 22).

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

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.

Business Combinations and Method of Accounting for Loans Acquired:

The Company accounts for its acquisitions under Financial Accounting Standards Board (“FASB”) ASC Topic 805, “*Business Combinations*,” which requires the use of the acquisition method of accounting. All identifiable assets acquired, including loans, are recorded at fair value. No allowance for loan losses related to acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding credit risk. Loans acquired are recorded at fair value in accordance with the fair value methodology prescribed in FASB ASC Topic 820, “*Fair Value Measurements and Disclosures*.”

Purchased credit-impaired loans (“PCI”) are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality, found in FASB Accounting Standards Codification Topic 310-30, “*Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality*,” formerly American Institute of Certified Public Accountants (“AICPA”) Statement of Position (“SOP”) 03-3, “*Accounting for Certain Loans or Debt Securities Acquired in a Transfer*,” and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loans. Loans acquired in business combinations with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be PCI loans. Evidence of credit quality deterioration as of purchase dates may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. The Company considers expected prepayments and estimates the amount and timing of expected principal, interest and other cash flows for each loan or pool of loans meeting the criteria above, and determines the excess of the loan’s scheduled contractual principal and contractual interest payments over all cash flows expected to be collected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount, representing the excess of the loan’s or pool’s cash flows expected to be collected over the fair value for the loan or pool of loans, is accreted into interest income over the remaining life of the loan or pool (accretable difference). Subsequent to the acquisition date, increases in cash flows expected to be received in excess of the Company’s initial estimates are reclassified from nonaccretable difference to accretable difference and are accreted into interest income on a level-yield basis over the remaining life of the loan. Decreases in cash flows expected to be collected are recognized as impairment through the provision for loan losses.

Acquired non-PCI loans are recorded at their initial fair value and adjusted for subsequent advances, pay downs, amortization or accretion of any premium or discount on purchase, charge-offs and additional provisioning that may be required.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements:

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2022. 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. The Company is evaluating the impact of the ASU on the consolidated financial statements. The Company expects the ASU will have no material 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 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 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. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company did not experience a material effect on its financial statements.

In August 2018, the FASB amended the Fair Value Measurement Topic of the Accounting Standards Codification. The amendments remove, modify, and add certain fair value disclosure requirements based on the concepts in the FASB Concepts Statement, Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this ASU and delay adoption of the additional disclosures until their effective date. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2018, the FASB issued guidance to amend the Financial Instruments—Credit Losses topic of the Accounting Standards Codification. The guidance aligns the implementation date of the topic for annual financial statements of nonpublic companies with the implementation date for their interim financial statements. The guidance also clarifies that receivables arising from operating leases are not within the scope of the topic, but rather, should be accounted for in accordance with the leases topic. The amendments will be effective for the Company for reporting periods beginning after December 15, 2022. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company is currently in the process of evaluating the impact of adoption of this guidance on the financial statements.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Accounting Pronouncements, continued:

In May 2019, the FASB issued guidance to provide entities with an option to irrevocably elect the fair value option, applied on an instrument-by-instrument basis for eligible instruments, upon adoption of ASU 2016-13, Measurement of Credit Losses on Financial Instruments. The amendments 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 November 2019, the FASB issued guidance to defer the effective dates for private companies, not-for-profit organizations, and certain smaller reporting companies applying standards on current expected credit losses (CECL). The new effective dates will be fiscal years beginning after December 15, 2022 including interim periods within those fiscal years. The Company is currently in the process of evaluating the impact of adoption of this guidance on its financial statements.

In November 2019, the FASB issued guidance that addresses issues raised by stakeholders during the implementation of ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments affect a variety of Topics in the Accounting Standards Codification. For entities that have not yet adopted the amendments in ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2022 including interim periods within those fiscal years. Early adoption is permitted in any interim period as long as an entity has adopted the amendments in ASU 2016-13. The Company does not expect these amendments to have a material effect on its financial statements.

In December 2019, the FASB issued guidance to simplify accounting for income taxes by removing specific technical exceptions that often produce information investors have a hard time understanding. The amendments also improve consistent application of and simplify GAAP for other areas of Topic 740 by clarifying and amending existing guidance. The amendments are effective for fiscal years beginning after December 15, 2020, 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.

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

Risks and Uncertainties:

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

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

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 1. Summary of Significant Accounting Policies, Continued

Reclassifications:

Certain captions and amounts in the 2018 consolidated financial statements were reclassified to conform with the 2019 presentation. The reclassifications did not have an impact on net income or shareholders' equity.

Note 2. Mergers and Acquisitions

On January 22, 2018, the Company acquired the outstanding common stock of Independence Bancshares, Inc. and its subsidiary, Independence Bank (collectively "INB") which are headquartered in Greenville, South Carolina. In connection with the acquisition, the Company acquired \$82.3 million of assets and assumed \$80.4 million of liabilities. The total purchase price was \$2.5 million consisting of cash.

The INB transaction was accounted for using the acquisition method of accounting, and accordingly, assets acquired, liabilities assumed, and consideration exchanged were recorded at fair value on the acquisition date. Fair values are subject to refinement for up to a year.

The following table presents the assets acquired and liabilities assumed as of January 22, 2018, as recorded by the Company on the acquisition date and initial fair value adjustments:

	As Recorded by INB	Fair Value Adjustments	As Recorded by the Company
Assets			
Cash and cash equivalents	\$ 4,681,439	\$ -	\$ 4,681,439
Investment securities	10,436,646	(110,297)	10,326,349
Certificates of deposit with other institutions	4,500,000	-	4,500,000
Loans	54,976,229	(2,454,693)	52,521,536
Allowance for Loan Losses	(1,290,000)	1,290,000	-
Premises and equipment	1,953,390	(412,599)	1,540,791
Core Deposit Intangible	-	880,000	880,000
Other Real Estate Owned	1,178,900	(524,450)	654,450
Deferred Tax Asset	-	4,066,293	4,066,293
Other assets	3,218,853	(106,152)	3,112,701
Total assets	\$ 79,655,457	\$ 2,628,102	\$ 82,283,559
Liabilities			
Deposits	\$ 80,336,319	\$ (98,290)	\$ 80,238,029
Other Liabilities	173,602	-	173,602
Total liabilities	80,509,921	(98,290)	80,411,631
Net assets acquired over liabilities assumed			\$ 1,871,928
Consideration:			
Cash exchanged			\$ 2,562,845
Goodwill			\$ 690,917

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 2. Mergers and Acquisitions, Continued

The merger included the acquisition of \$54.9 million in loans and \$80.3 million in deposits. The loan portfolio was purchased at a \$2.5 million discount. The deposits were purchased for a premium, including an \$880,000 core deposit intangible. The amortization of the core deposit intangible is based on the cash flows used to value the asset over approximately nine years utilizing sum of years' digits methodology

The consideration paid exceeded the fair value of the identifiable assets and liabilities acquired and resulted in the establishment of goodwill in the amount of \$690,917, representing the intangible value of INB's business within the markets it served.

Merger-related charges related to the INB acquisition during 2018 totaled \$1,005,195, and were recorded in the consolidated statements of operations. These merger-related expenses include legal, accounting, auditing, investment banker, travel, and other costs associated with closing the acquisition.

Note 3. 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, 2019 and 2018, this requirement was \$7,158,000 and \$5,395,000, respectively, net of vault cash and balances on deposit with the Federal Reserve.

Note 4. Investment Securities

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

	Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
December 31, 2019				
U.S. Government sponsored agencies	\$ 10,734,597	\$ 272,415	\$ 68,328	\$ 10,938,684
Municipal securities	1,383,917	80,748	-	1,464,665
Mortgage-backed securities	19,228,985	233,536	85,440	19,377,081
Corporate bonds	3,901,433	18,280	15,997	3,903,716
Total	<u>\$ 35,248,932</u>	<u>\$ 604,979</u>	<u>\$ 169,765</u>	<u>\$ 35,684,146</u>
December 31, 2018				
U.S. Government sponsored agencies	\$ 14,160,679	\$ 62,666	\$ 293,495	\$ 13,929,850
Municipal securities	1,382,787	-	49,336	1,333,451
Mortgage-backed securities	15,904,130	47,277	398,839	15,552,568
Corporate bonds	2,878,863	-	306,087	2,572,776
Total	<u>\$ 34,326,459</u>	<u>\$ 109,943</u>	<u>\$ 1,047,757</u>	<u>\$ 33,388,645</u>

At December 31, 2019 and 2018, the Company had marketable equity securities totaling \$30,895 and \$168,151, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 4. Investment Securities, Continued

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

	Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
December 31, 2019				
U.S. Government sponsored agencies	\$ 2,869,656	\$ 66,033	\$ -	\$ 2,935,689
Mortgage-backed securities	4,997,336	93,564	2,558	5,088,342
Municipals	2,578,386	144,232	-	2,722,618
Total	<u>\$ 10,445,378</u>	<u>\$ 303,829</u>	<u>\$ 2,558</u>	<u>\$ 10,746,649</u>

Capitalization of net unrealized gains on securities transferred from available-for-sale	28,210
Total	<u>\$ 10,473,588</u>

December 31, 2018				
U.S. Government sponsored agencies	\$ 3,384,184	\$ 46,545	\$ -	\$ 3,430,729
Mortgage-backed securities	8,109,388	108,090	85,702	8,131,776
Municipals	2,592,277	96,068	-	2,688,345
Total	<u>\$ 14,085,849</u>	<u>\$ 250,703</u>	<u>\$ 85,702</u>	<u>\$ 14,250,850</u>

Capitalization of net unrealized gains on securities transferred from available-for-sale	21,405
Total	<u>\$ 14,107,252</u>

The following is a summary of maturities of securities available-for-sale and held-to-maturity as of December 31, 2019. 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.

	Debt Securities Available-for-Sale		Debt Securities Held-to-Maturity	
	Amortized	Fair Value	Amortized	Fair Value
	Cost		Cost	
Due within one year	\$ 2,500,000	\$ 2,498,005	\$ -	\$ -
Due after one year but within five years	3,552,020	3,538,405	-	-
Due after five years through ten years	1,000,000	1,018,280	565,422	604,091
Due after ten years	<u>8,967,928</u>	<u>9,252,375</u>	<u>4,882,620</u>	<u>5,054,216</u>
	16,019,948	16,307,065	5,448,042	5,658,307
Mortgage-backed securities	<u>19,228,985</u>	<u>19,377,081</u>	<u>4,997,336</u>	<u>5,088,342</u>
Total	<u>\$ 35,248,933</u>	<u>\$ 35,684,146</u>	<u>\$ 10,445,378</u>	<u>\$ 10,746,649</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 4. 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, 2019 and 2018.

	December 31, 2019		December 31, 2018	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities Available-for-Sale				
Less Than 12 Months				
Mortgage-backed securities	\$ 440,380	\$ 5,168	\$ 172,307	\$ 3,399
Corporate bonds	-	-	2,572,776	306,087
Total	<u>\$ 440,380</u>	<u>5,168</u>	<u>2,745,083</u>	<u>309,486</u>
12 Months or More				
U.S. Government sponsored agencies	5,514,542	68,328	9,016,917	293,495
Mortgage-backed securities	5,185,486	80,272	10,545,054	395,440
Corporate Bonds	2,885,436	15,997	1,333,451	49,336
Total	<u>13,585,464</u>	<u>164,597</u>	<u>20,895,422</u>	<u>738,271</u>
Total securities available-for-sale	<u>\$ 14,025,844</u>	<u>\$ 169,765</u>	<u>\$ 23,640,505</u>	<u>\$ 1,047,757</u>
Securities Held-to-Maturity				
Less Than 12 Months				
Mortgage-backed securities	\$ 1,239,512	\$ 2,558	\$ 478,186	\$ 1,134
Total	<u>1,239,512</u>	<u>2,558</u>	<u>478,186</u>	<u>1,134</u>
12 Months or More				
Mortgage-backed securities	-	-	3,485,073	84,568
Total	<u>-</u>	<u>-</u>	<u>3,485,073</u>	<u>84,568</u>
Total securities held-to-maturity	<u>\$ 1,239,512</u>	<u>\$ 2,558</u>	<u>\$ 3,963,259</u>	<u>\$ 85,702</u>

At December 31, 2019, eight securities classified as available-for-sale and one security 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 2019, the Company sold securities with proceeds of \$1,638,332 and gross gains of \$23,834. During 2018, the Company sold securities with proceeds of \$3,100,000 and gross gains of \$800,000. During 2018, the Company recognized gain of \$38,151 within the consolidated statement of operations related to the increase in fair value of marketable equity securities as a result of the adoption of ASU 2016-01. During 2019, the Company recognized a gain of \$13,410 within the consolidated statement of operations related to the increase in fair value of marketable equity securities.

At December 31, 2019 and 2018, investment securities with a par value of \$14,832,908 and \$18,122,712 and a fair market value of \$15,103,164 and \$17,342,165, respectively, were pledged as collateral for securities under agreements to repurchase.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses

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

	<u>2019</u>	<u>2018</u>
Real estate loans:		
Construction	\$ 41,246,207	\$ 30,404,245
Residential	129,087,825	124,789,754
Nonresidential	171,148,893	144,103,065
Total real estate loans	<u>341,482,925</u>	<u>299,297,064</u>
Commercial and industrial	58,439,799	48,522,654
Consumer and other	80,262,671	82,976,173
Total loans	<u>\$ 480,185,395</u>	<u>\$ 430,795,891</u>

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank which totaled \$183,459,356 and \$137,040,574 at December 31, 2019 and 2018, 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 2019 and 2018 totaled \$353,530,732 and \$263,027,079, 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, 2019 and 2018.

	<u>December 31, 2019</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	\$ 2,788,188	\$ 83,200	\$ 1,049,913	\$ 676,598	\$ 1,809,711	\$ 359,919	\$ 618,558
Provisions	983,803	(20,826)	(413,291)	569,416	135,299	167,541	680,963
Recoveries	321,714	118,484	114,281	-	232,765	26,508	62,441
Charge-offs	(563,850)	-	(54,384)	-	(54,384)	(18,520)	(490,946)
Ending balance	<u>\$ 3,529,855</u>	<u>\$ 180,858</u>	<u>\$ 696,519</u>	<u>\$ 1,246,014</u>	<u>\$ 2,123,391</u>	<u>\$ 535,448</u>	<u>\$ 871,016</u>
	<u>December 31, 2018</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	\$ 2,453,875	\$ 168,541	\$ 985,897	\$ 372,356	\$ 1,526,794	\$ 257,298	\$ 669,783
Provisions	510,356	(169,726)	19,271	172,517	22,062	85,778	402,516
Recoveries	384,989	84,972	82,282	133,450	300,704	17,318	66,967
Charge-offs	(561,032)	(587)	(37,537)	(1,725)	(39,849)	(475)	(520,708)
Ending balance	<u>\$ 2,788,188</u>	<u>\$ 83,200</u>	<u>\$ 1,049,913</u>	<u>\$ 676,598</u>	<u>\$ 1,809,711</u>	<u>\$ 359,919</u>	<u>\$ 618,558</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2019.

	<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	\$ 2,478,331	\$ 2,478,331	\$ -	\$ 2,561,287	\$ 152,256
Nonresidential	<u>1,559,820</u>	<u>1,559,821</u>	<u>-</u>	<u>1,881,542</u>	<u>130,091</u>
Total real estate loans	4,038,151	4,038,152	-	4,442,829	282,347
Commercial and industrial	91,407	168,849	-	137,562	9,396
Consumer and other	<u>98,047</u>	<u>128,458</u>	<u>-</u>	<u>133,031</u>	<u>11,062</u>
Total	<u>\$ 4,227,606</u>	<u>\$ 4,335,459</u>	<u>\$ -</u>	<u>\$ 4,713,422</u>	<u>\$ 302,805</u>
With an allowance recorded:					
Nonresidential	<u>\$ 92,575</u>	<u>\$ 92,575</u>	<u>\$ 24,375</u>	<u>\$ 96,008</u>	<u>\$ 6,848</u>
Total real estate loans	92,575	92,575	24,375	96,008	6,848
Commercial and industrial	24,117	24,117	2,837	25,042	1,840
Consumer and other	<u>25,905</u>	<u>25,905</u>	<u>61</u>	<u>28,164</u>	<u>1,427</u>
Total	<u>\$ 142,597</u>	<u>\$ 142,597</u>	<u>\$ 27,273</u>	<u>\$ 149,214</u>	<u>\$ 10,115</u>
Total					
Real estate					
Residential	\$ 2,478,331	\$ 2,478,331	\$ -	\$ 2,561,287	\$ 152,256
Nonresidential	<u>1,652,395</u>	<u>1,652,396</u>	<u>24,375</u>	<u>1,977,550</u>	<u>136,939</u>
Total real estate loans	4,130,726	4,130,727	24,375	4,537,837	289,195
Commercial and industrial	115,524	192,966	2,837	162,604	11,236
Consumer and other	<u>123,952</u>	<u>154,363</u>	<u>61</u>	<u>161,195</u>	<u>12,489</u>
Total	<u>\$ 4,370,202</u>	<u>\$ 4,478,056</u>	<u>\$ 27,273</u>	<u>\$ 4,861,636</u>	<u>\$ 312,920</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses, Continued

The following summarizes the Company's impaired loans as of December 31, 2018.

	<u>Recorded Investment</u>	<u>Unpaid Principal</u>	<u>Related Allowance</u>	<u>Average Balance</u>	<u>Income Recognized</u>
With no related allowance recorded:					
Real estate					
Residential	\$ 2,570,672	\$ 2,778,105	\$ -	\$ 3,123,478	\$ 170,470
Nonresidential	<u>5,878,253</u>	<u>5,878,253</u>	<u>-</u>	<u>7,259,531</u>	<u>411,822</u>
Total real estate loans	8,448,925	8,656,358	-	10,383,009	582,292
Commercial and industrial	658,693	710,037	-	713,908	39,363
Consumer and other	<u>158,808</u>	<u>200,253</u>	<u>-</u>	<u>327,354</u>	<u>12,941</u>
Total	<u>\$ 9,266,426</u>	<u>\$ 9,566,648</u>	<u>\$ -</u>	<u>\$ 11,424,271</u>	<u>\$ 634,596</u>
With an allowance recorded:					
Real estate					
Residential	\$ 114,302	\$ 114,302	\$ 49,382	\$ 136,424	\$ 1,679
Nonresidential	<u>99,442</u>	<u>105,343</u>	<u>15,742</u>	<u>164,890</u>	<u>5,469</u>
Total real estate loans	213,744	219,645	65,124	301,314	7,148
Commercial and industrial	104,038	104,038	103,665	127,385	5,892
Consumer and other	<u>40,644</u>	<u>61,987</u>	<u>9,276</u>	<u>66,072</u>	<u>3,536</u>
Total	<u>\$ 358,426</u>	<u>\$ 385,670</u>	<u>\$ 178,065</u>	<u>\$ 494,771</u>	<u>\$ 16,576</u>
Total					
Real estate					
Residential	\$ 2,684,974	\$ 2,892,407	\$ 49,382	\$ 3,259,902	\$ 172,149
Nonresidential	<u>5,977,695</u>	<u>5,983,596</u>	<u>15,742</u>	<u>7,424,421</u>	<u>417,291</u>
Total real estate loans	8,662,669	8,876,003	65,124	10,684,323	589,440
Commercial and industrial	762,731	814,075	103,665	841,293	45,255
Consumer and other	<u>199,452</u>	<u>262,240</u>	<u>9,276</u>	<u>393,426</u>	<u>16,477</u>
Total	<u>\$ 9,624,852</u>	<u>\$ 9,952,318</u>	<u>\$ 178,065</u>	<u>\$ 11,919,042</u>	<u>\$ 651,172</u>

The following is an aging analysis of the Company's loan portfolio at December 31, 2019:

	<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	\$ -	\$ -	\$ -	\$ -	\$ 41,246,207	\$ 41,246,207	\$ -
Residential	-	-	399,746	399,746	128,688,079	129,087,825	-
Nonresidential	<u>156,322</u>	-	-	<u>156,322</u>	<u>170,992,571</u>	<u>171,148,893</u>	-
Total real estate loans	156,322	-	399,746	556,068	340,926,857	341,482,925	-
Commercial and industrial	-	-	12,244	12,244	58,427,555	58,439,799	6,294
Consumer and other	<u>148,559</u>	<u>12,171</u>	<u>110,310</u>	<u>271,040</u>	<u>79,991,631</u>	<u>80,262,671</u>	<u>49,672</u>
Total	<u>\$ 304,881</u>	<u>\$ 12,171</u>	<u>\$ 522,300</u>	<u>\$ 839,352</u>	<u>\$479,346,043</u>	<u>\$ 480,185,395</u>	<u>\$ 55,966</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses, Continued

The following is an aging analysis of the Company's loan portfolio at December 31, 2018:

	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	\$ -	\$ -	\$ -	\$ -	\$ 30,404,245	\$ 30,404,245	\$ -
Residential	46,967	694,960	117,606	859,533	123,930,221	124,789,754	114,301
Nonresidential	-	99,442	106,146	205,588	143,897,477	144,103,065	-
Total real estate loans	46,967	794,402	223,752	1,065,121	298,231,943	299,297,064	114,301
Consumer and industrial	-	4,314	18,973	23,287	48,499,367	48,522,654	-
Consumer and other	131,068	143,699	119,509	394,276	82,581,897	82,976,173	31,961
Total	<u>\$ 178,035</u>	<u>\$ 942,415</u>	<u>\$ 362,234</u>	<u>\$ 1,482,684</u>	<u>\$429,313,207</u>	<u>\$ 430,795,891</u>	<u>\$ 146,262</u>

The following is an analysis of the Company's nonaccrual loan portfolio recorded at December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Real Estate		
Residential	\$ 590,561	\$ 664,667
Nonresidential	517,639	205,588
Total real estate loans	1,108,200	870,255
Commercial and industrial	39,438	673,698
Consumer and other	328,183	321,807
	<u>\$ 1,475,821</u>	<u>\$ 1,865,760</u>

Troubled Debt Restructurings

The following table summarizes the carrying balance of troubled debt restructurings ("TDRs") as of December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Performing TDRs	\$ 2,469,036	\$ 3,786,544
Nonperforming TDRs	1,462,960	482,552
Total TDRs	<u>\$ 3,931,996</u>	<u>\$ 4,269,096</u>

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 2019 or 2018.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses, Continued

The following is an analysis of TDRs identified during 2019:

	For the year ended December 31, 2019		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real Estate			
Residential	1	\$ 24,151	\$ 24,151
Nonresidential	1	494,423	494,423
Commercial and industrial	1	24,117	24,117
Consumer and other	4	48,102	48,102
	7	\$ 590,793	\$ 590,793

During the year ended December 31, 2019, we modified seven loans that were considered to be troubled debt restructurings. The Company provided rate and term concessions for four of these loans due to bankruptcies and the other three loans were restructured due to borrower's inability to obtain financing elsewhere. During the year ended December 31, 2019, no loans that had previously been restructured during the year subsequently defaulted during the year.

The following is an analysis of TDRs identified during 2018:

	For the year ended December 31, 2018		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Real Estate			
Residential	3	\$ 288,584	\$ 288,584
Nonresidential	4	2,250,846	2,250,846
Commercial and industrial	1	96,000	96,000
Consumer and other	11	122,444	122,444
	19	\$ 2,757,874	\$ 2,757,874

During the year ended December 31, 2018, we modified nineteen loans that were considered to be troubled debt restructurings. The Company provided rate concessions for five of these loans and extensions for nineteen of the loans. During the year ended December 31, 2018, three loans with an unpaid principal balance of \$143,979 as of December 31, 2018 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, 2019 and 2018

Note 5. 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, 2019:

	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non- Residential			
Pass	\$ 464,643,034	\$ 40,308,707	\$ 125,951,550	\$ 162,804,795	\$ 329,065,052	\$ 56,150,250	\$ 79,427,732
Special mention	11,998,802	937,500	2,166,887	6,537,595	9,641,982	1,860,727	496,093
Substandard	3,543,559	-	969,388	1,806,503	2,775,891	428,822	338,846
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 480,185,395</u>	<u>\$ 41,246,207</u>	<u>\$ 129,087,825</u>	<u>\$ 171,148,893</u>	<u>\$ 341,482,925</u>	<u>\$ 58,439,799</u>	<u>\$ 80,262,671</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, 2018:

	Real Estate Loans				Total Real Estate Loans	Commercial	Consumer and Other
	Total	Construction	Residential	Non- Residential			
Pass	\$ 410,896,316	\$ 30,404,245	\$ 120,829,193	\$ 133,380,172	\$ 284,613,610	\$ 44,136,536	\$ 82,146,170
Special mention	13,543,249	-	2,857,269	6,890,781	9,748,050	3,301,378	493,821
Substandard	6,356,326	-	1,103,292	3,832,112	4,935,404	1,084,740	336,182
Doubtful	-	-	-	-	-	-	-
Totals	<u>\$ 430,795,891</u>	<u>\$ 30,404,245</u>	<u>\$ 124,789,754</u>	<u>\$ 144,103,065</u>	<u>\$ 299,297,064</u>	<u>\$ 48,522,654</u>	<u>\$ 82,976,173</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. 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>2019</u>	<u>2018</u>
Commitments to extend credit	\$ 92,921,655	\$ 71,885,360
Standby letters of credit	589,196	158,765

Acquired Loans:

On January 22, 2018, the Company acquired INB (see Note 2 for more information). PCI loans acquired totaled \$17.3 million, and acquired performing loans totaled \$35.2 million, both net of purchase discounts. The gross contractual amount receivable for PCI loans and acquired performing loans was approximately \$19 million and \$36 million, respectively, as of the acquisition date. The fair value of the total loan portfolio was estimated to be \$52.5 million, which represents a \$2.5 million discount.

The following table presents changes in the carrying value of PCI loans for the year ended December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Balance at beginning of period	\$ 14,666,715	\$ -
Additions due to acquisition of INB	-	17,313,626
Change due to payments received and accretion	(5,646,148)	(3,042,422)
Advances	93,398	395,511
Balance at end of period	\$ <u>9,113,965</u>	\$ <u>14,666,715</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 5. Loans and Allowance for Loan Losses, Continued

The following table presents changes in the nonaccretable yield for PCI loans for the year ended December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Balance at beginning of period	\$ 1,048,796	\$ -
Additions due to acquisition of INB	-	1,423,522
Reclassification to accretable yield	(95,494)	(158,064)
Change due to charge-offs	(461,929)	(216,662)
Balance at end of period	<u>\$ 491,373</u>	<u>\$ 1,048,796</u>

The following table presents changes in the accretable yield for PCI loans for the year ended December 31, 2019 and 2018

	<u>2019</u>	<u>2018</u>
Balance at beginning of period	\$ 618,281	\$ -
Additions due to acquisition of INB	-	421,179
Reclassification for nonaccretable yield	95,494	158,064
Accretion, net cash basis interest collections	(152,687)	39,038
Balance at end of period	<u>\$ 561,088</u>	<u>\$ 618,281</u>

Note 6. Premises, Furniture and Equipment

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

	<u>2019</u>	<u>2018</u>
Land	\$ 7,951,239	\$ 7,497,839
Buildings	14,822,259	14,766,184
Leasehold improvements	1,630,762	1,021,789
Furniture and equipment	9,464,291	9,322,077
Construction in progress	<u>1,062,491</u>	<u>1,308,421</u>
Total	34,931,042	33,916,310
Less, accumulated depreciation	<u>(14,510,536)</u>	<u>(13,605,431)</u>
Premises and equipment, net	<u>\$ 20,420,506</u>	<u>\$ 20,310,879</u>

Depreciation expense for the years ended December 31, 2019 and 2018 amounted to \$814,612 and \$900,631, respectively.

At December 31, 2019 and 2018, construction in progress consists mainly of architect fees and site work for potential new branches. As of December 31, 2019, there were no material commitments outstanding for the construction/or purchase of premises, furniture and equipment.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 7. Other Real Estate Owned

Transactions in other real estate owned for the years ended December 31, 2019 and 2018 are summarized below:

	<u>2019</u>	<u>2018</u>
Beginning balance	\$ 341,519	\$ 1,706,765
Additions	183,257	1,050,015
Sales	(176,724)	(2,415,261)
Write downs	(500)	-
Ending balance	<u>\$ 347,552</u>	<u>\$ 341,519</u>

The Company recognized net gains of \$27,676 and \$203,685 on the sale of other real estate owned for the years ended December 31, 2019 and 2018, respectively.

Note 8. Mortgage Servicing Rights

The Company retains right to service the residential mortgage loans that it sells to the Federal National Mortgage Association ("FNMA") and Freddie Mac ("FHLMC"). The Company accounts for MSR 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, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Balances, beginning of year	\$ 9,023,859	\$ 6,357,666
Additions	3,306,078	2,991,033
Change in MSR fair value	(1,307,299)	(324,840)
Balances, end of year	<u>\$ 11,022,638</u>	<u>\$ 9,023,859</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 MSRs. 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, 2019, the aggregate amount of loans serviced by the Company for the benefit of others totaled \$982,517,259.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 8. Mortgage Servicing Rights, Continued

The characteristics and sensitivity analysis of the MSRs are included in the following table as of December 31, 2019 and 2018.

	<u>2019</u>	<u>2018</u>
Composition of residential loans serviced for others		
Fixed-rate mortgage loans	100.00%	100.00%
Weighted average life	9.19 years	8.93 years
Constant prepayment rate ("CPR")	9.00%	10.57%
Weighted average discount rate	8.56%	9.48%

Note 9. Derivatives

The derivative positions of the Company for the years ended December 31, 2019 and 2018 are reported as other assets and liabilities and are as follows:

	<u>2019</u>		<u>2018</u>	
	<u>Fair value</u>	<u>Notional value</u>	<u>Fair value</u>	<u>Notional value</u>
Derivative assets (liabilities):				
Mortgage loan interest rate lock commitments	\$ 713,496	\$ 19,895,637	\$ 416,076	\$ 22,415,124
Mortgage loan forward sales commitments	(49,453)	18,000,000	(186,133)	22,250,000

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 10. Core Deposit Intangible

The following table presents information about our intangible assets related to acquisition of INB on January 22, 2018 as of December 31:

	<u>2019</u>		<u>2018</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Core deposit intangibles	\$ 880,000	\$ 366,965	\$ 880,000	\$ 195,783

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 10. Core Deposit Intangible, Continued

Based on the core deposit intangibles as of December 31, 2019, the following table presents the aggregate amortization expense for each of the succeeding years ending December 31:

	<u>Amount</u>
2020	\$ 146,582
2021	121,980
2022	97,379
2023	72,778
2024 and thereafter	74,316
Total	<u>\$ 513,035</u>

Amortization expense of \$171,182 and \$195,783 related to the core deposit intangibles was recognized in 2019 and 2018, respectively.

Note 11. Deposits

At December 31, 2019, the scheduled maturities of time deposits were as follows:

Maturing In:	<u>Amount</u>
2020	\$ 145,158,645
2021	7,340,876
2022	2,679,311
2023	1,439,054
2024	1,517,162
Total	<u>\$ 158,135,048</u>

Included in total time deposits at December 31, 2019 and 2018 were brokered time deposits of \$13,459,783 and \$4,966,726.

Note 12. 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>2019</u>	<u>2018</u>
Balance at December 31	\$ 14,637,332	\$ 16,852,981
Maximum month-end balance during the year	15,778,316	18,649,225
Average balance during the year	13,301,943	16,591,130
Average interest rate at the end of the year	0.51%	0.15%
Average interest rate during the year	0.56%	0.15%

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 12. Securities Sold Under Agreements to Repurchase, Continued

At December 31, 2019 and 2018, investment securities with a par value of \$14,832,908 and \$18,122,712 and a fair market value of \$15,103,164 and \$17,342,165, respectively, were pledged as collateral for the underlying agreements.

Note 13. Federal Home Loan Bank Advances

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

	Interest Rate	2019	2018
Fixed rate			
February 8, 2019	2.36%	-	3,400,000
August 8, 2019	2.64%	-	3,300,000
February 7, 2020	2.76%	3,300,000	3,300,000
September 20, 2029	1.62%	10,000,000	-
October 25, 2020	1.34%	5,000,000	-
January 27, 2020	1.80%	5,000,000	-
Daily rate			
January 17, 2020	1.78%	<u>20,000,000</u>	<u>10,000,000</u>
		<u>\$ 43,300,000</u>	<u>\$ 20,000,000</u>

At December 31, 2019 and 2018, the Company has pledged certain loans totaling \$183,459,356 and \$137,040,574, respectively, as collateral to secure its borrowings from the FHLB. Additionally, the Company's FHLB stock is pledged to secure the borrowings.

Note 14. 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, 2019 and 2018, the Company had accrued and unpaid interest totaling \$40,237 and \$50,073, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 15. 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, 2019, remaining issuance costs to be amortized totaled \$34,786.

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 Company 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 16.

Note 16. Shareholders' Equity

Common Stock - The following is a summary of the changes in common stock outstanding for the years ended December 31, 2019 and 2018.

	<u>2019</u>	<u>2018</u>
Common shares outstanding at beginning of the period	8,412,671	7,887,486
Conversion of Series D preferred stock to common stock	850	1,800
Conversion of Series E preferred stock to non-voting common stock	-	410,499
Restricted stock issuance	130,557	132,886
Forfeiture of restricted shares	<u>(100,000)</u>	<u>(20,000)</u>
Common shares outstanding at end of the period	<u>8,444,078</u>	<u>8,412,671</u>

During 2018, the Company authorized 430,000 shares of non-voting common stock, for which the 410,499 shares of Series E Preferred Stock issued during 2017 were converted to non-voting common stock during 2018.

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, 2019 and 2018

Note 16. 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 was 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 was generally non-voting.

The Series B Preferred Stock was 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 would received 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 (loss) 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 15.

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 2017 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. During 2018, the Series E Shares were converted to 410,499 shares of non-voting common stock.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 16. 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, 2019, the Bank had undivided profits of \$ 17,670,183. The Bank is authorized to dividend 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 17. Other Operating Expense

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

	<u>2019</u>	<u>2018</u>
Advertising	\$ 200,187	\$ 306,279
Office supplies, postage and printing	322,021	364,275
Telephone	313,198	312,631
Professional fees and services	1,339,913	730,057
Supervisory fees and assessments	164,890	343,855
Debit and credit card expenses	925,883	959,931
Insurance expenses	215,072	230,268
Net cost of other real estate owned	11,549	21,874
Core deposit amortization	171,182	195,783
Other	<u>2,042,389</u>	<u>2,084,609</u>
Total	<u>\$ 5,706,284</u>	<u>\$ 5,549,562</u>

Note 18. Income Taxes

Income tax provision for the years ended December 31, 2019 and 2018 is summarized as follows:

	<u>2019</u>	<u>2018</u>
Provision		
Current income tax expense		
Federal	\$ -	\$ -
State	<u>232,536</u>	<u>70,794</u>
Total current	<u>232,536</u>	<u>70,794</u>
Deferred income tax expense (benefit)		
Federal	1,005,350	589,897
State	<u>(56,175)</u>	<u>19,579</u>
Total deferred	<u>949,175</u>	<u>609,476</u>
Change in valuation allowance	<u>71,522</u>	<u>61,336</u>
Total income tax expense	<u>\$ 1,253,233</u>	<u>\$ 741,606</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 18. Income Taxes, Continued

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

	<u>2019</u>	<u>2018</u>
Deferred tax assets:		
Allowance for loan losses	\$ 596,882	\$ 585,519
Accumulated depreciation	-	2,945
Net operating losses	8,292,928	8,670,310
Non-accrual interest	12,893	10,829
Unrealized loss on securities available for sale	-	224,520
Deferred compensation	589,609	507,915
Federal and state credits	-	15,493
Other real estate owned	-	24,636
Purchase accounting on acquisition	163,668	309,455
Leases	6,758	-
Other	<u>129,225</u>	<u>135,056</u>
Gross deferred tax assets	9,791,963	10,486,678
Less, valuation allowance	<u>(626,955)</u>	<u>(555,433)</u>
Net deferred tax assets	<u>9,165,008</u>	<u>9,931,245</u>
Deferred tax liabilities:		
Accumulated depreciation	14,779	-
Prepaid expenses	21,547	22,645
Unrealized gains on securities available for sale	98,715	
Market to market adjustments	2,387,453	1,943,298
Other	<u>62,874</u>	<u>41,730</u>
Total gross deferred tax liabilities	<u>2,585,368</u>	<u>2,007,673</u>
Net deferred tax assets recognized	<u>\$ 6,579,640</u>	<u>\$ 7,923,572</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, 2019, 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 2019, the balance in the valuation allowance changed by \$71,522. The remaining valuation allowance relates to the parent company's state operating loss carryforwards for which realizability is uncertain.

The Company has federal net operating losses of \$36,630,028 and \$38,719,915 for the years ended December 31, 2019 and 2018, respectively. The Company has state net operating losses of \$15,205,628 and \$13,648,822 for the years ended December 31, 2019 and 2018, 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.

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Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 18. Income Taxes, Continued

A reconciliation between the income tax expense and the amount computed by applying the federal statutory rate of 21% to income before income taxes for the years ended December 31, 2019 and 2018 follows:

	<u>2019</u>	<u>2018</u>
Tax expense at statutory rate	\$ 1,121,835	\$ 666,086
State income tax expense (benefit), net of federal income tax benefit	139,325	71,395
Tax-exempt interest income	(28,525)	(30,839)
Disallowed interest expense	1,393	949
Life insurance surrender value	(81,075)	(82,017)
Change in valuation allowance	71,522	61,336
Other, net	28,758	54,696
Total	<u>\$ 1,253,233</u>	<u>\$ 741,606</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 2016 and subsequent years are subject to review by taxing authorities.

Note 19. Related Party Transactions

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) are 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, 2019 and 2018, the Company had related party loans totaling \$1,318,435 and \$1,422,497, respectively.

Deposits from directors and executive officers and their related interests totaled \$2,546,515 and \$1,610,022 at December 31, 2019 and 2018, respectively.

Note 20. 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, 2019, 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.

Effective January 1, 2019, the Company adopted ASC 842 "Leases". Currently, the Company has operating leases on eleven of its facilities that are accounted for under this standard. At December 31, 2019 the Company had operating lease right of use asset of \$5,669,144, and operating lease liability of \$5,701,327.

Rental expense recorded under the leases for the years ended December 31, 2019 and 2018 was \$1,028,736 and \$937,904, respectively.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 20. Commitments and Contingencies

The weighted average remaining lease term as of December 31, 2019 is 10.32 years and the weighted average discount rate used is 3.12%. The following table shows future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2019 are as follow:

2020	\$	815,341
2021		628,880
2022		651,205
2023		583,722
2024		595,877
Thereafter		<u>3,316,203</u>
Total undiscounted lease payments		6,591,228
Less effect of discounting		<u>(889,901)</u>
Present value of estimate lease payments (lease liability)	\$	<u><u>5,701,327</u></u>

Note 21. Equity Incentive Plan

On April 20, 2017, the Company approved the 2017 Plan (collectively "the Plan"). 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 in 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.

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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 21. Equity Incentive Plan

During 2019 and 2018, the Company issued 130,557 and 132,886 shares, respectively, of restricted stock pursuant to the 2017 Equity Incentive Plan, as amended. As of December 31, 2019 and 2018, 558,176 and 579,838 shares, respectively, issued under the Plans 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 2024, subject to meeting the performance criteria of the Plan. During 2019 and 2018, 8,496 and 26,618 shares, respectively, were issued which vested during each of the respective years. The weighted-average fair value of restricted stock issued during 2019 and 2018 was \$7.07 and \$7.39 per share, respectively. During 2019 and 2018, 100,000 and 27,930 shares, respectively, were either forfeited or cancelled having a weighted average price of \$7.50. Also, during 2019 and 2018, 53,552 and 26,618 shares were exercised, respectively. The weighted-average fair value of restricted stock Exercised during 2019 and 2018 was \$5.84 and \$3.82, respectively. Deferred compensation expense of \$354,714 and \$294,069 during 2019 and 2018, respectively, was recorded in salaries and employee benefits expense.

During 2019 no stock options were issued. During 2018, the Company issued 40,000 stock options pursuant to the 2017 Equity Incentive Plan.

The fair value of 2018 options granted was estimated on the date of the grant using the Black-Scholes option pricing, resulting in a total expense of \$92,958. The Black-Scholes model with assumptions is presented below:

Grant date	January 18, 2018
Total number of options granted	40,000
Expected volatility	20.58%
Expected term	7 years
Expected dividend	0.00%
Risk-free rate	2.55%
Grant date fair value	\$7.75

	<u>Options</u>	<u>Weighted-Average Remaining Life (Years)</u>	<u>Weighted-Average Exercise Price</u>
Outstanding at December 31, 2018	200,000		\$ 7.26
Granted	-		-
Exercised	-		-
Forfeited	-		-
Outstanding at December 31, 2019	200,000	3.80	7.26
Options exercisable as of December 31, 2019	82,944	3.77	7.26

The Company recognized stock-based compensation costs related to stock options of \$58,684 and \$57,532 for the years ended December 31, 2019 and 2018, respectively.

As of December 31, 2019, there was \$248,984 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, 2019, there were 300,000 stock awards available for grant under the 2017 Equity Incentive Plan.

First Reliance Bancshares, Inc. and Subsidiary

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Note 22. Income Per Common Share

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

The following is a summary of the income per common share calculations for the years ended December 31, 2019 and 2018.

	<u>2019</u>	<u>2018</u>
Income available to common shareholders		
Net income	\$ 4,088,839	\$ 2,430,234
Preferred stock dividends	-	-
Net income available to common shareholders	<u>\$ 4,088,839</u>	<u>\$ 2,430,234</u>
Basic income per common share:		
Net income available to common shareholders	<u>\$ 4,088,839</u>	<u>\$ 2,430,234</u>
Average common shares outstanding - basic	<u>7,937,617</u>	<u>7,738,547</u>
Basic income per common share	<u>\$ 0.52</u>	<u>\$ 0.31</u>
Diluted income per common share:		
Net income available to common shareholders	<u>\$ 4,088,839</u>	<u>\$ 2,430,234</u>
Average common shares outstanding - basic	7,937,617	7,738,547
Dilutive potential common shares	<u>124,869</u>	<u>129,039</u>
Average common shares outstanding - diluted	<u>8,062,486</u>	<u>7,867,586</u>
Diluted income per common share	<u>\$ 0.51</u>	<u>\$ 0.31</u>

Note 23. 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.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 23. Regulatory Matters, Continued

The Bank is also required to maintain capital at a minimum level based on total assets, which is known as the leverage ratio. The Bank is required to maintain a required minimum leverage ratio of 4%.

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.

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, the Bank is required to maintain a “capital conservation buffer” in addition to its minimum risk-based capital requirements. This buffer is required to consist solely of CET1, but the buffer applies 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 was fully effective on January 1, 2019, consisting 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, 2019 and 2018.

<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, 2019						
The Bank						
Total capital (to risk-weighted assets)	\$ 62,299	11.54%	\$ 43,183	8.00%	\$ 53,978	10.00%
Tier 1 capital (to risk-weighted assets)	58,752	10.88	32,387	6.00	43,183	8.00
Tier 1 capital (to average assets)	58,752	9.23	24,290	4.00	35,086	5.00
Common Equity Tier 1 Capital (to risk-weighted assets)	58,752	10.88	25,473	4.50	31,841	6.50
December 31, 2018						
The Bank						
Total capital (to risk-weighted assets)	\$ 56,216	12.05%	\$ 37,308	8.00%	\$ 46,635	10.00%
Tier 1 capital (to risk-weighted assets)	53,191	11.41	27,981	6.00	37,308	8.00
Tier 1 capital (to average assets)	53,191	9.51	22,380	4.00	27,975	5.00
Common Equity Tier 1 Capital (to risk-weighted assets)	53,191	11.41	20,986	4.50	30,313	6.50

First Reliance Bancshares, Inc. and Subsidiary

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December 31, 2019 and 2018

Note 24. Unused Lines of Credit

The Bank had available at December 31, 2019 several unsecured lines of credit, which were unused, to purchase up to \$22,500,000 of federal funds from one unrelated correspondent institution. Also, as of December 31, 2019, the Bank had the ability to borrow funds from the FHLB of up to \$150,158,851. At that date, \$43,300,000, had been advanced.

Note 25. Fair Value Measurements

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

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

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 and Marketable Equity Securities - 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

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 25. Fair Value Measurements, Continued

techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the counter markets and money market funds. Level 2 securities include mortgage backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Loans - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value, and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2019 and 2018, 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

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December 31, 2019 and 2018

Note 25. 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, 2019 and 2018.

	December 31, 2019			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored agencies	\$ 10,938,684	\$ -	\$ 10,938,684	\$ -
Municipal securities	1,464,665	-	1,464,665	-
Mortgage-backed securities	19,377,081	-	19,377,081	-
Corporate bonds	<u>3,903,716</u>	-	<u>3,903,716</u>	-
Total available-for-sale securities	<u>35,684,146</u>	-	<u>35,684,146</u>	-
Marketable equity securities	30,895	-	30,895	-
Mortgage loans held for sale	27,901,419	-	27,901,419	-
Mortgage servicing rights	11,022,638	-	-	11,022,638
Derivative assets (liabilities):				
Mortgage loan interest rate lock commitments	713,496	-	713,496	-
Mortgage loan forward sales commitments	<u>(49,453)</u>	-	<u>(49,453)</u>	-
	<u>\$ 75,303,141</u>	<u>\$ -</u>	<u>\$ 64,280,503</u>	<u>\$ 11,022,638</u>

	December 31, 2018			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
U.S. Government sponsored agencies	\$ 13,929,850	\$ -	\$ 13,929,850	\$ -
Municipal securities	1,333,451	-	1,333,451	-
Mortgage-backed securities	15,552,568	-	15,552,568	-
Corporate bonds	<u>2,572,776</u>	-	<u>2,572,776</u>	-
Total available-for-sale securities	<u>33,388,645</u>	-	<u>33,388,645</u>	-
Marketable equity securities	168,151	-	168,151	-
Mortgage loans held for sale	12,713,361	-	12,713,361	-
Mortgage servicing rights	9,023,859	-	-	9,023,859
Derivative assets (liabilities):				
Mortgage loan interest rate lock commitments	416,076	-	416,076	-
Mortgage loan forward sales commitments	<u>(186,133)</u>	-	<u>(186,133)</u>	-
	<u>\$ 55,523,959</u>	<u>\$ -</u>	<u>\$ 46,500,100</u>	<u>\$ 9,023,859</u>

First Reliance Bancshares, Inc. and Subsidiary

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December 31, 2019 and 2018

Note 25. 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, 2017	\$ 6,357,666
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	2,991,033
Total net gains (losses) included in:	
Net income	<u>(324,840)</u>
Balance, December 31, 2018	9,023,859
Transfers into/out of Level 3	-
Purchases, sales, issuances and settlements, net	3,306,078
Total net gains (losses) included in:	
Net income	<u>(1,307,299)</u>
Balance, December 31, 2019	<u>\$ 11,022,638</u>

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, 2019 and December 31, 2018, 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, 2019				
Impaired loans	\$ 4,342,929	\$ -	\$ -	\$ 4,342,929
Other real estate owned	<u>347,552</u>	<u>-</u>	<u>-</u>	<u>347,552</u>
Total assets at fair value	<u>\$ 4,690,481</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,690,481</u>
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2018				
Impaired loans	\$ 9,446,787	\$ -	\$ -	\$ 9,446,787
Other real estate owned	<u>341,519</u>	<u>-</u>	<u>-</u>	<u>341,519</u>
Total assets at fair value	<u>\$ 9,788,306</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 9,788,306</u>

The Company had no liabilities measured at fair value on a non-recurring basis.

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Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 25. 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, 2019 and December 31, 2018, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value as of December 31, 2019	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 4,342,929	Appraisal Value	Appraisals and/or sales of comparable properties	Appraisals discounted 5% to 30% for sales commissions and other holding cost
Other real estate owned	\$ 347,552	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, 2018	Valuation Technique	Significant Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 9,446,787	Appraisal Value	Appraisals and/or sales of comparable properties	Appraisals discounted 5% to 30% for sales commissions and other holding cost
Other real estate owned	\$ 341,519	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 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, 2019 and 2018.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 25. Fair Value Measurements, Continued

	December 31,			
	2019		2018	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	\$ 40,340,683	\$ 40,340,683	\$ 34,561,988	\$ 34,561,988
Securities available-for-sale	35,684,146	35,684,146	33,388,645	33,388,645
Marketable equity securities	30,895	30,895	168,151	168,151
Securities held-to-maturity	10,417,168	10,746,649	14,107,252	14,250,850
Mortgage loans held for sale	27,901,419	27,901,419	12,713,361	12,713,361
Loans held for investment, net	476,655,540	474,301,267	428,007,703	426,199,683
Nonmarketable equity securities	2,423,200	2,423,200	1,393,500	1,393,500
Deposits	505,087,637	505,307,623	476,168,709	477,204,481
Securities sold under agreement to repurchase	14,637,332	14,637,332	16,852,981	16,852,981
Federal funds purchased	16,500,000	16,500,000	-	-
Federal Home Loan Bank advances	43,300,000	42,997,000	20,000,000	20,020,000
Subordinated debentures	15,275,214	13,813,483	15,244,877	14,546,533

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 market prices, 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.

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.

Loan fair value estimated using exit price notion as of December 31, 2019 based on adoption of ASU 2016-01. The methods used to estimate fair value of loans do not necessarily represent an exit price as of December 31, 2018.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 25. Fair Value Measurements, Continued

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.

Other borrowings

The fair value of federal funds purchased and securities under agreements to repurchase approximate the carrying amount because of the short maturity of these borrowings.

First Reliance Bancshares, Inc. and Subsidiary

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Note 26. Revenue and Recognition

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation.

The Company only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Company assesses the goods or services that are promised within each contract and identifies those that contain performance obligations, and assesses whether each promised good or service is distinct. The Company then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

Deposit Service Charges: The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposits accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

Check Card Fee Income: Check card fee income represents fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the VISA payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the card. Certain expenses directly associated with the debit card are recorded on a net basis with the fee income. This income is recognized within "Other" below.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 26. Revenue and Recognition, Continued

Gains/Losses on OREO Sales: Gains/losses on the sale of OREO are included in non-interest income and are generally recognized when the performance obligation is complete. This is typically at delivery of control over the property to the buyer at the time of each real estate closing.

Non-Interest Income	December 31, 2019	December 31, 2018
Deposit service charges	\$ 1,681,812	\$ 1,597,211
Mortgage banking income ⁽¹⁾	5,593,441	5,138,660
Income from bank owned life insurance ⁽¹⁾	386,073	390,557
Gain on sale of securities ⁽¹⁾	21,168	-
Gain on nonmarketable securities ⁽¹⁾	16,077	800,000
Other service charges, commissions and fees	1,548,202	1,510,405
Other ⁽²⁾	456,192	487,529
Total non-interest income	\$ 9,702,965	\$ 9,924,362

⁽¹⁾ Not within the scope of ASC 606

⁽²⁾ Includes Check Card Fee income discussed above. No other items are within the scope of ASC 606

Note 27. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before 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 financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 31, 2020, the date the financial statements were available to be issued.

The 2019 novel coronavirus (or "COVID-19") has adversely affected, and may continue to adversely affect economic activity globally, nationally and locally. Following the COVID-19 outbreak in December 2019 and January 2020, market interest rates have declined significantly, with the 10-year Treasury bond falling below 1.00% on March 3, 2020 for the first time. Such events also may adversely affect business and consumer confidence, generally, and the Company and its customers, and their respective suppliers, vendors and processors may be adversely affected. On March 3, 2020, the Federal Open Market Committee reduced the target federal funds rate by 50 basis points to 1.00% to 1.25%. This rate was further reduced to 0% to 0.25% on March 16, 2020. These reductions in interest rates and other effects of the COVID-19 outbreak may adversely affect the Company's financial condition and results of operations.

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 27. First Reliance Bancshares, Inc. (Parent Company Only)

Condensed Balance Sheets

	<u>December 31,</u>	
	<u>2019</u>	<u>2018</u>
Assets		
Cash	\$ 1,380,350	\$ 3,235,365
Investment in banking subsidiary	69,046,787	62,420,978
Equity securities	30,895	168,151
Nonmarketable equity securities	58,100	58,100
Investment in trust	310,000	310,000
Deferred tax asset	1,687,908	1,338,543
Other assets	129,637	81,897
Total assets	<u>\$ 72,643,677</u>	<u>\$ 67,613,034</u>
Liabilities		
Junior subordinated debentures	\$ 10,310,000	\$ 10,310,000
Subordinated debentures	4,965,214	4,934,877
Accrued salary benefits	105,196	-
Accrued interest payable	177,807	199,708
Total liabilities	15,558,217	15,444,585
Shareholders' equity	<u>57,085,460</u>	<u>52,168,449</u>
Total liabilities and shareholders' equity	<u>\$ 72,643,677</u>	<u>\$ 67,613,034</u>

Condensed Statements of Operations

	<u>For the years ended</u>	
	<u>December 31,</u>	
	<u>2019</u>	<u>2018</u>
Income		
Interest income	\$ 14,161	\$ 12,023
Gain on sale of trust preferred security	-	800,000
Dividend from banking subsidiary	-	2,100,000
Gain on fair value of equity securities	16,076	38,151
Total income	<u>30,237</u>	<u>2,950,175</u>
Expenses		
Salaries and employee benefits	666,563	351,801
Equipment expense	56,154	57,630
Interest expense	782,220	765,076
Acquisition-related costs	37,210	1,005,195
Other expenses	393,749	293,160
Total expenses	<u>1,935,896</u>	<u>2,472,862</u>
Income before income taxes and equity in undistributed income of banking subsidiary	(1,905,659)	477,313
Equity in undistributed earnings of banking subsidiary	<u>5,625,633</u>	<u>1,653,666</u>
Net income before income taxes	3,719,974	2,130,979
Income tax benefit	(368,865)	(299,256)
Net income	<u>\$ 4,088,839</u>	<u>\$ 2,430,234</u>

First Reliance Bancshares, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2019 and 2018

Note 27. First Reliance Bancshares, Inc. (Parent Company Only), Continued

Condensed Statements of Cash Flows

	For the years ended	
	December 31,	
	<u>2019</u>	<u>2018</u>
Cash flows from operating activities		
Net income	\$ 4,088,839	\$ 2,430,234
Adjustments to reconcile net income to net cash used in operating activities:		
Deferred income tax expense	(349,365)	(318,756)
Net equity in undistributed earnings of banking subsidiary	(5,625,633)	(1,653,666)
Gain on sale of trust preferred security	-	(800,000)
Gain on fair value of equity securities	16,076	(38,151)
Stock based compensation expense	58,683	57,732
Increase (decrease) in accrued interest payable	(21,901)	15,219
Increase in other assets	(47,740)	(15,459)
Increase in accrual salary benefits	105,196	-
Net cash used in operating activities	<u>(1,775,845)</u>	<u>(963,078)</u>
Cash flows from by investing activities		
Proceeds from sale of equity security	121,180	-
Purchase of trust preferred security	-	(2,300,000)
Proceeds from sale of trust preferred security	-	<u>3,100,000</u>
Net cash provided by investing activities	<u>121,180</u>	<u>800,000</u>
Cash flows from financing activities		
Net proceeds from issuance of common stock	173,738	955,443
Accretion of debt issuance costs	30,337	22,914
Decrease (increase) in restricted stock	254,924	(640,231)
Capital contribution to subsidiary	-	(15,000,000)
Purchase of treasury stock	<u>(659,349)</u>	<u>(394,276)</u>
Net cash used in financing activities	<u>(200,350)</u>	<u>(15,056,150)</u>
Decrease in cash	(1,855,015)	(14,578,997)
Cash and cash equivalents, beginning of year	<u>3,235,365</u>	<u>17,814,362</u>
Cash and cash equivalents, ending of year	<u>\$ 1,380,350</u>	<u>\$ 3,235,365</u>



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